The best way to summarize the 3rd quarter is “it was a really tough quarter for the stock market in a year where the stock market was flat going into the quarter.” The returns for the major stock indices in the 3rd quarter were as follows:

Dow Jones Industrial: -7.58%
S&P 500: -6.44%
MSCI EAFE: -10.23%

On a more positive note, as I write this newsletter on October 28th, the stock market has recovered most of its 3rd quarter losses over the course of the past four weeks. Below is a chart of the S&P 500 Index in 2015 from January 1, 2015 - October 27, 2015.

The question that we as advisors have to ask ourselves when there is a significant market correction is: “Is this the end of the bull market or is this just a correction in an on-going bull market rally?” We seek to answer that question for our clients in this quarterly newsletter.
Let’s start off with the most obvious question. Why did the stock market fall so significantly in the 3rd quarter? Our response is there are three main factors that really drove the stock market lower in the 3rd quarter: China, Trade, and Inventories.

We will start off by looking at the situation in China. GDP (Gross Domestic Product) is the primary measurement to determine the growth rate of a country’s economy. China’s GDP growth has been slowing since 2010 (See the bar chart below).

In 2009, China’s GDP grew by 9.2% which is a lot compared to U.S. GDP which over the last 5 years grew an average of 2.5% per year. As you can see in the chart, China’s GDP growth has now declined to 7%. So it’s not breaking news that the Chinese economy is slowing but what sparked the sell off in the third quarter is the markets perception of the accuracy of the GDP data being reported by China. Based on other economic indicators it would seem that the GDP numbers in China could be much worse than they are reporting.
One of the barometers that we use to gauge the trend of consumer spending is vehicle sales. History has shown us when consumers are healthy and growing, people stop fixing their old cars and just go buy new ones because they have the financial security to do so.

When we look at the chart below which shows the vehicles sales in China, there has been a dramatic slow down in their domestic car sales at a magnitude larger than what their GDP numbers would suggest. Vehicle sales peaked toward the end of 2014 at approximately 22 million cars and have since dropped to an annualized rate of 18.8 million cars as of August 2015.

In addition, the housing market in China is also slowing. China measures their residential housing market by amount of residential floor space added. Their index of “construction of private residential floor space” was down 18.2% year over year as of August 2015*. The housing sector represents a large portion of China’s overall economy.

China relies more heavily on their exports to drive economic growth which are also down 5.5% year over year as of August*. China’s exports represent 22.6% of their GDP compared to the U.S. which exports only account for 9.3% of GDP*.

When we group all of these macroeconomic indicators together, even though China is reporting a GDP of 7%, we believe their actual GDP may be under 5% which is a dramatic difference.

Often times when the market feels like it is receiving inaccurate or manipulated economic data, by default it will automatically assume the worst which we believe led to the market correction in the 3rd quarter. Good or bad the market just wants data that it can rely on. China really needs to improve their economic reporting if they want to avoid the recent market events from repeating themselves in the future.

With all of that said, we feel investors should not overreact to China. In our view, China is not collapsing. They still have tools at their disposal that they could use to initiate growth in their economy. China has room to decrease interest rates and reserve rates from their current levels. They also have a war chest of capital reserves that could be used to help spur growth via infrastructure spending and other projects. It seems that China’s leaders are reluctant to pour too much stimulus into their economy because they are currently transitioning from a manufacturing based economy to a consumer driven economy and they do not want too much excess in the system as they make that important transition.

It’s also important to keep China in context from our perspective in the United States. The U.S. receives less than 1% of its GDP from exports to China so China’s economy slowing does not have a material impact on our economic growth*. The same goes for the Eurozone which is the other large global economy. The Eurozone receives less than 1.5% of their GDP from exports to China*. Thus, in our view a slowdown in China alone is not enough to derail the recovery of the world’s two largest developed economies.

The emerging market economies are a different story. Russia, Brazil, and Korea’s exports to China represent a much larger percent of their GDP. See the chart below. The slowdown in China has had a much greater negative impact on those economies which is reflected in the emerging market stock index (MSCI EME) which is down 15.2% YTD as of September 30th*.

![Exports as a % of GDP](chart.png)

The next item that we identified as a catalyst for the recent market volatility is U.S. trade. More specifically the affects of the rapid rise in the value of the U.S. dollar versus other currencies around the world which has hurt U.S. exports.

If the value of the dollar is rising, when U.S. companies go to sell their goods outside of the U.S. their currency buys less of our U.S. dollars which makes those goods more expensive for consumers to purchase outside the U.S. That in turn decreases demand for U.S. goods around the globe which in turn has a negative impact on our GDP. Per the chart below you will see that the value of the dollar has risen dramatically over the past 18 months.

The value of the dollar is up 17% year over year as of September 30th*. This alone could decrease our GDP by as much as 1% which is a lot considering the U.S. economy has only been growing by 2.5% on average per year*.

The good news is we view this dramatic increase in the value of the dollar as temporary. So what was a headwind for the economy of most of 2015 should be less of a headwind going into 2016.

The third item is an increase in the level of U.S. manufactured goods inventories which is largely a result of the weakness in exports. U.S. multinational companies have been increasing output over the past 9 months because they are anticipating that consumer spending in going to pick up. So going into the 3rd quarter companies had a lot of inventory. Due to the decrease in the value of the dollar, demand has been weaker than expected so U.S. companies have been selling out of their inventory over the past 3 months which in turn slows production and puts downward pressure on the labor markets.

We also see higher inventory levels as just a temporary headwind. We are already starting to see U.S. companies decrease their levels of inventory which will give rise to more production as long as consumption remains strong. See below a chart of U.S. Manufacturing and Trade Inventories.

At this point we have presented our analysis of what happened to the marketing in the 3rd quarter but we also want to provide our clients with our expectations for the U.S. economy over the next 12 months.

Given the temporary nature of the weakness in exports and higher inventory levels that have hurt the U.S. economy in 2015, our analysis suggests that once those headwinds subside the U.S. economy has the potential to grow at a faster pace in 2016.
We have to remember that the U.S. is a consumer driven economy. Two of our main barometers of the health of the U.S. consumer is vehicle sales and housing starts. Both of these indicators have remained strong in the U.S. despite the poor economic data coming out of the China. The 3rd quarter was one of the best quarters for vehicle sales since 2007. Consumer spending grew by 3.5% in the 2nd quarter and we anticipate it to grow by more than 3% in the 3rd quarter.

The Federal Reserve has also provided the U.S. economy with more breathing room with their decision not to increase the Fed Funds Rate in September. The decision not to hike rates in September was a bit of a surprise. Language from the FOMC minutes suggests that the Fed remains concerned with the impact of slowing global growth and the structural issues with our labor markets. With inflation nowhere to be seen, the Fed seems to be in no hurry to raise rates.

Sincerely

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