Palmetto Wealth Management

"It's like deja-vu, all over again!"

John Gustafson – 1 October 2015

Normally I would hate to be quite that cliché with a title to one of these notes, but in honor of the great Yogi Berra passing recently, it seemed fitting to use his quote as the title of a review for a quarter that felt very similar to the 3rd quarter of 2011 - the last time we've had such a rough ride.

If you recall, that correction in the markets had a very obvious cause: Our "leaders" in Congress somehow thought it may make sense to stop paying our bills - not permanently, but simply to get the Tea Party point across. That was a stupid and dangerous notion and since markets value things on confidence and clarity most of all (fear the unknown) that ridiculous stunt and rhetoric quickly took away two of the three legs of the stool. (the third is actual economic performance)

Which bring us to Q3 2015 - the correction that many had been *hoping* for over what seems like the last couple of years finally arrived. This time it wasn't the stupid musings coming from D.C. (although they are still on the side of *not helping*, even though they are at least not actively hurting things currently) it is straight economics. A continued slow grind in the U.S. with little visibility, (compounded by the Fed's lack of action, even though many thought they would begin their move), a faltering China that I think is more of an honesty crisis (finally) with their economic reporting and the super-strong dollar helping to accelerate the drop in oil prices.

Let's hit these items individually to see what's going on, as taken in one swallow it is a lot to safely digest. China's economy has continued to slow as they move from emerging, to mature and see the growth of their middle class. Although, *slowing* is a relative term as they still grow at about 3-times our pace and in all actuality it may be more similar to their previous rate of growth than we think. Primarily because there are signs pointing to the fact that some of the *butcher's finger on the scale* of their historical reporting may be going away. They want continued foreign investment and understand that honesty is key for future growth.

I know China's numbers are important to the overall global economy's numbers, but they are a much larger *supplier* to US firms than a source of revenue, so a strong dollar coupled with excess capacity on their end isn't the worst news I've heard for U.S. manufacturing. It has been quick and dramatic and which will cause revaluations to ripple through the markets with the high numbers of companies now doing business in the Middle Kingdom. Although, the crash of their domestic stock market gained a good deal of headlines, that is mostly a domestic Chinese problem - outsiders couldn't generally own those *Red* shares anyway.

Oil and the dollar are interesting pieces to this puzzle for a couple of different reasons… If you recall only a couple of years ago when *experts* were calling for $150/barrel, it was at a time prior to US production really coming on-line, as well as a period of weakness in the dollar. Weakness that caused large producers in the Middle East - joined by our nemesis Vlad Putin - to discuss trading oil in a currency other than the dollar (likely Euros) simply to poke the U.S. in the eye. Smash-cut to the EU financial crisis shortly thereafter, which also pushed the dollar higher and that proposal has faded from memory. The bottom line is, as much as folks "hate" America, they still come flying into our system for bonds and cash at the first sign of trouble elsewhere. (Which is also why the behavior of Congress back in 2011 was insanely childish, ignorant and dangerous.)

Now, the shale fields have been producing at capacity for a few years, conflict and financial problems elsewhere have pushed the value of the dollar higher and higher, and we are seeing just the opposite - oil becoming devalued in dollar terms. In previous notes we have mentioned the Saudi's *oil hammer* being deployed, not specifically to harm America's drillers / producers (though for them this is a pleasant side benefit) but in order to keep their enemy Iran, continually economically hobbled. Recently I've read some news that may give some visibility as to how much longer the Saudi's can keep the spigot open - and also has more explanation into the falling markets. They are becoming a little cash-poor and pulling billions back home from large asset managers who have only seen inflows from the Saudis for years.

Apparently, they do have a very low production cost (< $10/barrel) but just like Baby Boomers, have altered their lives to the income derived from prices much closer to $100/barrel. Again, this is a supply-glut, not a drop in demand. America and most other consumers have not slowed in their use of fossil fuels at all - and if car sales statistics tell us anything, big, honking SUV's are back! I'm expecting OPEC to figure out a way to slow the flow sooner rather than later because as we all learned during the great recession - nobody likes to reach into their pockets to live, we all prefer to live on current cash flow. I don;t believe we get anywhere near $100 for awhile - especially with the strong dollar that will only increase when rates finally lift off - but we should continue to move away from the recent lows now that the House of Saud is beginning to blink.

Moving on to the Fed - the real confidence issue in our markets, in my opinion… In previous quarters, much (virtual) ink has been spilled describing the fact that the initial stock-move from slightly higher rates would be down, but the message of economic confidence would quickly be heard. Think about it, when news comes out it is either what you expect and you do nothing, or you don't get what you expect and you hit the sell button. (and by "you" I of course mean short-term, institutional traders, with volatility enhanced by our good friends and SEC-authorized, front-running thieves, the high-frequency traders) The fact that the Fed sat on their hands once again was ominous and did little to boost confidence. So here we sit… Back to *the malaise* I outlined several years ago where confidence lacks and we slowly grind forward in the economy. Please remember though, slow growth is NOT recession. It might not sustain ultra-high forward PE ratios, but it's not going backward.

What's the bottom line in this scenario? Cheap money and cheap oil is not terrible for the lives of Americans - nor is a weakened China. The strong dollar is tough on companies that do business abroad, discounting their earnings translations back home. (hence the multiple compression on forward PE) John Boehner finally doing the right thing and falling on his sword will likely keep the ridiculous Congress from doing anything too dangerous and at least kick the can down the road once again. I do feel like we will see continued volatility through the end of the year, but not quite what we've experienced of late.

