Maintaining a Healthy Investment Landscape
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Summary
When you see water flowing from your neighbor’s yard, should you be pleased or concerned? That depends on why the water is flowing. If your neighbors are watering the lawn to extinguish a fire, that’s cause for concern. But if they are watering to maintain a healthy landscape, it’s a positive development for the whole neighborhood. Better-looking lawns should raise everyone’s property values.

Likewise, when the Fed raises interest rates, it’s important to understand why. If it’s to combat rising inflation, the result will be to dampen overall economic activity, which is generally not positive for the investment landscape. Fortunately, the Fed has embarked on its gradual path toward higher rates because the economy continues to exhibit signs of recovery rather than because it sees any signals of rampant inflation. Labor market conditions are improving—the headline unemployment rate has plunged from 10.0% to 5.0%—while the inflation rate remains below the Fed’s target mandate.

In other words, the Fed is watering the lawn to support continued growth, instead of trying to extinguish the flames of inflation. A better-performing U.S. economy should boost imports and make a positive contribution to the investment landscape worldwide.

THE SLUGGISH RECOVERY MARCHES ON
The Federal Open Market Committee has ultimately decided to raise rates, but we expect additional rate increases to be very gradual. We think this is a constructive development for investors overall, because the Fed is responding to positive economic conditions. When the Fed is raising rates due to an improving economy, as opposed to doing so in reaction to rising inflation, our analysis shows the outcome for U.S. equity markets has been far more favorable.
We anticipate the U.S. economy will continue to grow at about 2% or perhaps even accelerate somewhat in 2016. This is a modest, sustainable, non-recessionary but non-inflationary rate of growth. The economic recovery has already lasted six-and-a-half years, even though it has been the most sluggish recovery from any recession since World War II. That may not be the best news if you’re out there looking for a job or hoping for a hefty wage hike. But if you’re an investor, you should be pleased. Sluggish recoveries typically result in longer-lasting expansions, which are accompanied by longer bull markets.

For investors, anything that avoids or postpones a recession is favorable, even if it means the recovery is less robust than we might otherwise prefer. Recessions are what end bull markets. Our research shows that market declines during periods of recession average –27.3% versus average market corrections of just –13.0% during economic expansions. Similarly, it takes an average of 1.2 years to recover from recession-caused bear markets, compared to only 3.8 months to recover from market corrections in an expanding economy.

SHORT-TERM VOLATILITY, LONG-TERM GAINS

However, investors should expect some volatility since the Fed has begun raising rates. We saw some of that volatility in recent months as the market tried to anticipate the Fed’s moves and responded to concerns about China (which, in our view, were greatly exaggerated). But our research on market volatility using the CBOE Volatility Index (better known as the VIX) shows that volatility had stayed sharply below its average of 19.83 from 2013 to early 2015, before briefly spiking to a reading of over 40 in late August 2015. We may see similar episodes of rising volatility during the next several months as the Fed has begun to raise short-term rates.

This should not be any cause for concern. Our analysis shows that volatility typically rises during policy transition periods. But without volatility, you can’t expect to earn nearly 7% a year—which has been the average rate of growth in the U.S. stock market since the 1940s (excluding dividends, which can add another potential 2% in today’s market environment). Investors who maintain a long-term horizon can accept short-term volatility in the expectation of superior returns over time.

CHEAP ENERGY IS BOOSTING SPENDING

Another important development has been the volatility of energy prices driven by overproduction. While the demand for energy is increasing worldwide, the markets were swamped by massive additional production in the United States as well as OPEC and other countries. However, markets are now adjusting to lower prices so we are somewhat constructive on energy over the next 12–18 months. We’ve seen a cutback in oil production in the United States from 9.6 million to 9.1 million barrels, and the Department of Energy is forecasting further contraction of 300,000–400,000 barrels in the next year. As supply continues to contract, we foresee oil prices (e.g., West Texas Intermediate) finding a bottom and rebounding to about $55 by the end of 2016. Investments in oil exploration contracted by around 20% in 2015 and should continue to remain restrained next year.

