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WHAT HAPPENS NEXT?

Once again, worries about the economic situation and outlook in China have sent shock waves through the equity markets around the globe. Since the end of last year, the S&P 500 and the Dow Jones Industrial Average have both fallen more than 10% which is generally regarded as a stock market correction. Other major market indices, including those in China, Japan and the U.K., all posted similar declines during the first two weeks of 2016. It was, to say the least, a gloomy start to 2016.

The proximate cause of the market's selloff was China's decision to devalue its currency which exacerbated concerns regarding the underlying health and strength of the Chinese economy. Of late, investors have become increasingly concerned regarding the Chinese government's seeming preference for governmental controls and regulation as opposed to free market forces. For instance, China has been reluctant to lower obstacles to trade and investment, notably capital account controls. Then too, the financial sector is inefficient and in need of fundamental reform designed to increase the reliance on free-market forces rather than state control. The Chinese authorities have also continued to favor inefficient state-owned enterprises, largely it would seem, at the expense of more productive firms in the private sector. Indeed, this misallocation of capital has, in the opinion of many observers, significantly reduced productivity growth in China. At the same time, moreover, the lack of an adequate social safety net in China is viewed as another deterrent to more stable economic growth.

Bearing in mind that China accounted for almost 50% of the world's increase in current-dollar GDP during 2014, it is not surprising that many observers are worried that a pronounced slowdown in China's growth rate could have a very negative impact on the global economy. The need for structural reform, along with an aging population, declining productivity growth and a near-explosive rise in debt, are seen as signs that China's "growth miracle" has run its course, with no clear indication as to what might follow. While these and other concerns regarding the outlook for the Chinese economy may be justified, they should not be viewed as an indication that China's economy is about to collapse. Far from it. In our view, China's incredible and unprecedented economic performance over the past 30 years offers hope that, despite some recent policy missteps, China will be able to implement plans for structural reform and regain a path of stable and steady long-term economic growth. At the moment, however, it is difficult to escape the conclusion that China seems trapped between a market-oriented economic system and one which is subject to extensive state control.

The economic situation and outlook in China, however, does not seem to have been the only worry on the minds of many investors. Other factors, including reports of a nuclear test in North Korea, continued violence and unrest in the Middle East and a further drop in the price of oil to less than $30 a barrel, all contributed in varying degrees to the malaise on Wall Street and elsewhere. Despite all this turmoil, however, the U.S. economy still seemed to be on a steady, albeit subdued, growth track. Notably, a significant number of observers have been cheered and reassured by the latest developments in the labor market, which showed another robust increase in jobs. The BLS reported that nonfarm payroll employment posted a substantial, and better-than-expected, gain of 292,000 in December, while numbers for October and November were revised upward by 9,000 and 41,000, respectively. Over the final quarter of 2015, therefore, job gains have averaged a strong 284,000 a month. So far so good.

Despite these impressive gains in employment, however, American workers have seen very little increase in their paychecks. Last year, for instance, the average weekly earnings of all employees in the private sector were up a feeble 2.3% over 2014. And after adjusting for inflation, the real increase was less than 1%, which scarcely bodes well for a steadily rising trend of discretionary spending over the coming months ahead. As we have noted in previous commentaries, the fact that most households have seen very little increase in their earnings stems, in part, from the type of jobs that have been created over the past year or more. A significant percentage – 53% – of last year's increase in payroll employment were in what are generally regarded as low-wage industries, including food services, retail sales, employment services and the like. Another constraint, perhaps, is that job growth has been concentrated in the West, South and Mountain regions of the country. Consider that, during the first 11 months of last year, these three regions posted job gains of about 3% over the comparable period of 2014, almost double the pace recorded in the East, North Central and West North Central regions of the country.

Against this back drop of little or no growth in earnings, it is not surprising to find that consumers see little improvement in their financial situation over the coming year. The December 2015 Survey of Consumer Expectations, conducted by the Federal Reserve Bank of New York, found that growth in household earnings and spending are all expected to decline over the next 12 months. As the survey reported "one year ahead median household spending growth expectations decreased sharply from 3.6% to 2.9%, setting the lowest level since the inception of the Survey in June 2013."

To a degree, the recent lackluster pace of retail sales can be attributed to the near stagnant pattern of earnings growth. In December, core retail sales, which exclude food services, motor vehicles, building materials and gasoline stations, were up a sluggish 2.3% over a year ago, which, after adjusting for the rise in prices, suggest a real or volume gain of less than 1%. Looking at the fourth quarter of 2015 as a whole, the year-over-year gain was 2.6%, which translates into an estimated real increase of about 1.2%. Even more sobering, perhaps, is the fact that in 2015 GAF retail sales (general merchandise, apparel, furniture and appliances), which is a good measure of discretionary spending, were up a negligible 1% over a year ago. What seems to be happening is that a significant number of households anticipating little or no increase in their incomes are keeping a tight grip on the purse strings.

Meanwhile, the plunge in oil prices is not having the positive impact on the economy as most observers had hoped and expected. While the latest statistics on retail sales suggest that the oil price decline has had little, if any, stimulative effect on consumer spending, it has triggered major cutbacks in capital spending and employment by a large number of firms in the energy sector, which, in our view, is taking its toll on overall economic activity. The slowdown or downturn in the energy sector is in our opinion contributing to the pervasive weakness in manufacturing activity. For the year as a whole, manufacturing production was up a weak 2% from 2014 and, even worse, the output in December of 2015 was just 0.8% ahead of a year earlier. And with manufacturing employment at the end of 2015 essentially the same as it was a year earlier, we find that activity in the goods-producing sector of the economy has, for all practical purposes, come to a standstill.

What are the possible implications for the equity markets? While it bears repeating that no one can predict where the markets may be headed over the coming year, we hold the view that the economic and political environment in sight for 2016 does not seem conducive to a sustained uptrend in equity prices any time soon. That said, the equity markets now look less frothy than they did before the recent correction, and recent price declines could well offer buying opportunities to even the most cautious investor. At the same time, however, it might be well to expect continued volatility in equity valuations as investors endeavor to determine whether the U.S. economic expansion, now in its seventh year, may be starting to run out of steam. Investors are also facing renewed uncertainty regarding the outlook for monetary policy. Simply put, recent events at home and abroad have raised doubts about the probability of another interest rate increase within the next 2-3 months. All in all, 2016 appears to be shaping up as a difficult year for the economy and the equity markets. Despite this bearish assessment, it might be appropriate to remember that the equity markets have, over the years, successfully weathered any number of political and economic crises and, in all likelihood, will do so again. Finally, it is worth repeating that no one ever said that investing in equities would be risk free.

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