<u>Monthly Outlook: September, 2015: "May you live in interesting times…"</u>

We are not sure if the old Chinese saying, which serves as the title for this month's Outlook, was uttered as a ***blessing or a curse!*** The eternal optimist in us believes the former, but our skeptical and analytical bent of mind casts a wary eye towards the latter. Regardless, it is apropos to use a Chinese saying, as every market maven, some of them self-described as such, now has an opinion on the Middle Kingdom and how it is likely to impact global markets.

Speaking of China, it is very clear that the country's economy is going through a ***very difficult transition*** from an export-led infrastructure-intensive investment economy to one that is consumer and domestic consumption driven while it is oriented towards services. Just as the US economy is now much more services oriented, and has been for decades, this transition in China is likely ***to take years if not decades*** to accomplish. China will probably be able to make this transition successfully, but the process is likely to be characterized by volatility and progress will probably come in fits and starts.

There is no question that the ***"old" Chinese economy*** of infrastructure investment is ***struggling,*** and might even be contracting at a time when there has been excess supply of homes (remember the "ghost cities"?), roads (Beijing a city of approximately 12 Million people has seven ring roads around it!), bridges and dams (the infamous Three Gorges Dam – the world's largest hydro-electric generation facility). Clearly, the powers that be in China conducted a mad dash to improve infrastructure in an economy that sorely needed it. However, like most human endeavors, the pendulum swung too far to the other side!

The "new" service economy within China is sizable and appears to be growing well. GDP statistics are notorious for missing inflection points in economies – particularly in a case like China's **-** where the economy itself is undergoing a ***structural change***. US GDP statistics do a brilliant job of measuring its manufacturing output from the 1950s, but a real poor job of measuring the "sharing" economy of today, as businesses like AirBnb, Uber and Amazon, represent some of the key components of consumer spending.

The size of the "services" economy within China is growing, but at last count still represented less than half of total GDP during the last quarter. Contrast this with the US, where consumer spending represented 68.6% (a little over two thirds) of total GDP during the last quarter. Clearly, China is also attempting to ***scale the value chain*** of economic activities, going from a low technology shop floor to the world to one of value added services to its citizens and the rest of the world.

While Chinese GDP statistics have been the subject of much ***derision*** (given that their GDP releases are never revised!) and they are able to produce their measure within a mere few days of the end of the quarter (compared to the US, where we see three full revisions and the initial estimate is not released until three weeks after the end of the quarter), we do believe China will eventually get its GDP measurement right. Regardless of whether the true rate of growth is the ***7.0% "official" target or closer to the rumored 4.0%,*** China does not appear to be slipping into a proverbial recession.

However, a ***substantially weaker Renminbi Yuan*** will cause deflation to be exported from Chinese shores to the rest of the world, particularly in terms of ***cheaper imports of consumer goods*** into those countries. This wave of deflation, if it were to happen, would stress many a policymaker in the Western world – ill equipped as they are to handle such a massive force given the ultra-low levels of interest rates currently in vogue in many parts of the world.

Economic data released in the US was ***reasonably positive***: The US economy added 173,000 jobs in August – slightly below consensus expectations around 215k. The private sector added 140k jobs during the month, as the unemployment rate dipped another tenth of a percentage point to 5.1%. In terms of sectors, education and health services grew 62k jobs, leisure and hospitality gained 33k as did professional and business services. However, manufacturing lost -17k jobs, while mining and logging (-10k), information (-7k) and other services (-4k) were the other laggards.

The labor force ***participation rate*** stayed at 62.6% - a measure that refuses to climb as more and more workers resort to part time jobs in the "sharing" economy. The median weeks unemployed – a measure of how quickly laid off workers are able to find new jobs - increased significantly to 12.1 weeks in August from 11.3 weeks in July. The ***U-6 measure*** – a more robust indicator of the health of the labor market posted a decline of one-tenth to a still high 10.3% for August.

While the 173k gain was below consensus, we do believe that ***August*** has a history of seeing sizable upward revisions in future months' enumerations. For example, the past three August numbers have seen ***upward revisions*** of a net 75k (on average) since 2012 – of 61k, 69k and 96k respectively. We suspect that this is a function of kids going back to school and vacations in general playing havoc with the survey data. Nonetheless, it is quite obvious that the pace of improvement in the labor market remains gradual and steady.

The Federal Reserve's policy setting Federal Open Market Committee will meet on Sep 16^{th} and 17^{th} to decide whether to start the process of ***rate normalization***. While September seemed to be a cinch a few weeks ago, financial market volatility (mostly in equity markets, but not as much in the bond markets) as well as worries about a slowing China and a rising US Dollar have all taken their toll on expectations.

Speeches by Bill Dudley, the President of the New York Fed (and a known confidant of Chairwoman Janet Yellen) along with doubts expressed by Minneapolis Fed President Narayana Kocherlakota have added uncertainty to the outcome. It is quite sad to see the parlor game of "will they, won't they" played out in the media, as in the ***ultimate analysis,*** it matters little when the Fed actually does start the process. What matters is the pace of rate increases (probably slow and gradual) and the ultimate peak in the Fed Funds Target (probably around 3.0 to 3.5%).

Farther afield, Europe appears to be lurching from one crisis (Greece) to the next (***immigration***). Pictures of Syrian refugees crowding bus and train stations in Hungary in an effort to get to the rest of Europe are being beamed all over the world. The human toll and suffering in this saga is quite startling, as more and more migrants seek a better life in regions that do respect the sanctity of human life. There are no easy solutions here, only difficult decisions that will cast a shadow on history.

Volatility in equity markets has reappeared in our daily lives with a vengeance – just as we suspected it would – as market participants had gotten increasingly complacent about volatility. We do believe that this volatility is ***exacerbated by the unusual confluence of policy uncertainty as well as lofty expectations***. We do believe that markets were ripe for a correction, after all it has been over four years since markets experienced one, and they do happen to occur at mostly inopportune times.

As a ***plain vanilla garden variety correction***, we view the current market gyrations – as just that: A pause that refreshes, allowing markets to head higher once some of the policy uncertainties are resolved and expectations for earnings growth and valuation multiples are reset. If anything, the lower valuations do make us re-examine the thesis that equities are the best place to be over a twelve to eighteen month time horizon. Clearly, as interest rates rise – even if only modestly – equities at lower valuations represent much better "value" for the longer term and patient investor.

May you live in interesting times, indeed!

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