Episode 29: CIO Commentary on Recent Market Volatility

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Well happy new year to everybody out there. We are now about six days into the trading year and given the increased volatility that we've seen year to date, I thought it would be a good thing to give you all an update on our current thinking since I wrote the year-end letter. I think the key investment issue facing investors today, is the U.S. economy on the road to a recession? And my answer to that is probably not, but I want to go through why that's important. First of all, if you look at the history of the stock market since 1926, there's been 10 declines of 20 percent or more from their all-time highs, which is what is considered a bear market. So it's only happened 10 times over the last almost 100 years. And 8 out of the last 10 times that this has occurred, it's been triggered by a full-fledged economic recession as defined by the National Bureau of Economic Forecasting.

So, there were two periods where the market declined 20 percent and went into a bear market which was not triggered by a recession. One was the Cuban Missile Crisis back in 1962 when Kennedy was the president. For obvious reasons, this created a lot of consternation in the stock market because of the prospect of the thermonuclear war. It didn't last very long, it only lasted seven months and the market went down about 28%, but it was a bear market as we are defining it.

And the second time that it happened was in the 1987 crash, which I would argue was mainly triggered by portfolio insurance trading and technical glitches at the time. And I actually lived through that decline and that really lasted only three months as defined by most market people, and I would tell you it really only lasted about three days. And you did make a lot of money if you bought the week that the market opened down on that Monday.

So, 8 out of 10 of these recessions triggered a bear market, so the real question I think now is, are we going into a bear market? We are clearly already in close to correction territory. Some industries are already in a correction territory, but the real issue for longer term investors is, is this going to be a serious bear market? And, what's causing these concerns to surface in the first six days of trading in 2016?

Well number one, and the most important, is a slowdown in China. There's been currency depreciation in which the yuan is down about 6 percent since last summer, and currency markets today are projecting another 5 percent in the futures market of decline for the Chinese currency over the next 12 months. So the Chinese currency is depreciating and this is causing concerns about the Chinese growth rate and the ability of other countries to sustain their currencies at current levels, particularly in emerging markets, many of which do business with China and compete with China in global markets. So there's this fear of a downward spiral of currency depreciation among emerging markets, many of whom have been responsible for good growth in the global economy over the last 5 to 10 years. So global growth rates are coming into question.

The second thing that's happening is crude prices have collapsed. First it was all supply driven and now, as prices continue to decline and have moved into the low 30s, people are starting to question whether or not there's actually a demand issue as well. We think there is little to no evidence of this yet, but it does bear watching and crude prices certainly seem to have trouble finding a bottom.

The third thing is (and I mention this in my annual letter) energy, materials, and manufacturing—particularly anything related to the oil patch—are already in a recession. And many industrial companies are as well. Despite the fact that energy, materials, and manufacturing are a small piece of the economy today (only comprising about 15 percent of the S&P 500's earnings), there is a fear that the weakness that we are seeing in these areas, which are clearly already in a recession, will spread to other areas as we move forward. The weakness we've seen in energy and materials in particular has led to credit spread widening in the high-yield market over the last 18 months because energy is the biggest weighting in the high-yield credit markets. But credit spreads widening in the high-yield market is never a good sign for risk assets overall and gives people pause. So these yield spreads have been widening over the last 18 months fairly consistently. Interestingly though year to date, these spreads have hung in there fairly well so, so far at least in the whopping six days of trading. The weakness we are seeing is more equity related than credit related.

And then the last concern, I think, is will the Fed tighten too much in 2016? The Fed has telegraphed and many investors believe that the Fed will raise rates four times during the course of 2016. They started obviously in December of 2015, but remember the Fed only controls the short end of the curve and as these events continue to unfold overseas and these concerns that I mentioned above occur, it wouldn't surprise me at all if the Fed only ended up raising rates once or twice during the course of 2016.

So what's the tricky part about recessions as an investor, having lived through several of these myself (four out of the last ten that have occurred over the last 100 years)? The first thing is, is once everybody understands and recognizes that we are in a recession, in financial-market terms, it's over. In other words, by the time people really fully understand how much the economy has suffered and how poor things are, the financial markets are always way ahead of that and actually on the road to recovery by the time it becomes conventional wisdom that we are in a recession. This is what makes it difficult to forecast them. And stocks lead the fundamentals of companies by six to nine months. In other words, many businesses won't see it either until it becomes very apparent in their own financial returns. So this is the downside of being focused purely on company fundamentals and not enough on macro fundamentals over time is that the lag between the actual fundamentals of companies and what's happening in the stock market can be very tricky to investors.

Remember unemployment, which we got a big number on Friday, which was very sound and reassured a lot of bulls that times were still good in the U.S. Unemployment is a lagging indicator. It lags in both directions. It's the last thing to turn up in a recovery and it's the last thing to turn down when things are starting to go into recessionary mode.

My bottom line on a recession and a recession outlook for 2016 is that I think a recession is still several years away. I can't completely rule it out at this point in time, but I think it's a very low probability event at best for 2016. The U.S. economy is still strong; the U.S. economy is still a net beneficiary of lower energy prices which we are still seeing plenty of. And the consumer is still very strong with good job growth, good net worth, and good consumer confidence. And remember, the consumer is 70 percent of the economy in terms of GDP.

