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Investment Strategy Update

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This summer was a quiet one for financial markets—until it wasn't. From Memorial Day through the middle of August, the S&P 500 was range-bound, within 40 points either side of 2090.

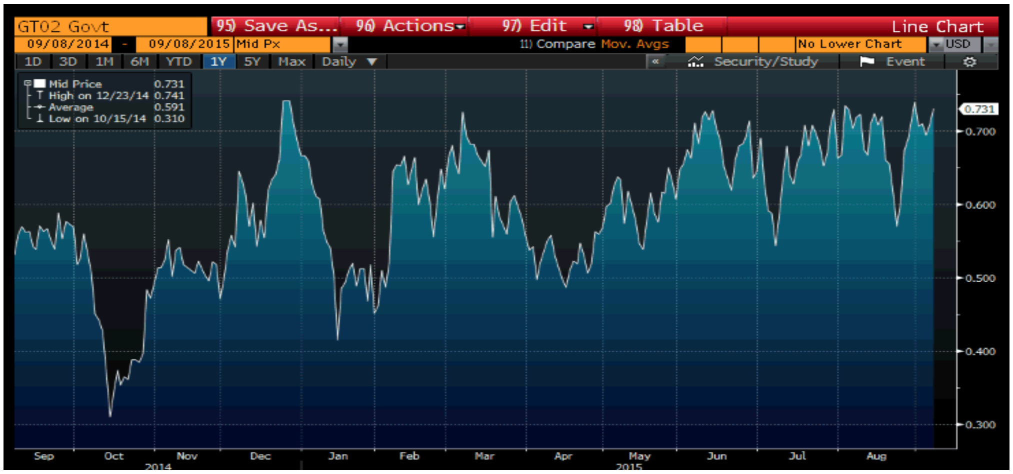
S&P 500 – The Calm before the Storm…

The calm ended suddenly in the third week of August. On the 18th, the Chinese benchmark Shanghai Composite Index started falling sharply, closing down slightly over 6%. By the 19th, the selling spilled over into Europe, with the MSCI falling 2%. When US markets opened on Thursday the 20th, the unease generated by the declines in Asian and European equities had penetrated the minds of American investors. The S&P started sliding, falling 2% that day, 3% on Friday, and almost 4% the next Monday. The other equity indices followed suit, with the Dow Jones Industrial Average falling 8 ½% between the 19th and the 24th, and the NASDAQ Composite declining nearly 10%.

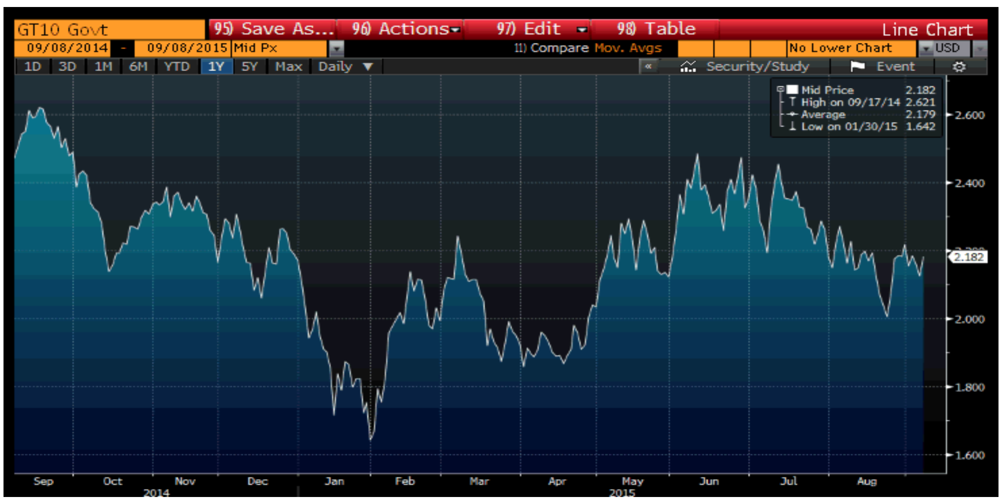
...And the Storm.

