MARKET UPDATE

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A TURBULENT START TO 2016

After negative equity market returns in 2015, hopes of a more prosperous 2016 were dealt an early blow. Widely reported, last week represented the worst start to a new year in history and one of the worst weeks the market has seen since fall 2011. For the week, the S&P 500 declined 5.9%, and the Russell 2000, the MSCI EAFE and the MSCI Emerging Markets returned -7.88%, -6.14%, and -6.8% respectively. A confluence of factors ranging from increased volatility in China's equity markets, continued price declines in commodities, slowed manufacturing in the US, and concerns surrounding the economic growth in China, led to broad based selling and steep declines in equity prices. The abrupt change in investor sentiment was surprising given the lack of change in underlying market fundamentals. Below we discuss our view on some of the more notable catalysts for last week's decline, recent volatility, and LAMCO's perspective on how this impacts portfolio design.

- **China**

China is the world's second largest economy and much of its growth over the last decade has been fueled by exports and capital spending. With the Chinese government's concerted efforts underway to transition to a service and consumption based economy, growth rates are expected to moderate. However, weaker than expected manufacturing numbers reignited concerns that the transition is not going as smoothly as most had hoped. With ramifications that extend beyond China, concerns about the health of China's economy will weigh on the markets throughout the year.

While these concerns have taken center stage in the press, the weakening of the Yuan (China's currency) and the negative implications which could result are of greater concern. Despite the assertions made by current US presidential candidates, China has not been systematically devaluing their currency. Rather, as evidenced by the $108 billion December decline of China's foreign reserves, there has been a concerted effort to protect the currency from devaluation.

Despite these efforts, the Yuan depreciated last week. A continued decline would likely cause continued investor withdrawals from Chinese markets. This would require China to consider additional measures to protect the currency; many of which would have a side effect of adversely impacting growth.

These concerns were at the core of the selling pressure in mainland China stocks. Selling pressure was magnified as smaller investors tried to exit securities in advance of the expiration of a restriction, enacted in summer 2015, preventing investors with 5% ownership stakes from selling prior to January 8th. This enhanced selling drove prices down and tripped poorly conceived circuit breakers which suspended trading on two occasions. As an example, because the decline exceeded 7% in the first 29 minutes on Thursday, trading was suspended for the day.

As we experienced in the US in 2008, restrictions like these which are designed to maintain market order, often do more harm than good. Restricting liquidity rarely ends well and, in this case, added to the panic last week.

- **US Economy**

Largely overlooked last week was a strong US jobs report which provided supporting evidence that, despite the global turmoil, the economic recovery in the US remains on stable footing. However, while stable, US economic growth is far from robust. Despite the continued improvements in the job market and real wage growth (after taking into account low inflation and declining energy prices), personal consumption remains muted and manufacturing has slowed, due in large part to the strengthening US dollar. With exports accounting for less than 15% of GDP and exports to China accounting for less than 10% of that number, the US economy is amongst the most insulated to the challenges abroad. However, concerns about a slowing US economy remain nonetheless.

- **Valuations**

While the US economy remains more insulated from a slowdown in foreign GDP growth, the US Stock Market has a much broader exposure to foreign events as nearly 40% of the profits of S&P 500 companies are attributed to foreign sales. As we have been consistently saying since late 2013, US stock market valuations have become expensive and are not reflective of the financial performance of the companies behind those stock prices. From December 31, 2012 through June 30, 2015, the S&P 500 rose nearly 45% while the sales of the underlying companies rose a mere 1%. With low interest rates, low volatility, and an expectation for improving earnings, investors were willing to accept these higher valuations.

Much of what we saw in the first week of 2016 was a repricing of that risk given rising interest rates, increased volatility, and concerns about global growth. Simply, the prices investors are willing to pay for future earnings have fallen.

Bottom Line: More Bad News than Good

The world markets are looking for global economic growth. There was hope that 2015 would deliver it, but it did not. For the reasons listed above, among others, there is a growing pessimism that 2016 will deliver it either. This malaise has translated into an environment where there is little buying interest, resulting in the selloff we experienced last week.

LAMCO is monitoring the market very closely. We will continue to keep you updated when we have relevant new information. If the market volatility continues, we will host a series of webinars for participants of your plan.

If you have any immediate questions, please feel free to contact us.