Financial Wanderings

January 2016

A masterful examination of the previous month's financial events, written by Brad Blackburn, CFP ®
(and made even awesomer by Andrea Dickerson)

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January Market Numbers:

S&P 500: -5.1%% to 1,940

NASDAQ: -7.9% to 4,614

DJIA: -5.45% to 16,466

10-Year Treasury Yield: -14.5% to 1.94%

Gold: +5.24% to $1,116/oz

What in the ___ is happening?

Writing financial articles is much easier when times are good. My normal shtick is to be as irreverent and obnoxious as possible when writing about the financial world. But that tone doesn't seem to fit the times.

The S&P 500 has fallen nearly 10% since its all-time high in May (and more than 5% just this year). As painful as that is, it actually understates the damage. If you look at other parts of the stock market, like international and small-cap stocks (which are cornerstones of a diversified portfolio), the drop has been closer to 20%. Ouch.

So what's causing the panic? With all due respect to the Fed, it comes down to two things: China and oil. Because the world is already awash in negative thoughts, I'm going to give you my optimistic take on both of them.

<u>Oil</u>

Let me take a moment to be confused: Isn't cheap oil supposed to be good? The common wisdom is that cheap gas gives consumers more money to spend, which helps the economy, which helps stocks, which helps my clients, which makes me happy. So why is the world freaking out over cheap oil?

There are two lines of thinking here. The first is that the world is awash in oil because of low demand, which means the global economy is even weaker than expected. If that's true, and a lack of global demand is the real reason oil prices are falling, the panic in the markets makes perfect sense.

But the other line of thinking is the "open conspiracy" that Saudi Arabia is allowing low oil prices to force other oil producers out of business (Saudi Arabia has admitted as much). Once those producers are gone, Saudi Arabia can allow the price of oil to rise again. But that begs the question: Isn't this a temporary thing? According to the IMF (International Monetary Fund), even with oil at $50 a barrel, most

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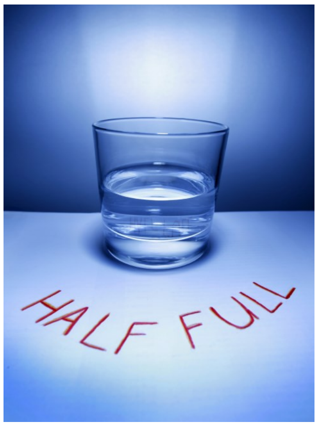
of the Middle East will run out of money in less than five years. That means it's not sustainable for anyone if oil remains so cheap.

If Saudi Arabia's games are the primary reason oil is down, then why is the stock market freaking out? Yes, oil companies and the banks that loaned money to them are likely to struggle. But cheaper gas should help the majority of consumers and businesses; that's a positive thing.



China

If you listen to the headlines, China is in the middle of a major crisis. It's true that their stock market has fallen precipitously over the last year. To make matters worse, China recently announced that their GDP in the 4th quarter fell to a 25-year low of +6.9%.

Wait, what…? Isn't GDP growth of nearly 7% a good thing? Of course, you can't take China's "official" statistics at face value. So, let's assume they only grew at 5%. That's still pretty impressive.

China's economy is slowing, and they have significant problems, but the 40% drop in their stock market isn't a big deal. The only reason Chinese stocks have dropped so much is because they went up so much. Over the first 5½ months of last year, the Shanghai Index grew more than 40%. That dramatic rise set the stage for this dramatic fall. In fact, at the time I'm writing this, the S&P 500 has fallen more over the last 12 months than the Shanghai Index (but the Shanghai Index has fallen much more over the last 6 months).

However, let's not discount the problems in China. China's amazing growth over the last 30 years was based on enormous government investments and exporting lots of stuff to the world.

But neither of those things is sustainable forever. At some point the Chinese economy has to focus on growth from its own people. In America, consumers account for nearly 2/3rds of the economy. In China, it's closer to 1/3rd. That is a very difficult transition to make, and the world is watching closely. In my opinion, it's just a matter of time until China runs into some serious speed bumps.

However, maybe a struggling China won't impact us as much as we think. According to Citigroup, only about 0.7% of the American economy is exposed to China. But those ties are increasing every year.

<u>So what should you make of all this?</u>

While I'm not ready to panic over any one specific thing, the "big picture" makes me a little skittish. The American economy is still solid, but nearly everything else in the financial world is in turmoil. China, the dollar, interest rates, oil… Everything is volatile right now, so you can understand why the markets are freaking out. But there's another very simple, very basic reason the markets are tanking: ***This is what markets do.***

Sometimes the markets go down simply because the markets go down sometimes.

Here's the key question: Many parts of the markets have already fallen more than 20%. Has enough changed over the last year to justify that drop? At what point will investors look at the falling price of stocks and get greedy again? My instinct is that we are getting close to that point. But… I had that same instinct a few weeks ago.

Both Sides of Deflation

Originally, this article was going to be a much more pessimistic look at something I've been worried about: Deflation. However, after many hours of exhaustive research and deep meditation, I've come to a more optimistic place.

