BULL & BEAR BULLETIN

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Uncertainty Breeds Volatility:

The stock market finally experienced a long overdue correction. The sell-off was induced by signs of slower global growth and investor concerns that an interest rate hike by the Federal Reserve could exacerbate the global slowing and ultimately push the U.S. economy into a recession. The heightened level of anxiety and uncertainty resulted in the most market volatility since the recession (Chart 1). Despite many investors anticipating such a correction, there is a growing sense of "what next?" The answer depends on where one falls in the growing debate between U.S. growth and resiliency versus foreign contagion.

The bears will argue that the massive imbalances (bubbles) that have been growing in China over the past decade are finally reversing (popping) and China's economy is destined to crash, which will ultimately drag a vulnerable global economy down with it. A great example of this impact is currently showing up in commodity-based economies such as Canada, Australia, Russia and the Middle East nations.

The bullish counter argument is that China has plenty of capital reserves available to stabilize the volatility associated with its transition from an export-driven manufacturing economy to a more domestic and service-driven economy, allowing the country to avoid a hard economic landing.

Returning to the domestic front, bears believe that an interest rate hike by the Federal Reserve will only further strengthen the U.S. dollar against its major trading partners and produce greater deflationary forces and weaknesses within the domestic manufacturing sector (Chart 2). Furthermore, bears will also warn that consumers will be unable to make up for the decline in the manufacturing sector due to lackluster wage growth and a slowing pace of growth in consumer spending.

Market bulls are likely to reference the resilient job growth over the past year, an unemployment rate near the previously stated Federal Reserve target rate for an interest rate hike and an economic growth rate that exceeds 3% over the past 12 months when excluding a supposedly weather weakened first quarter figure (Chart 3). The bulls will also suggest the minimal impact a 0.25% increase in interest rates is likely to have on the economy and the importance of having room to lower interest rates when the economy does enter its next recession.

At this point, we believe it is premature to forecast a recession from the adjustment occurring in China or from the prospects of a minimal interest rate increase.

Starting with China, there is no question that its central planners are going to face some difficult decisions as their economy transitions to one that is more internally driven and its currency devalues to a more natural state against other major currencies like the dollar. The Chinese central planners, however, have trillions of dollars and plenty of room to lower interest rates to help smooth this process and to avoid a financial crisis similar to our 2007-2009 recession.

Domestically, an interest rate hike is likely to further strengthen the U.S. dollar and add to the previous pain within the commodities market and the manufacturing sector of our economy, but the service sector still represents the majority of our economy and remains in an expansionary mode. We also view the resiliency in the housing market and the auto sector as positive indicators for consumer behavior and confidence in their spending. Furthermore, we do not foresee the Federal Reserve lifting rates in an aggressive manner, which should keep interest rates low from a historical context and supportive to the overall economy.

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Lastly, a fair amount of the stock market volatility can be traced to reduced levels of market liquidity and record levels of programmed trading, leaving the market with fewer buyers of last resort and higher levels of herd mentality trades that happen in seconds versus days. Until we see signs of increased economic distress, whether it be from a massive jump in the U.S. dollar's value, higher interest rates or a collapse of multiple developed nations' economies, we expect only a modest softening in the U.S. economy. Within the context of this forecast, a 10% market correction may be viewed as healthy, as it readjusts stock prices for lower growth expectations and reduces the prospect of a stock bubble.

