

Clients of Yanni & Associates Investment Advisors, LLC

08/25/2015

Due to this recent market correction, we are writing a mid-quarter update to our clients. Outlined below are our thoughts as to the current market circumstances:

We believe this is a short-term pullback due to a global economic slowdown, not the start of a global recession.

For several weeks, we have been communicating to our clients that we did not believe 2015 was going to produce substantial gains in the stock market. We were doing this in an effort to “shape expectations” as we have all grown accustomed to the gains we have experienced over the last few years. While we have been forecasting continued volatility in the stock market for quite some time, this recent pullback is well beyond our own internal predictions. With that said, we have been absent the international markets throughout 2015 and concerns over China has been one of the main factors. Other notes include:

- A similar phenomenon took place in the mid-1990s, dubbed the “Asian financial crisis”, but the structure of the Asian financial systems is considerably improved today.
- The price of oil has been falling for over a year now. Originally, one of the many factors was due to slowing Chinese consumption. Oil prices have fallen below \$40 / barrel and are anticipated to fall slightly more before potentially bottoming-out. A sustained low oil price could ultimately force smaller domestic based oil related companies out of business. While conventional wisdom would think that lower oil prices would potentially be beneficial for the average consumer with gasoline prices, this positive offset has not yet fully materialized.
- China’s growth is slowing down from levels above 7%; to what degree this slowdown will ultimately bring has yet to be seen. Many major economists would also question the accuracy in this governmental released growth rate over the last few years.
- China surprised markets with a devaluation of the yuan two consecutive days on August 11th, fixing it to a total of approximately 3.5% lower versus the U.S. Dollar. This move continues to bode questions in our mind as to how significant is this economic slowdown projected by the Chinese government after they only devalue the yuan by such a small percentage. In reaction to China’s devaluation, a few emerging market countries have either devalued their currencies as well or witnessed significant depreciation.
- Emerging Markets continue to be an area of concern as many of these countries export heavily into China. Several of these countries are primary producers of commodities of which China is the largest global consumer. Many emerging countries are not as diversified into other products exposing them to further risk. Finally, an interest rate hike by the U.S. Federal Reserve could potentially hurt Emerging Market countries who have debt in U.S. Dollars (weaker currency = more difficult to pay back debt). We have been fully absent the emerging markets segment for many months now.
- For many quarters, the S&P 500 has been trading at the slightly higher end of its Price-to-Earnings Ratio close to 17 times projected earnings on a relative historical average of 14-16. After this recent market correction, the S&P 500 is now trading at 14.86 times projected earnings. From a valuation perspective, the S&P 500 is much more in-line with historical standards. While extremely difficult to experience, sometimes small, periodic corrections of 10% are better to occur than substantially larger ones. While we have recently not grown accustomed to stock market corrections, they typically can occur about once a year. Prior to this, we have not had a market correction in about four years.

What next:

1. Thus far, we have not seen domestic economic figures hurt by this recent crisis; the unemployment rate is still at very low levels, home prices and auto sales are still at high levels, second quarter GDP growth was 2.3%, and one argument is these lower oil prices should ultimately be a benefit to global consumer consumption.
2. Domestic corporate earnings growth has been slowing, but it is still positive. Again, from a P/E range, we are much more in-line with historical standards.
3. Global Central Banks will ultimately need to intervene.
 - a. Overnight, China reduced interest rates for the fifth time since November and lowered the amount of cash banks must set aside. More specifically, the central bank said the benchmark for a one-year loan would be reduced by 0.25% to 4.6% and the one-year rate for deposits would fall by a similar margin to 1.75%. They also increased the amount of money available for lending by reducing the minimum reserves banks are required to hold by 0.5%. As a result, the domestic markets are set to rebound substantially on Tuesday, August 25th. Beyond this, China has enacted a variety of other monetary easing strategies over the last year. At this point, it appears the Chinese government will need to be the main contributor in halting this market slide. They may have to do an exceptional amount more with their efforts in order to help prevent further global market deterioration. On a good note, it does appear their central bank has both the flexibility to incorporate additional monetary easing programs in the upcoming months and the desire to do so.
 - b. The European Central Bank, which is in the middle of a quantitative easing program, may also need to accelerate their efforts.
 - c. Domestically, the Federal Reserve is now forced to re-evaluate its plans to start raising interest rates in September. While they probably should still raise interest rates, it now seems less likely than just a few weeks ago.

Earlier in August, we made internal adjustments to client portfolios lowering-the-duration on fixed-income holdings. Essentially, we have shifted part of our bond holdings to shorter-term bond, which should be less effected in an upward rising interest rate environment. However, we have not made material changes on the stock portion of client accounts as a result of this recent crisis. While we have received a few phone calls from clients seeking to increase their stock exposure as a result of this pull-back, we are not making this shift firm-wide. At this point, our view is still this is a market correction, not the start of a global recession. Stabilization in these markets may not happen immediately. We continue to guide clients to keep a long-term approach to investing in both the equity and fixed-income markets.

As always, please call or email us with questions on your assets.

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