# Stonebrook Investment Co.

**A Registered Investment Advisor**

**2042 Royal Fern Court, Suite 11 B   Reston, Virginia 20191**
**mburkhardt@stonebrookinvestment.com**
**703-587-8683 or 304-728-6175**


## Update on Current Market Conditions

Mark Burkhardt, Portfolio Manager                                        October 15th, 2015

Our concerns about slowing global growth and richly valued stock prices came to fruition in the third quarter as many markets experienced extreme volatility as numerous sectors suffered significant price declines. The focus of concern remains China and the impact that their slowing economy will have on many emerging market economies. Over the last twenty years, many of these countries have become ever more dependent on supplying the world's fastest growing economy and its voracious appetite for commodities and natural resources. China's Central Bank added fuel to those fears with their decision in August to devalue their currency which led to further dramatic selloffs in the oil and mining sectors. While many criticized their action, China remains primarily an export dependent nation. Many of their Asian competitors, such as Japan, Korea, Vietnam and India have all seen substantial declines in each of their respective currencies for over a year. Chinese manufacturers were quickly losing their competitive pricing advantage, forcing the government's hand to devalue the yuan and leaving open the possibly of additional further actions in the future.

A currency devaluation is a rather quick way to make your country's products cheaper and therefore more competitive. Neither are they the first large economy to undertake the same action.  Devaluation can take many forms, "Quantitative Easing" as embraced by our Federal Reserve, the Bank of Japan and the European Central Bank are all policies of devaluation, just more subtle and complex in their execution. The only reason that an obvious currency devaluation can be easily accomplished in a communist country is that any public backlash will be quickly suppressed by the government. Whereas the same policy outcome must be more nuanced in democratic countries where institutions have much greater accountability and leaders are easily influenced by public opinion.

As I had discussed in my previous letter, the reason why fears of a Chinese slowdown are having such an inordinate effect on investor sentiment is because growth everywhere else in the developed world is either barely positive or actually declining. I had expected the US economy to slowly gather strength and to some degree offset growing weakness abroad, but with the latest jobs report and economic indicators showing surprising weakness in many key economic sectors. While our economy remains fundamentally sound, the dollar's strength versus other currencies now works as a negative influence hurting the sales of any company doing business abroad. Corporate earnings are slowing and expected to fall year over year with an estimated 5.1% decline in the third quarter with the caveat that the bulk of the shortfall is in the energy sector due to the collapse in oil prices earlier in the year. The real cause for concern is being seen in the quarterly declines in revenues across a number of other sectors, especially those with significant international exposure. First and second quarter revenues for the S&P 500 index fell -2.9% and -3.4% respectfully and results for the third quarter are estimated to fall an additional -3.5%. A strong US dollar, whose strength will only increase if the Federal Reserve decides to raise interest rates, and weakening global economic demand will eventually put corporate profits under increasing pressure. Profit margins are already close to historic record highs running year to date at 10.1%, so companies will be forced to either let profitability decrease or cut costs to make up the difference. Cutting costs will be very difficult as most US companies have been very frugal both on wages paid and on capital spending since the financial crisis and severe recession leaving little fat left to trim.

With the Federal Reserve unwilling to raise rates at both their August and September meetings, equity markets have been able to repair a substantial portion of their earlier losses. Chairwoman Janet Yellen stated that with the global economic outlook looking weaker than previously expected, the board was reluctant to begin raising interest rates. By postponing that action, fears of additional dollar strength abated and allowed all of the emerging market currencies to begin to recover from their dramatic selloffs. These smaller economies are unfortunately not very well diversified and therefore any change in demand for their exports has a direct and immediate impact upon their currencies and ultimately their citizen's standard of living.

The real risk that equity investors will have to confront if economic growth slows will be the inevitable compression in the price to earnings ratio, the multiple which the market is willing to award future profits. Currently that multiple, commonly known as the P/E ratio, for the S&P 500 index is 21.4 times based on trailing twelve month "as reported" earnings. That ratio is well above the historical average of 15.5 times earnings, which tells us that investors are still very optimistic about estimates for future growth. This means that even if corporate earnings stay the same, the value the market decides to gives those earnings as reflected in the stock's price, will be less if they believe future growth won't be a strong as they once expected.