Think about it this way - the market (S&P and Dow) was nearly even YTD at the end of June, with the NASDAQ still a few points in the green - ALL three ended solidly negative, dropping roughly 8+% in the quarter. It was ugly… BUT, as I was asked more than once, nowhere near 2008 - that was the 100-year flood.

In reality, I hope we recover slightly, but finish the year a little in the red across the board. I know that sounds crazy from the person you hire to *make* money for you, but it is more of a rhetorical item to stop all the super-negative coverage of "the markets haven't been down since, blah, blah, blah…" that only serves to further sap public confidence. To use our oft-quoted saw from Ben Graham, "In the short run, the markets are a voting machine, in the long run, they are a weighing machine." Which brings us to politics…

Unfortunately you know with the wide-open, Presidential election (i.e. No incumbent running) coming next year, politics will be the topic of these notes as well as much of the chatter on TV for many months ahead. At this point, the Democrats are completely predictable and boring and require no discussion - but the Republican Clown Car is non-stop entertainment!

Love him or hate him, The Donald has turned things upside down. Yes, his answers are generally lacking detail, (other than his tax plan, which steals form both sides fairly well) but what he does is bring honesty to the conversation, which is refreshing. Again, you may hate him and think he's a blowhard-clown, but all of our politics could use a shot of non-PC, non-lobbyist purchased honesty. Also, his underlying message of "Make America Great Again" is the one item the GOP has completely lost in their fan-boy pursuit of the great-and-powerful Gipper. Reagan's primary issue was that America is the greatest country in the world, the land of opportunity (whatever you think of his policies) and he and Tip O'Neil understood the art of the compromise and that an 80% win is NOT a 100% loss as it is in the current Congress / White House dynamic. Extremism like that did begin under Bush (43) and the Democratic Congress - they have merely switched chairs, but it is the same harmful rhetoric.

However this comes out, my hope is that the other candidates stop pandering and start being honest, and also stop being so negative on everything - discuss what we can do to make things go the way we want, rather than constantly lamenting that there are problems in the world. (And stop blaming your predecessor!) It was so tiring to hear Democrats blame Bush (which they still do, 8 years later) that I'm not interested in hearing what a disaster Obama was either. Win the job and make your way forward - stop looking in reverse!

A little handicapping (for fun) prior to finishing with the market path forward… The one thing all politicians should fear the most from President Trump would be he truly understands how to use the bully-pulpit of the presidency. Something President Obama has only done occasionally and President Bush (43) only did early in his tenure. Clinton was a master as was Reagan - that is a powerful tool to have your way. That is why I think the GOP is so scared of him. He does need to stop being so petty - if you're not afraid of losing your lead, stop giving your competitors publicity. ESPN never talks about Fox Sports, because they don't have too - whereas Fox is always taking shots at "the four-letter." (same with Fox News vs MSNBC)

Carson is interesting and has the outsider qualities, as does Fiorina, though both will need funding from the outside and it will be interesting to see how their messages may change because of it. Bush is the legacy and I'm afraid Bush v Clinton is the last thing anyone wants to see, but because of how things are done, may be most likely.

Cruz may win the nomination, but you better be ready for whomever the Democrats put up - he is simply too far to the right to win a general election. I always hear folks tell me, "He's so brilliant!" Well then he should learn to not be such a robot, stop with the ridiculous talking points to win over people who would never vote Democrat anyway and try to seem human. Bottom line, the Democratic attack-ad creators are salivating to crush Teddy by scaring the crap out of everyone.

I am looking forward to Christie hanging around as I think he can be honest like Trump, has fans on both sides of the aisle and actually knows how politics work. Kasich would be great as well - he has done a great job in Ohio, speaking from the seat of a small-business owner - but he just can't get any traction in the shadow of the rest. Perhaps he's just biding his time until closer to actual voting takes place.

Too early to say who I think would be best for the markets, but I think the fight will be fun to watch. Stay tuned…

Finally, for the markets in general and our portfolios specifically… Unfortunately, corrections happen, they are scary, uncomfortable and seem to remove all hope. This is the worst quarter in 4 years, but as mentioned earlier, it is nothing like the systemic failure of 2008. Also, my love of energy has added to the hurt, though with a great flow of dividends to soften the blow somewhat. I don't think that will go away - I can remember $11 oil at the end of the 90's and nobody gave up at that point. Also as previously mentioned, this is a supply glut, not a demand drop. America will throw aside all thoughts of conservation and take that challenge to sop up all that extra petrol - I'm confident in it. That said, I still prefer MLP's and such who don't actually own the commodity, they merely transport it and earn a return that is removed from the commodity prices.

In terms of the overall global allocation, the strong dollar and crazy Chinese markets are going to exert opposing forces on the portfolio, but I am comfortable with our overall mix currently. If the Fed were to begin to raise rates, that confidence (along with many others, I expect) would begin to rise as well. I am looking forward to the day once again when holding a little cash is less like dragging the boat anchor in terms of our performance. I also disagree with folks who say that continued low rates will encourage too much speculation - it looks like the public is still less fearful of earning zero in cash (based on fund flows and such) versus reaching too far and risking a big loss. Institutions, perhaps not, but they should know better and deserve what they get in the end. You must live to fight another day when things get tough - we will.

To close on a Yogi quote, “The future ain’t what it used to be.” I hope it is better… Hang tight and we will arrive in calmer waters, hopefully in the spring.

Thanks as always for your business, friendship and support. If you have questions or comments, please call or e-mail and we will discuss as much as you would like.

Enjoy the fall… Cheers!