Market Volatility Continues

Despite a change in the calendar to a New Year, global markets continue to be ***buffeted*** by the same set of events that had an outsized impact in 2015: China, and the fumbling by regulators there, as well as the ongoing slump in crude oil prices.

Chinese regulators had put in place so called ***"circuit breakers"*** to take effect on January 1st, 2016 in order to prevent precipitous declines in their equity markets. While this is common practice (we do have such circuit breakers in the US too, but our bands are considerably wider), the ***retraction*** of these circuit breakers after mere days of their being triggered smacks a little of panic.

Many analysts worry that while the Chinese authorities are focused on economic fundamentals, and not on financial markets, it is hard to shake the ***perception*** that the awkward efforts point up an inadequacy about their understanding of transmission mechanisms between financial markets and the real economy. Indeed, the very ***opaque nature*** of some of these rules and regulations make it hard to feel confident about the direction of Chinese markets in the near to medium term.

We have often suggested in the past that the Chinese economy is in the midst of a ***difficult transition*** from an export led infrastructure intensive economy to one that is driven by consumer spending. Many economies take years if not decades to accomplish this transition and we fully expect China to do so as well – just not within a timeframe informed by the instant gratification world of Twitter and Facebook.

Financial markets have also worried that a weakening Chinese currency (the Renminbi Yuan) might be a harbinger of another round of ***devaluation*** which could well set-off a "currency war" and have significant negative impact for US companies operating in China. In addition, a declining RMB also has significant implications for policy making in China.

Equity markets have also been roiled by ongoing declines in the prices of ***crude oil*** and worries that this might be suggestive of an impending recession. Indeed, while crude oil prices have been impacted by conditions of over-supply, the old saw goes "the cure for low oil prices is low oil prices". In contrast, the prices of many of the best managed companies in the energy sector have been sold off well beyond what is justified by their underlying fundamentals.

Despite its ***challenging local impact*** (after all Houston is the center of global energy markets), falling crude oil prices do, at the margin, represent a tailwind for consumers (they can spend money on things other than just gasoline) and businesses (where profit margins widen with cheaper energy). However, the upsurge in consumer spending has been elusive so far, but certainly seems to be helping in the sales of larger automobiles in general and pickup trucks in particular.

With many "experts" calling for crude oil prices to decline further (perhaps into the $20-$25 per barrel level), we have used the recent decline to ***initiate*** a small position in an energy exchange traded fund ("XLE") today. We view this as the ***first of perhaps three or four tranches*** to be bought over a period of the next few weeks/months.

Our longer term view on this sector is informed by extensive work on fundamentals and our steadfast belief that over the next eighteen to twenty four months we do see significant upside in this sector - not as a result of speculation on where crude oil prices will be, but on the underlying strength of the US economy. The specific ETF we have chosen to invest in your portfolio is made up of large capitalization US energy companies - names that are familiar to most of you.

The fundamentals for the US economy remain reasonably positive and we fully expect that the Federal Reserve will continue to raise interest rates at a "gradual" pace over the rest of 2016 taking their cue from incoming economic data. Despite the ***painful nature of the current market correction,*** we view this as an opportunity to conduct a thoughtful repositioning of portfolios to take advantage of these near term gyrations.

Please do not hesitate to contact us if you would like to discuss this or any other issues in more detail.