Southern Capital Perspective

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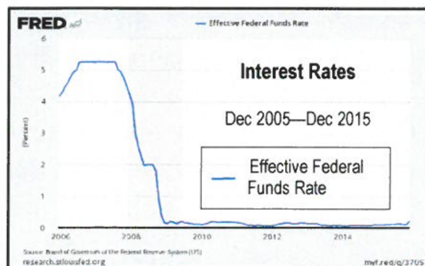
What will Determine the Direction of the Market in 2016?

Will it be the Federal Reserve Board and its policy of beginning to raise interest rates? Will it be the state of the Chinese economy? Will it be geo-politics, the Mideast or North Korea? Will it be the wild fluctuation in the price of oil? Will it be the sluggish US economy? Or will it be the ocean of liquidity and the new money being created by some of the major economies of the world?

The Federal Reserve Board and Its Policy of Beginning to Raise Interest Rates

Janet Yellen and the FED raised interest rates by .25% in December for the first time since June of 2006. Ordinarily, the FED will increase rates a number of times in a tightening cycle, and they indicated that there would likely be two to four more increases in 2016. This would imply that short-term interest rates will be .75% to 1.25% by December meaning that rates will still be very low and probably will not prevent consumers from buying big ticket items that require financing. Therefore, the impact on the real economy should not be dramatic.



In the investment world it works differently. Higher interest rates will attract more foreign investment into US bonds and interest–bearing accounts. This will cause the US dollar to rise in value in relation to other world currencies which will make American goods more expensive and put US exporting companies at a disadvantage. The earnings of these US exporters will be put under pressure along with their stock prices. Additionally, as interest rates rise, fixed dollar investments like bonds and CD's become more attractive and could begin to pull some money out of the stock market.

There are three other considerations in regard to the FED:

- First, Janet Yellen has said that their decisions will be data-dependent, not automatic increases. This means that if the economy is suffering or the markets are in great distress, then she will postpone increases to a more favorable time.
- Second, this being an election year, the FED does not want to be accused of influencing the outcome by tightening too rapidly and causing a recession.
- Third, the FED has created about $3.5 trillion since 2009 and has not taken any of that money out of the system; therefore, their stance is still considered "accommodative," which means lots of money is available for the markets.

The State of the Chinese Economy

China now has the second largest economy in the world and is having an increasing effect upon global markets. In the first few days of 2016, China instituted a 7% limit on the amount the China stock market can decline in any one day. The first three trading days of the new year have seen the 7% limit on two of those days and on the other day the Chinese government poured in enormous amounts of money to avoid another large decline. Obviously, market sell-offs of this magnitude cannot go on for very long but, in the short-run, it has caused instability in the world markets.

The reason that the Chinese market has been falling is because the Chinese economy has slowed down. China had been growing year after year at a 9% to 10% rate, vast amounts of infrastructure (roads, bridges and whole cities) had been built and millions of new jobs created for the people migrating to the new cities. However, that rate of

growth became unsustainable because of the size of their economy – it is called the law of large numbers. Officially, the Chinese say that growth is in the 6% to 7% range, but many experts believe that the growth rate is significantly lower.

Geo-politics – the Mideast and North Korea

Geo-politics is weighing on the world markets especially in the Mideast and more recently with North Korea performing another nuclear weapon test. The march of ISIS in Syria and Iraq has not caused a sharp sell-off, but it is a steady negative influence on market confidence. Even the terrorist attacks in Paris and San Bernardino were not big market moving events.

Terrorism is scary but limited in scope. Of more concern, potential conflict between Saudi Arabia and Iran could result in great market volatility if they start attacking each other's oil producing means and transporting capabilities.

North Korea's nuclear test adds another layer of uncertainty to the geo-political environment. Instead of an actual threat of nuclear war, Kim Jong-un (North Korea's youthful leader) is most likely trying to frighten the world powers into giving food and other necessities to this rogue nation. He does this because time after time the world (especially the US) gives in and then Kim Jong-un can continue to spend about 25% of GDP on the military and weapons development. Since this process has become a time honored tradition, his antics are generally not market-moving events.

The Fluctuating Price of Oil

The price of oil does have a substantial affect upon the markets and the economies of the world. However, it is not always the affect that one would expect. Normally, it is assumed that a drop in the price of oil is good for the economy because people spend less on gas and heating or air conditioning; they can spend more on other things. This activity is considered good for the markets and the economy. Yet, if the price of oil is plunging because world economic activity is slowing and there is too much oil, then the market is hurt. This is because the energy sector greatly underperforms.

The Sluggish but Steady Growth of the US economy

The slow but steady progress of the US economy is an important underpinning for the stock market. The strong recovery that usually follows a deep recession has not occurred, but the 2% sluggish recovery pace has been stubbornly long lasting. Most indications are that this tepid progress will continue through 2016 unless an unforeseen event or circumstances derails it. A positive market performance is very much dependent upon continued economic gains.

The Massive Liquidity that Already Exists and the Additions by Some of the Major Global Economic Powers

The FED halted its money creation operation in 2014, which was called quantitative easing (QE). The Eurozone, Japan, and China, however, all have ongoing QE programs. Money, like water, will flow to where there is the greatest receptivity or least resistance – in the case of water, it is the low lying area. Therefore, new money will flow all over the world including to the US. This will be in addition to the $3.5 trillion that the FED had already created making a vast pool of liquidity for the markets.

Outlook

The correct answer to the questions posed in the first paragraph is: All of the above. The FED has the power to move the markets and ultimately will rely on its "data -dependent" mantra to reverse course if the economy falters or the market gets into a distressed state. The China effect, which has been very substantial the first week of 2016, should moderate because the US does not export much to China; therefore, their economic woes should not have a large affect upon our economy. China's market movements also should have a declining influence upon US markets. In the geo-political realm, North Korea will continue to bluster but is unlikely to roil the markets. However, in the Mideast a conflict between the Saudis and the Iranians would disrupt the markets. The price of oil is likely to fluctuate but remain low (unless there is a Mideast war). The sluggish but steady US economy should continue, barring some unforeseen circumstance. Global liquidity is already abundant and it will get more so if the FED is forced to act.

The first week of January was ushered in with a sharp decline in the markets taking us down near the correction lows of September/October. The blame for the decline was placed on the economic and market problems in China. It is true that China has the second largest economy in the world and its problems do affect the US. However, the relatively small amount that America exports to the Chinese makes the market reaction seem overblown. We expect the stock market to have a rebound based on the US employment report and the fact that the economy is still growing – slowly, but still growing. Our stance at this point is to stay with our funds and fund managers that we have confidence in. If, however, other negative factors arise, we will deploy defensive measures as needed. ***Happy New Year!***

Terry E. Nager is a CFP®, CLU®, and ChFC®. He is also the President of Southern Capital Services, Inc. — a registered investment adviser. The information presented by the author and the publisher is for informational and educational purposes only. It should not be considered specific investment advice, does not take into consideration your specific situation, and does not intend to make an offer or solicitation for the sale or purchase of any securities or investment strategies. Additionally, no legal or tax advice is being offered. If legal or tax advice is needed, a qualified professional should be engaged. Investments involve risk and are not guaranteed. This newsletter contains information that might be dated and is intended only to educate and entertain. Any links or websites referred to are for informational purposes only. Website not associated with the author are unaffiliated sources of information and the author takes no responsibility for the accuracy of the information provided by these websites. Be sure to consult a qualified financial adviser and/or tax professional before implementing any strategy discussed herein.