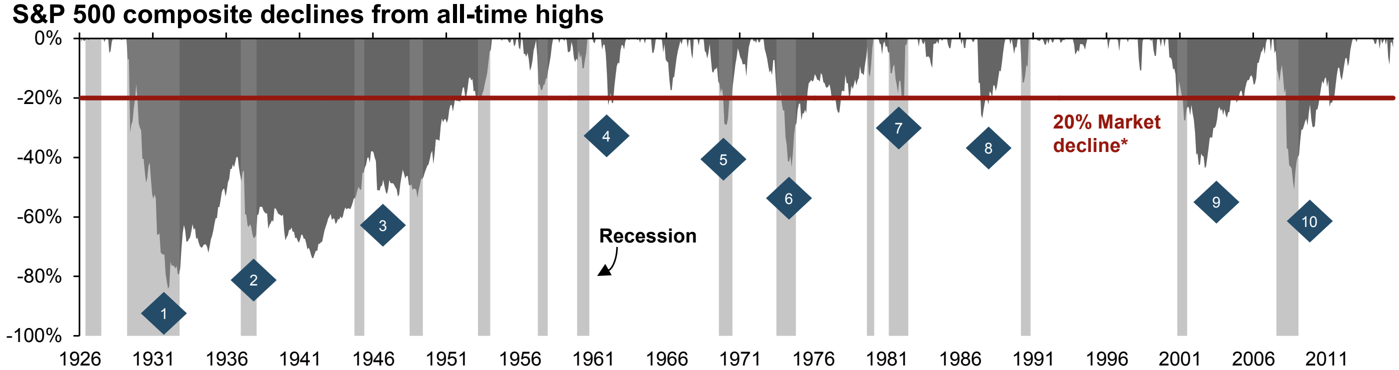
So the outlook for 2016 is I still believe we can get a 5 to 10 percent annual return out of the S&P 500 by year-end 2016, but there are a few things that need to happen in order for investors to regain confidence in global growth. Number one I think is just an end to collapsing crude prices. Crude prices need to stabilize at least in the mid-to-high 30s at least from here in order for investors to get comfortable with the overall stock market. Credit spreads, if this happened, would stabilize. Breadth in the market (the number of stocks actually declining) would start to improve, which I think would give investors more confidence in the stability of the equity market.

Many of these things can happen. Remember we are only in the bottom of the first inning, to use a baseball analogy, so we have a long way to go, but I think those are the conditions to get us to that 5 to 10 percent type return.

What are we doing at Kayne Anderson Rudnick? Well, on the equity side, we are doing the same thing we've always done. We are buying quality businesses that should do well in both good and bad times. It doesn't mean they are immune to price declines, it simply means that they will outperform their peers, use these periods of weakness and recessionary environment to take market share to improve their competitive position and to ultimately grow the business to better and better levels. Even though we've had 10 bear markets over the last almost 100 years, every single time the market has recovered and gone to newer price highs as these businesses have recovered.

So our job is just to make sure that we own the companies that are going to thrive and prosper longer term, that will be able to ride out and survive a bad period if in fact we are wrong and we do go into recession, and that they will come out the other side stronger than ever with good returns for investors over a three-to-five year period.

S&P 500 composite declines from all-time highs



Characteristics of bull and bear markets

Market Corrections	Bear Markets			Macro environment				Bull Markets		
	Market Peak	Bear Return*	Duration (months)*	Recession	Commodity Spike	Aggressive Fed	Extreme Valuations	Bull Begin Date	Bull Return	Duration (months)
1 Crash of 1929 - excessive leverage, irrational exuberance	Sep 1929	-86%	33	◆			◆	Jul 1926	152%	38
2 1937 Fed Tightening - premature policy tightening	Mar 1937	-60%	63	◆		◆		Mar 1935	129%	24
3 Post WWII Crash - post-war demobilization, recession fears	May 1946	-30%	37	◆			◆	Apr 1942	158%	50
4 Flash Crash of 1962 - flash crash, Cuban Missile Crisis	Dec 1961	-28%	7				◆	Oct 1960	39%	14
5 Tech Crash of 1970 - Economic overheating, civil unrest	Nov 1968	-36%	18	◆	◆	◆		Oct 1962	103%	74
6 Stagflation - OPEC oil embargo	Jan 1973	-48%	21	◆	◆			May 1970	74%	32
7 Volcker Tightening - Whip Inflation Now	Nov 1980	-27%	21	◆	◆	◆		Mar1978	62%	33
8 1987 Crash - Program trading, overheating markets	Aug 1987	-34%	3				◆	Aug 1982	229%	61
9 Tech Bubble - Extreme valuations, .com boom/bust	Mar 2000	-49%	31	◆			◆	Oct 1990	417%	115
10 Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2007	-57%	17	◆	◆	◆		Oct 2002	101%	61
Current Cycle								Mar 2009	202%	83
Averages	-	**-45%**	**25**					-	**151%**	**53**

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
*A bear market is defined as a 20% or more decline from the previous market high. The bear return is the peak to trough return over the cycle.
Periods of "Recession" are defined using NBER business cycle dates. "Commodity Spikes" are defined as significant rapid upward moves in oil prices.
Periods of "Extreme Valuations" are those where S&P 500 last 12 months' P/E levels were approximately two standard deviations above long-run averages. "Aggressive Fed Tightening" is defined as Federal Reserve monetary tightening that was unexpected and/or significant in magnitude.
Guide to the Markets – U.S. Data are as of December 31, 2015.