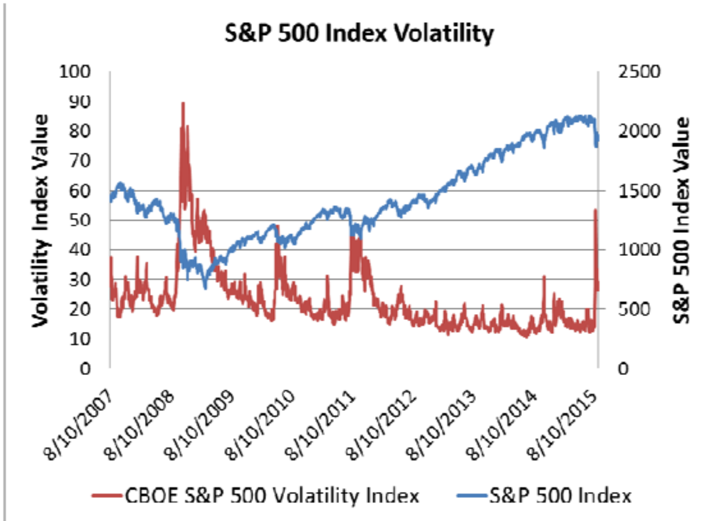

Chart 1

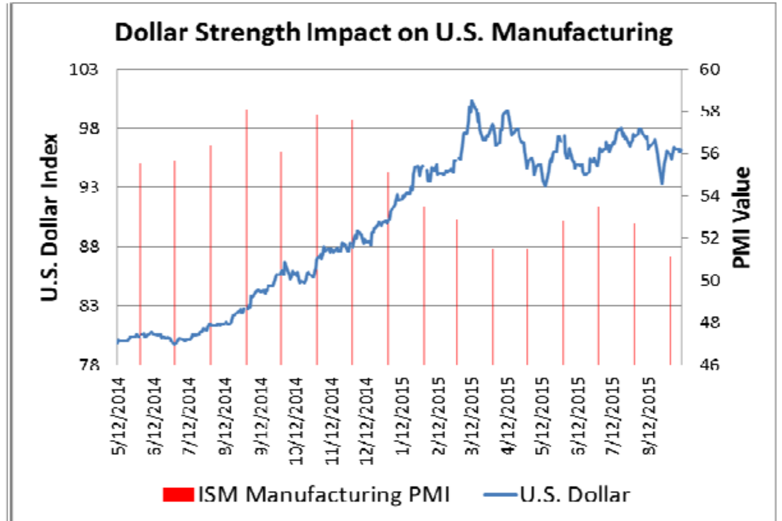

Chart 2

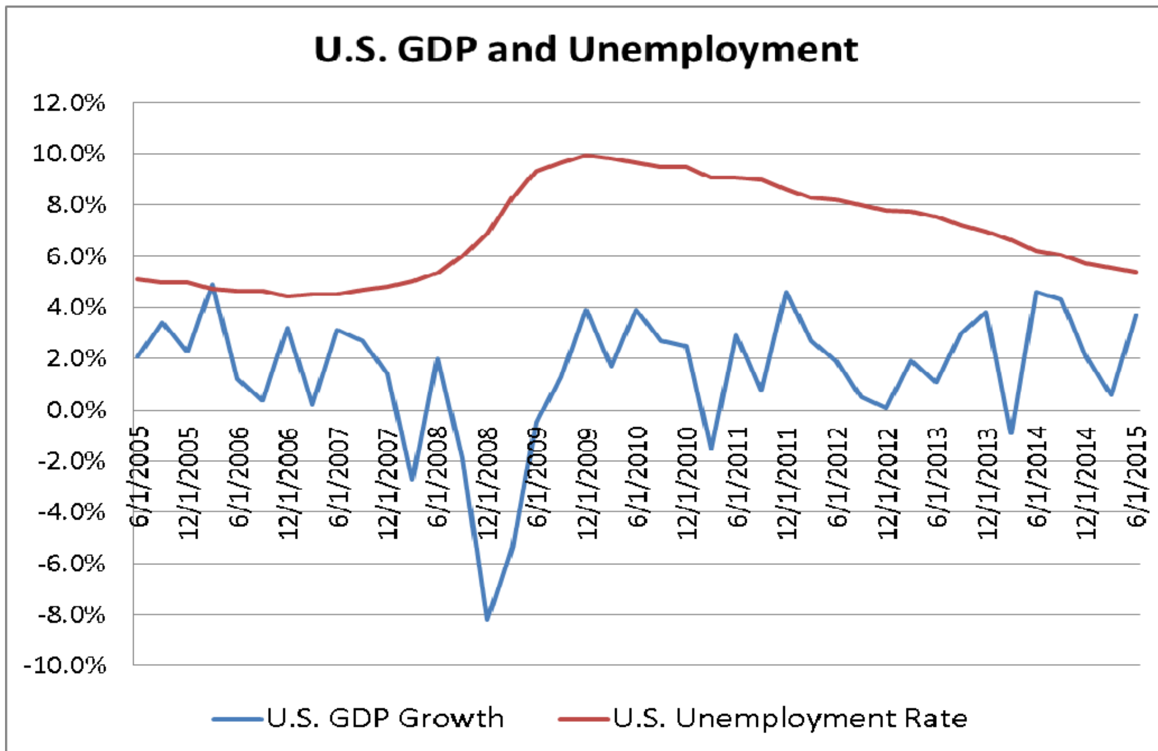

Chart 3

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