Altavista Wealth Management Investment Team Commentary: Distinguishing Between Opportunities and Threats – January 7, 2016

Global stock indices are sharply down this week and so we are taking this opportunity to give you our take on current market conditions.

Figure 1 – Five Day: Tough Week

Today, on the other side of the world, in the Middle Kingdom, stock markets began trading as most of us slept. Within 30 minutes of the opening bell China's stock market as measured by their major indices fell by over 7%. The Chinese officials who run the world's largest planned economy are clearly uncomfortable with the chaos that accompanies a slowing economy and the workings of free markets. So with market prices plunging, they closed the exchange and predictably a whiff of panic spread through global markets.

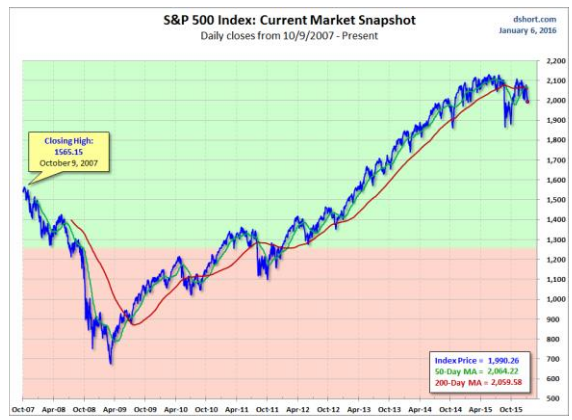

Figure 2 – Snapshot: Moving averages "rolling over"

U.S. stock futures fell in sympathy and markets opened to the downside. The S&P now stands around 8% below its peak in May of 2015 and hasn't made any substantial progress in the last 7 months. Does this week's market action presage a market decline like investors endured in 2008 or 2000? We do not know (and are skeptical of anyone claiming the ability to forecast short-term market moves). To us current market conditions, are cause for caution, not panic. We have advocated a cautious stance toward stocks (less than benchmark exposure, holding extra cash), particularly during the last 18 months based on elevated stock valuations, the pending end of aggressive Fed stimulus and a global economy with sub-par growth.

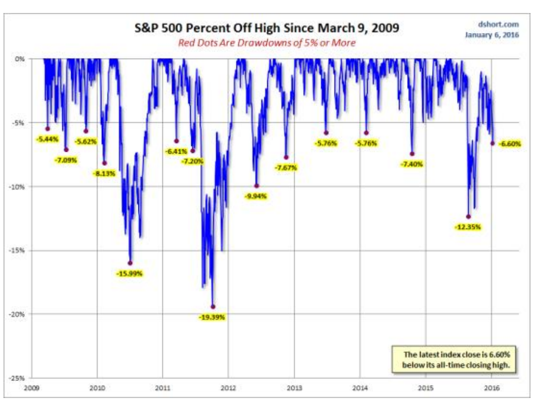

Figure 3 – Drawdowns: Second big declines since August 2015

We do not discount the importance of turmoil in China's credit and stock markets or the lukewarm economic indicators in the U.S. and other developed counties. However, as our clients will see echoed in the *Outlook* accompanying their next reports, we believe the U.S. is in relatively good shape. Profits seem set to improve modestly in 2016 and stocks are facing certain headwinds. In total we think modest profit growth will support the index. In fixed income markets, while short term interest rates are headed up we believe long term rates are more likely to remain steady in this more risk averse environment.

If such a decline occurs in the equity markets we believe it is more likely to be an opportunity to deploy cash reserves than a threat to our client's long term finances. Of course we are prepared to revise our advice as new information is revealed, but now see no reason to abandon our cautious but substantially invested stance.

As our long time clients know our analysis starts with valuation, and while it is elevated, it is not at the nosebleed levels it achieved in 2000 or 2008.

Figure 4 shows Tobin's Q, one of our favorite valuation metrics compared with the stock index returns for the subsequent 10 years. The scale for Q is inverted (i.e. a lower reading equals a higher valuation). It is almost axiomatic that expensive markets lead to disappointing future returns. At the peak of the tech bubble in 2000, the value of Q was predicting a negative outcome from the market for the next 10 years, a disappointingly remarkable feat the market achieved. At current levels it is predicting modest, but respectable, returns of 4-5% for the next 10 years.

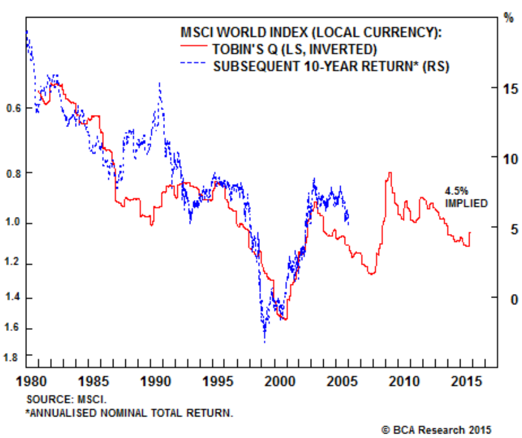

Figure 4 - Current market shows modest but reasonable values

Metrics like Tobin's Q and Schiller P/E we often cite are not infallible and are useless in the task of divining the short-term direction of markets. As we said a sharp decline would not surprise us but neither would an unexpected rally. What we can say is if a decline does occur it could create an opportunity that offers reasonable value and decent future returns.

– The Altavista Investment Team

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