The inability of the world's central banks to stimulate economic growth and generate even a 2% inflation rate tells me that there are other more powerful opposing forces at work. In the developed world, a combination of an aging and shrinking population base have created powerful deflationary forces that even a central bank can't counteract. With tax rates rising around the world to deal with mountains of government debt only further impairs the desire of both individuals and firms to take on more debt even while rates remain historically. The three biggest reserve banks have pumped nearly $8 trillion dollars into the global financial system since the economic crisis but have succeeded mostly in just raising prices of equities and other investments rather than actually creating economic growth and increasing workers' wages.

Unfortunately the Federal Reserve's persistent low interest policy has created a number of unintended consequences such as allowing corporations to borrow hundreds of billions of dollars but instead of deploying those funds into the real economy, they have used the proceeds to buy back stock. Corporate plans to buy back shares of their own stock are running at an annual rate of over $1 trillion so far in 2015, well above 2007's record of $863 billion. Adding debt and reducing the number of shares outstanding also creates the illusion of much stronger earnings growth when in fact there are just far fewer shares splitting the same pot of money. IBM has been doing this for years and should be the poster child for this type of financial engineering, growing earnings while showing 14 straight quarters of declining revenues. You don't need to go to business school to figure out how to make that work, and yet I imagine that they still want their year-end bonuses.

With a Fed that is still intent upon raising interest rates even as the American economy is facing increasing headwinds, the long term risks in holding US Treasury bonds become all the more obvious as the taxable yield on a 10 year bond now hovers around 2.0%. However, not all bonds are the same as I find there is still compelling value in many state issued municipal bonds. Not only are their yields much higher than their corresponding federal counterparts, their tax-free structure gives them a substantial taxable equivalent yield that is significantly higher than that of any US government bond. There is also a safety issue that is seldom talked about but should enter into any investor's decision making process. The big difference is that while the federal government owns a printing press and can print as much money as it wants, the individual states cannot. Many states have passed balanced budget amendments or have other fiscal controls already in place that the Federal budget simply lacks. Therefore state governments are by their very nature forced to be better stewards of the debt they issue than their larger federal brethren with their never ending deficits. The numbers don't lie, since 1979 state budgets have averaged yearly deficits of 0.3% of GDP while the federal deficits averaged 3.4%. When any government has the ability to print more money, fiscal discipline is always the first victim.

While I will continue to maintain a more defensive posture in how the assets that I manage are deployed I believe that compelling values will present themselves over the coming weeks and months. Investment opportunities abound when either or both the global and domestic economies are growing, but in a slowing economic environment, the best individual companies will typically outperform each of their respective sectors. As my partner and I use to say on our radio program, "It takes no skill to buy a fully priced stock", I can add that it takes even less skill to buy one that is overpriced. Looking at the current incoming data, I feel that China will avoid the most negative of predicted outcomes and that the emerging market economies will prove to be more resilient than in past global downturns. A growing global middle class will demand action and accountability from their leaders more so now than ever before. Unfortunately here at home, our domestic economy while slowly improving, continues to be hamstrung by a large amounts of debt as well as a tax and regulatory environment that actually constrains growth.

While patience and caution are virtues that should and will continue to influence our actions for the remainder of the year, they can't be an excuse for inaction either. Even as we wait for greater economic clarity both here at home and abroad, opportunities will undoubtedly emerge that will create compelling entry points where we can put some of our cash reserves to work. Every stock market is essentially a forward looking pricing mechanism, in that prices should always reflect the expectations of what the future holds not what the past has already shown. Looking back over the last sixty years, investors tend to focus on gains made during bull markets but often overlook the 41% of the time that the stock market is either down or sideways. Passively managed portfolios are by their very nature unable to take advantage of the opportunities and avoid the pitfalls that each of these market environments present. Market downturns and the ensuing volatility that it creates will always take a toll on investor confidence, but it is equally important to remember that it is during these periods of time that true values are revealed and often overlooked.