Southern Capital Perspective

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What is Currently Affecting the Markets?

There are the usual four major influences: the US economy, the global economy, the Federal Reserve (FED), and the other major central banks. There are also three other players on the scene: the US election, the Brexit situation and the ever present uncertainty of geo-political events and terrorism. The fourth quarter of 2016 will reflect the unfolding impact of these seven influences, and the stock market's progress will be determined by which ones will dominate.

The following paragraphs will examine each of the seven in light of its potential impact on the stock market.

The US Economy

The US economy is still the largest in the world representing about 20% of total global output. The US has a highly-developed and technologically-advanced services sector which represents about 80% of the total American economy while manufacturing is around 15%. Some of the advantages that the US economy has are: abundant natural resources, a well-educated workforce that is very productive, and being blessed with access to abundant capital for business investment. However, significant problems do exist: "Deteriorating infrastructure, wage stagnation, rising income inequality, elevated pension and medical costs, as well as large current account and government budget deficits, are all issues on the radar."* These impediments act to slow the growth in the US.

Thus far in 2016, Gross Domestic Product increased .8% in the first quarter and 1.4% in the second quarter which is very sluggish, but there is hope that the third quarter will show improvement. Personal income and labor participation rates are still sub-par, especially when they are compared with the present unemployment rate of 5.0% which would indicate that the US was near full employment. The bottom line is that the economy in America is sluggish but moving forward as it has over the last several years.

The Global Economy

According to the Conference Board (a global independent business membership and research association founded in 1916), global growth will remain weak for the remainder of 2016 with some upside for 2017. The growth rate for this year remains at a modest 2.2% with slight improvement up to 2.6% next year. They expect:

- Growth in the US to remain subdued.
- The EURO-area to have modest growth despite some political risks. Domestic demand and improving labor markets continue to drive the current moderate recovery. Also, investment and productivity are projected to improve somewhat.
- The Asia-Pacific area to be unable to improve growth. China is not expected to improve above its 3.6% growth rate in 2015. India is not robust but still may overtake China as the growth leader in the region.
- The Latin America region is "losing the race" according to the Conference Board primarily because low oil and commodity prices have exacerbated the ongoing problems especially for Brazil which is the biggest economy in the region. Therefore, weakness is still their verdict for the global economy.

The Federal Reserve (FED)

The economic reports on the US economy have been improving; consequently, the FED is becoming emboldened in regard to hiking the short-term interest rate in December by .25%. The FED governors have been wanting to hike rates since they raised them by .25% last December. Throughout 2016 whenever the FED was going to raise the rates, they were stopped by weak US economic reports or by the actions of other major central banks that were easing monetary policy which the FED would be contradicting. Now, the conditions as of the beginning of October seem ripe for an interest rate hike. A poll of economists shows that there is a 70% likelihood of a December rate rise.

The big question is why does the FED want to raise rates?

There are three basic reasons:

- First, the FED wants to normalize the economy by giving savers an opportunity to earn some interest on their savings.
- Second, Janet Yellen (the FED Chairperson) wants to have some ammunition (the ability to lower rates) to combat a future recession.
- Third, there is some evidence that inflation is beginning to rise and she does not want to get behind the curve and have to raise rates aggressively to fight it. She prefers the gradual approach to increasing rates in order to avoid abrupt shocks to the economy.

Last December the rate-rise caused a market sell-off. The perception of a rate hike this December is at this point being met with acceptance; however, we

will have to withhold judgement until we get closer to the time that it actually happens.

The Action of other Major Central Banks

The world economy is global in nature, therefore, the actions of any major central bank affects the economies worldwide. Also, money is fungible (interchangeable) meaning that regardless of which central bank creates the money it will flow freely throughout the world.

The European Central Bank (ECB) headed by Mario Draghi has been adding 80 billion euros per month of new money (called quantitative easing or QE). It appears that this massive QE is not getting the job done and negative interest rates haven't been a solution either. There is now some discussion of the ECB beginning to taper down its QE effort as the US did in 2014.

The Bank of Japan (BOJ) has been using almost every monetary tool imaginable. BOJ Governor Haruhiko Kuroda has employed negative interest rates, QE, purchasing bonds, purchasing equities and possibly even funding infrastructure projects. However, the Japanese economy remains sluggish and is teetering on the edge of deflation. It is clear that Kuroda's strategies have not been working yet he intends to continue his monetary policies of stimulus and increase them if he feels it is necessary.

The People's Bank of China (PBOC) is not transparent. Therefore it is difficult to determine what actions they are going to take until they take them. The Chinese economy has been growing at about one-half of the 7.5% target rate of growth. Periodically they come out with some type of stimulus package or a currency devaluation on an unannounced basis.

The US Election

The US election cannot be determined at this point in time. It is extremely close and it would be very foolish to pretend to know the outcome. The long-term effects of the policies of the two leading candidates will be profoundly different. However, regardless of who wins, he or she will not take office until January and even then there will be a significant time lag before his/her policies are enacted. Also, enactment will depend upon who controls the House and the Senate. There is no doubt that perception will play a role, but real change will take some time and, at this point in time, any strategizing would be pure speculation.

The Brexit Vote

On June 23, 2016, the English people decided to leave the European Union (EU). At the time there were predictions of catastrophic economic consequences especially for the British people but also for the world's financial markets. It has now been over three months since and everything is pretty much business as usual with no Brexit disasters. That is not to say that there will not be some disruption for the United Kingdom (UK) or for the European Union (EU), but it appears that it will be manageable and the necessary adjustments will be made to carry on international trade.

Geo-political Event

Geo-political events and terrorism are unpredictable. There is little doubt that they will occur, but where? When? And of what magnitude cannot be determined. Therefore this is always the unknown that has to be coped with but cannot really be dealt with via an investment strategy.

In summary, all seven of the above-listed influences will play a role in the way the various stock markets will perform. The biggest impact will come from the US economy which is not only the largest in the world but is also the leader even though it is certainly not robust. The second most impactful will be the other world economies where the EU is showing some signs of recovery and at least Japan and China are not declining. The FED is third which is probably going to give us a rate hike in December of .25% but then is likely to be dormant for a while in terms of future rate increases. The other central banks are likely to continue to pursue stimulative economic policies in varying degrees which should be supportive of most equity markets. Brexit is not likely to have any major economic or market impact especially in the next quarter or two. Finally, geo-political events or terrorism cannot be pre-determined or quantified from a market standpoint therefore they are not factored in. The bottom line from the information available at this time leads to the conclusion that fourth quarter is likely to be a continuation of the sluggish but steady progress that we have been experiencing but, as always changes in these seven factors could profoundly alter the expected market impacts.

**Sources: FocusEconomics/Conference Board*

Outlook

The third quarter was a strong one which was a welcome rebound from the first quarter of 2016. All of the market sectors were up, especially the technology area which had sold off sharply early in the year. The health care sector recovered but still has not made it back to the break-even level. As a whole, tech and healthcare have restrained performance thus far in this year.

The fourth quarter indicates that we should expect volatility. First, we are in October which historically is the most volatile month, and second, we have a tight political contest that changes direction constantly. Unless we get some radical surprise(s) from one or more of the seven influences, the market should continue on its sluggish but steady path forward although with additional volatility.

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