As opposed to inflation, where the value of your money shrinks over time, deflation causes your money to get ***more*** valuable over time. That sounds pretty good, right? However, the common wisdom is that deflation kills economies by encouraging consumers not to spend. After all, if your cash got more valuable every day (and the stuff you buy got cheaper every day), you'd probably want to hang on to more of your cash.

But it doesn't have to be that way. What if you have a job… and you have money… and there's stuff you want to buy…? I mean, that new Justin Bieber poster isn't going to buy itself.

The "deflation is bad" argument assumes people stop spending. However, if lots of people have jobs, and consumer confidence is solid, people are going to buy stuff regardless of whether or not prices might fall. Doesn't that sound a little like our current economy?

Deflation doesn't have to be horrible, which is a good thing because technology and globalization are deflationary forces that are here to stay. Do you ever wonder why American wages aren't inflating? In a global, technological economy, there's never a labor shortage. If workers get too expensive, there's nearly always a way to get the same job done in a less expensive way. Because of that, the risk of deflation is here to stay. But maybe we don't have to be so scared of it.

No, Congress isn't Taking Away Billions in Social Security Benefits

As you might imagine, my clients often ask me about articles, emails, or social media postings that scare, excite or confuse them. Sometimes they are legit, but more often than not they are based on an intentional lie designed to terrify you so much that you'll buy whatever junk they are selling.

It's not often that one of these stories gets much traction, but this one touched a nerve. I guess that's what happens when you start talking about taking away someone's social security.

So let me get to the point:

No one is taking away huge chunks of your Social Security. There's nothing you need to do. PLEASE don't listen to anyone who's pitching this idea.

It's true that Congress is closing a couple Social Security loopholes in May. "File and Suspend" and "Restricted Access" are going away. But those loopholes affect only a very small percentage of people, and the damage to those select people isn't all that significant anyway. Further, those strategies seem like legitimate loopholes that need to be closed.

(Congress did something good? That can't be right)

Thank you to my clients who brought this question to me. Please continue to do so. I never want my clients to think I'm ignoring something that could be so vital to their financial lives.

The Rising Dollar Matters Too

While China, oil and the Fed have grabbed all the attention, there's another reason for the recent stock market tantrum: The dollar.

Since the beginning of 2015, the dollar index, which measures the dollar against a diverse group of other currencies, is up more than 9%. However, against many important currencies, it's up even more (for example, the dollar is up nearly 15% versus the Euro). In many ways, that's a good thing – a strong dollar means there's plenty of global demand for American stocks, bonds and real estate. America isn't perfect, but we must be doing *something* right.

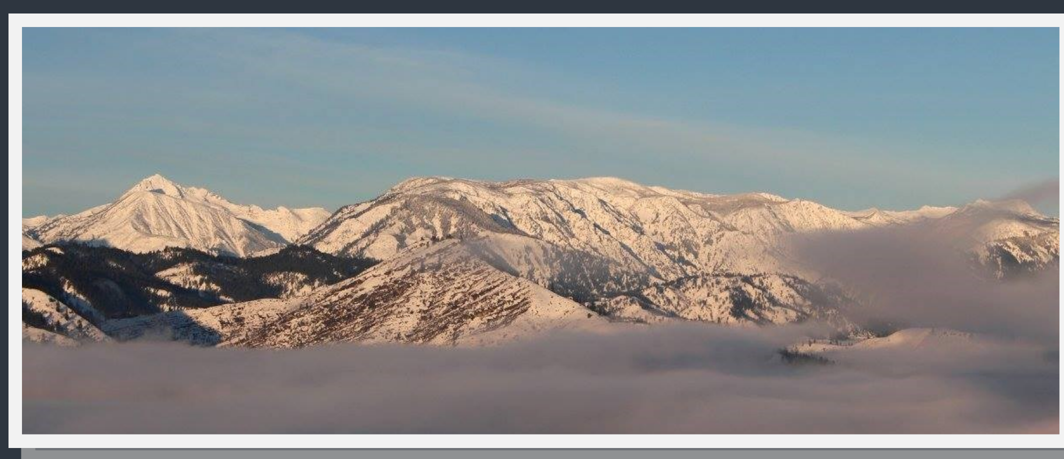
Or maybe we're just doing less dumb stuff than everyone else.

The dollar is rising for all the right reasons, but there's a very real downside to it: A strong dollar makes our products more expensive across the globe. In the "old days," this wouldn't have mattered as much. But in today's global economy, nearly 50% of the S&P 500's earnings come from outside of America. So a rising dollar is a real problem for the economy and stock market.

The recent GDP report gave us a great example, as U.S. exports dropped 2.5% in the 4th quarter. If the dollar keeps rising, that negative trend will continue. On the other hand, I find it hard to root for a weaker dollar. Therefore, I have no idea how to end this column.

Probably a Mountain or a Lake

This picture was taken from Butler Ridge in Cashmere. The town of Cashmere is somewhere down under the clouds. Mt Cashmere and Icicle Ridge are standing tall above it all.



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