

A SHIFT IN PERCEPTIONS



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“Indiscriminant selling is perversely a better background in a tough environment.”

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- The decision by the Fed to NOT raise rates was greeted by fear of global weakness.
- The stock market has not been selective in its recent decline.
- The dividend yield on stocks is now higher than the yield on 10-year Treasury notes — a rare occurrence.
- Unlike earlier quarters this year when earnings optimism reigned, expectations are now low. Therefore, we expect the fourth quarter to see an abatement of selling pressure.

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Low oil prices, low interest rates — A shift in perceptions

Our last letter discussed the possibility of a minor rise in interest rates. We concluded that it was hardly worth worrying about, because any lift would be small and gradual. The market had plenty of other things to worry about and rates seemed low on the list. We suggested that near zero rates were having an impact counter to the original intent of the Federal Reserve (Fed)!¹ The necessary zero interest rate policy of 2008–2013 was now harming savers and pension funds, both of which needed much higher returns to avoid financial stress. The ultra-low rates have affected spending by individuals and have created fiscal problems for municipalities trying to meet pension obligations. There are also warnings about bubbles in art and real estate because of the ultra-low rates, which made leveraged borrowing too easy.

Until August, our forecast for a flattish year for stocks was on target. However, beneath the relative stability of the popular averages, deterioration was occurring in many stocks. Worse, downside moves in individual stocks were often way out of proportion to actual earnings results. After almost six years of rising stock prices, distribution and de-risking were taking place, leaving the market vulnerable to a wider decline. Often, a catalyst for a more general market decline comes seemingly out of the blue and selling becomes widespread and ultimately indiscriminate. It seems likely that we recently saw the latter.

A pronounced economic slowdown in China, made evident by a devaluation of its formerly strong currency, set off a chain reaction of pain. From a downward revision in expectations for growth in the Chinese economy, fears quickly developed around the likelihood of a global slowdown.

Oil prices fell sharply after an early summer recovery. Other commodities collapsed in price. A recovering Europe began to worry about its exports to a weakened China and Brazil as well.

Are commodities a symptom of economic weakness or more of a cause? The decline in oil, as discussed in past letters, has hurt manufacturers more than it has helped consumers as layoffs have been heavy in oil companies and their suppliers. Overproduction around the world led to a price decline. But so many economies have been hurt by low prices. Oil prices need to stabilize in order for the economic jitters to subside. Supply and demand should slowly come into balance. The decision by the Fed to NOT raise rates was greeted by fear of global weakness. Clearly, the narrative around Central Bank liquidity and asset prices has shifted from fear of rate rises to fear of a lack of good outcomes.

¹ The **Federal Reserve Board ("Fed")** is responsible for the formulation of U.S. policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

The slogan “When it rains, it pours” was certainly true in the past month, as fraud was detected at Volkswagen, threatening to disrupt related manufacturers of auto parts and services. The global slowdown has impacted industrial companies to a greater extent than consumer producers. But the stock market has not been selective in its recent decline. Baskets of stocks have been liquidated, leaving few intact survivors. With the U.S. economy limping but not declining, and with rates offering no competition for stocks, something else underlies the declines. It is quite possible that global sovereign-funds have done massive sales. Saudi Arabia, for example, was a huge investor in the U.S. It is possible that low oil prices have caused them to sell stocks to meet spending requirements. One cannot rule out the role of large liquidations of Exchange Traded Funds² in illiquid markets.

The problems seem fairly well defined and serious. The question becomes whether the stock market has priced them in. While there is no certain way of knowing, there are some reasons for optimism in this dreary environment. Most important, from our perspective, is that dividends continue to rise. The dividend yield³ on stocks is now higher than the yield on 10-year Treasury notes. As discussed in the past, this is rare, and suggests that value does exist. The big problem is patience. It has been a most frustrating year. We enter earnings season with its attendant anxiety-producing results. However, unlike the earlier quarters this year when optimism reigned, expectations are low. The indiscriminant selling mentioned earlier is perversely a better background in a tough environment. Therefore, we expect the fourth quarter to see an abatement of selling pressure.

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³ **Dividend yield** is a financial ratio that shows how much a company pays out in dividends each year relative to its share price.

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