Now, if the drop in the S&P 500 was a sign of an impending economic downturn in the United States, we'd expect to see that reflected in the bond market. We haven't seen that. After an initial shock when the equity market first dropped, bond yields have stabilized and mostly reverted to the pre-existing trend.

Two-Year Treasury – Reverting to Trend



Ten Year Treasury – Where's the Crash?



So if it's not the US economy, what *is* the problem?

In a word: China.

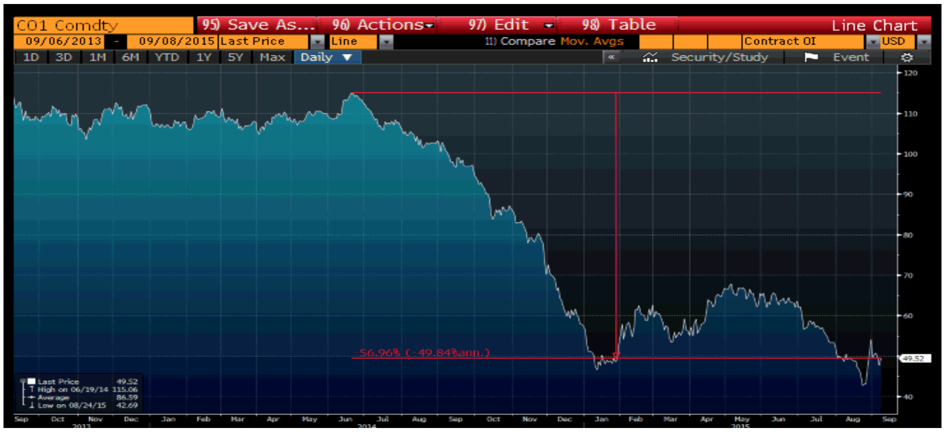
The Chinese economy grew virtually without pause for more than two decades. Massive investment in infrastructure—railroads, highways, factories, apartment buildings—resulted in excessive consumption of raw materials. Chinese demand sent prices of Chilean copper, Brazilian iron ore, Nigerian oil and Indonesian tin into multi-year bull markets.

But trees do not grow to the sky. China may have reached the limits of the infrastructure-heavy growth model. Steel mills are closing; apartment towers stand empty. As less gets built, there is reduced demand for commodities. And that, in turn, means fewer US dollars (world trade is overwhelmingly conducted in US dollars, even when it does not actually touch the United States) flowing into the economies of Brazil, Nigeria and their peers. This is a problem for those countries. Debt denominated in US dollars becomes harder to service when the supply of dollars falls.

Things don't look good for the emerging world.

For the US, however, the picture looks different. Unemployment is falling: the latest report, published Friday morning, showed it at 5.1%. Manufacturing survey data is healthy. Auto sales are running at the highest monthly level in a decade, while weekly jobless claims are running at 15 year lows. And the decline in commodity prices—particularly oil—sparked by a slowing China is putting more dollars every week into the pocket of the American consumer.

Oil – Down 60% from last year's highs



So what's on tap for the balance of 2015?

The Fed will most likely raise rates. It's hard to see how an economy running at 5.1% unemployment (right in the middle of the Fed's target 5.0 – 5.2% range) justifies interest rates at zero. The members of the Federal Open Market Committee know their history, they know that at some point in the future there will be another US recession, and they likely want to start building some recession fighting ammunition. They are not likely to repeat their behavior in the last tightening cycle 10+ years ago, raising in a stair-step every meeting; rate hikes will be gradual.

And there should be increased volatility in the US markets. Emerging Market turmoil may be a big part of this. But another factor may simply be that it has been so long since the Fed last started raising rates that there has been a loss of institutional knowledge of how to trade around the event (we discuss this in more detail here: http://blog.treasurypartners.com/2015/08/17/the-disruption-of-2015/)

But the US economy continues to grow. The yield curve is not forecasting a recession. Falling gas prices and cheaper imported goods are both a plus for the American consumer. We think there may be rough patches ahead, but ultimately we think both equity prices and interest rates will be higher by the end of the year.