On the positive side, lower energy costs and increased household net worth are flowing through to consumer spending. While some analysts didn’t expect to see much impact from cheap oil, our study using proprietary Chase credit card data revealed that as much as 80% of the savings from lower oil prices is actually being spent. Also, U.S. personal savings rates are relatively unchanged from a year ago at 4.7% in the third quarter, according to the U.S. Bureau of Economic Analysis—which confirms that consumers are spending rather than saving their windfall from lower prices at the pump.
We're also seeing the fastest pace of new car sales since the recovery began—and buying a car has a lot more economic impact than getting a new pair of shoes. Even though the economy slowed down somewhat in the third quarter of 2015 to 1.5%, after rising by an outsized 3.9% in the prior quarter, consumers (who represent two-thirds of the total economy) are continuing to spend. This can be seen by the outsized growth rate of 3.2% for overall consumer spending during the third quarter. As a result, we continue to favor consumer discretionary stocks, which will benefit from these extra dollars in consumers’ pockets.

LOOK OVERSEAS FOR A STRONGER OUTLOOK

Investors seeking higher returns in the next 12–18 months may do well to look at other developed countries. We are currently overweight in Europe and Japan. While corporate profits in the United States are constrained by low energy prices and the strong dollar, we forecast European profits in the range of 10% for 2015—more than twice the growth rate expected for U.S. profits—while Japanese profits could grow even twice as fast as in Europe.

It should therefore come as no surprise that both Europe and Japan are outperforming U.S. equity markets this year, which we expect to continue due to more expansionary monetary policies in those regions. Quantitative easing will continue in Europe until at least September 2016 and could even accelerate, judging from recent comments by Mario Draghi, head of the European Central Bank. European companies are also helped by the Euro’s weakness relative to the dollar. In Japan, quantitative easing has been even larger as a percentage of the overall economy than it has been in the United States. Historically, these kinds of monetary conditions have been very favorable for equity market investing.

Within emerging markets, we have largely stepped away for the time being. We were particularly concerned about Chinese intervention in the equity markets. As by far the largest emerging market, China has inordinate influence over other Asian countries—even in such markets as India, which we think offers greater near-term growth potential than China. Likewise, we are not invested in Latin America due to sluggish growth, rising inflationary trends and low commodity prices, which have reduced the value of overall exports to China. Only Mexico appears to be showing some resilience due to its close trading relationship with the United States, and appears to be decoupling from the rest of the region.

CHINA SHIFTS TO A CONSUMER ECONOMY

Over a longer time frame, we remain quite positive on China. As the Chinese economy grew by 6.9% in the third quarter of 2015, the shift from manufacturing to the services sector proceeded apace. Services grew at 8.6% in that quarter, which picked up most of the slack from the industrial sector (mostly manufacturing) which slowed its growth to about 5.8%.

The People’s Bank of China and the Chinese government have responded to the manufacturing slowdown with a massive, multipronged stimulus: lowering interest rates six times, reducing reserve requirements four times, cutting tax rates on small car sales by 50% and lowering deposit requirements to purchase homes. The Chinese government is ramping up its infrastructure investments on a scale that would be unimaginable in any other country. Government expenditures rose by almost 27% on a year-over-year basis as of September 2015. Chinese officials are making sure these investments are put to work immediately; when they find local governments sitting on the money, they quickly shift funds to other government jurisdictions with more shovel-ready projects. China has already spent close to $7 billion on its Silk Road infrastructure initiative (investing in roads, railways, ports and airports to
enhance trade links with nearly 50 countries). They have begun building a highway system between China and Pakistan that will cost more than $40 billion to complete. The impact of this spending, along with all the monetary easing they have conducted, should boost overall economic growth, which will become more apparent some time in the next 6–18 months.

KEEP A LONG INVESTMENT HORIZON

Although markets stumbled in the third quarter, long-term investors know that corrections are a natural part of the investment landscape. As noted above, outside of economic recessions, the recovery from a market correction has historically taken fewer than four months, on average. We continue to foresee the risk of a near-term recession as quite low (less than a 10% probability), even though we all know the United States will eventually slip into a recession at some point in the future. But even market declines during recessions have been recouped on average in about 1.2 years. That's why a minimum 3–5 year time horizon is essential to being an investor.

WHAT THIS MEANS TO YOU

The longer you stay in the equity markets, the more likely you are to have a positive outcome. As always, the best defense against volatility is to keep your own investment landscape well-watered with a globally diversified portfolio and a longer-term investment horizon.