While most Americans, Europeans and many people in finance were enjoying their annual break from the intensity of their jobs, the world seemed to change in the middle of August. The Chinese revalued the renminbi by 2% and suddenly everyone began to wonder whether its miracle of growth, which brought that country to account for 10% of global Gross Domestic Product (GDP) and at least a third of the world’s annual growth, was coming to an end. Emerging market equities and their currencies declined and their economies entered recessions. Developed country equity markets had their first 10%-plus “correction” since 2011. The complacent and/or resigned belief that Europe and the United States were in a period of slow growth with small but positive earnings increases and tame inflation was being questioned. What was supposed to be a period of relaxation and preparation for the hard work at year-end became a time of anxiousness. By Labor Day in America, you could sense the tense nerves behind the smiles at social gatherings.

So is this an overreaction or not? Starting in China, the fear of that country experiencing a hard landing appears to be overdone. China has clearly stated its objective of shifting the components of growth from infrastructure and investment in state-owned enterprises toward the consumer. In doing so, its need for raw materials has necessarily declined and this has caused concern. Strategas Research has run regression analyses of eighteen indicators ranging from exports to retail sales and concluded that estimates of real growth of 7% are not too far off the mark. I believe that may turn out to be too optimistic, but it certainly challenges the view that a hard landing (real growth of less than 4%) in China is facing us. There are other analytical studies that share this view, whereas the negative assessments of the slowdown in the Chinese economy seem to be more subjective.

Recent data on manufacturing for China’s major trading partners – Australia, Korea and Japan – showed improvement, although China’s data on manufacturing contracted. Information from Blackstone’s shopping malls in China supports the view that the consumer there is still spending at a reasonable rate. Nike’s China sales were strong in the second quarter. Even if the economic situation in China is worse than I think, the policy makers have the tools to deal with the problem. The country has over $3 trillion in reserves and the willingness to use those resources to keep the economy growing at better than 4%. The leadership is also aware that the political implications of a sharp slowdown, with reduced job creation, could be severe and very challenging to the government.

If China’s slowing were less dramatic than widely expected, the implications could be significant, according to the Strategas study. Policymakers everywhere could slow down their stimulative monetary
accommodation. There would be fewer cases of competitive currency devaluations; the dollar would be less likely to appreciate, giving the Federal Reserve some slack so that its tightening decision could be based on domestic economic factors; and commodity prices could stabilize. In any case, China makes up only a small part of the market for U.S. exports, and a slowdown there is not likely to have a major negative impact on our growth.

Back in the United States, the data describes a mixed, but not dire, view of the economy. Retail sales were up .2% in August compared to July but lower than the .3% median forecast. Industrial production was down .4% in August, below the negative .2% median forecast, and capacity utilization was slightly below the median forecast. This has been the pattern of recent months: softness but not a recession. The economy is still on a path toward better than 2% real GDP growth. Remember, the second quarter surprised everyone with real growth of 3.7% (now revised to 3.9%). The September decision by the Federal Reserve to refrain from raising short-term interest rates reflects the weak recent data on the U.S. economy as well as the uncertainties abroad. If the Fed tightened and markets around the world went into a sharp decline, the Fed would be blamed for it. If the markets declined as they have without a change in Fed policy, the Fed would be able to claim its position was a neutral factor. In the current situation, the failure to raise rates was interpreted as a negative opinion on the U.S. economic outlook. Janet Yellen would have liked to “normalize” rates, but she felt the markets were too vulnerable for a move now, and the market has read her prudence as pessimism. Going back to 1953, the market has never peaked until after the Fed has begun raising interest rates, and on average the high is reached 30 months after the first increase in rates, according to Omega Advisors.

What hit the stock market in August was the concern that the slowdown in China and the emerging markets (together accounting for 40% of world GDP) would cause recessions in the developed economies of the United States, Europe and Japan. Usually the stock markets top out ahead of recessions, but the current weakness in the developed economies has occurred when the markets were near all-time highs. Before pronouncing that the August decline is predicting a recession in Europe and the United States, a number of reliable developed economic indicators would have to change quickly.

Omega Advisors has prepared a useful list of recession warning signs. Before a recession, inflation is usually increasing, giving the Federal Reserve a reason to raise short-term interest rates. Right now, inflation is stable and below target. In anticipation of a recession, the yield curve would be inverted; it is reasonably steep now. Inventories are above average and increasing in the period prior to a recession; that is not the case now. Employment is declining prior to a recession; it is increasing now. Wages are increasing more than 3.5% annually; the current increase is closer to 2%. Some indicators have started to turn negative, however. A recent University of Michigan survey showed a sharp decline in consumer confidence. Equity markets have been soft recently while industrial production is declining, but most of the warning signs support the view that a recession is not imminent. In spite of its longevity, it looks like the current economic expansion is going to continue for a while. This economic expansion is about 76 months old; the average since 1953 is 60 months, according to Omega Advisors. Since 1949 the stock market has served as a predictor of a coming recession by beginning a major decline an average of 7.4 months before the start of the recession, so the current sell-off would have to be more than a temporary “correction” for a recession to be on the way.

One factor that does worry me somewhat is the cessation of monetary expansion by the Federal
Reserve last October. The Fed had expanded its balance sheet from $1 trillion in 2008 to $4.5 trillion in 2014 and stopped buying bonds in the fourth quarter of last year. That is when the broad U.S. stock market began to run into trouble. This raises the question of whether the rise in U.S. equities over the past six years was driven by fundamental earnings improvement or liquidity provided by the central bank. The answer is that both played a role, which is not good news for stocks if Fed accommodation is over.

Without the liquidity driver, the equity market is dependent on earnings, because multiple expansion is less likely. So far this year, according to Bianco Research, earnings for the Standard & Poor’s 500 have been disappointing. For the second quarter, earnings for all companies in the index are expected to be down about 2%. If you exclude the energy sector, earnings would be up 4.5%. The appreciation of the dollar is another factor holding back earnings comparisons. For the full year, earnings are expected to be down about 1% compared with 2014. Excluding energy, they are expected to be up about 7%. Estimates for S&P 500 earnings are about $118 for 2015 and $125 for 2016. At the current level of 1907, the S&P 500 is selling at 16.2 times this year’s earnings and 15.3 times 2016 earnings. The historical median multiple on trailing earnings is 16.3, so while the market may have been somewhat overvalued before the August correction began, it seems more fairly priced now, but still not cheap.

At the beginning of the year investor sentiment was extremely optimistic. I was positive on the full-year outlook but knew that the S&P 500 was unlikely to make major progress when investors were so bullish. The major moves come when investors are pessimistic, or at least skeptical. I knew the market was vulnerable and that a correction of over 10% would turn sentiment from near-euphoric to cautious, but had no idea of what the catalyst that would change the mood would be. The Ned Davis Crowd Sentiment Poll uses a combination of technical (e.g., the put/call ratio) and opinion data to measure investor attitudes. The reading was 73.3 at the beginning of the year, near a 12-year high. Anything above 62 is in optimistic territory. The latest reading is 48.2, well into pessimistic territory, which starts at about 55. The current reading is not yet extreme. The last significant low was almost five years ago (in conjunction with the last 10% correction) at 38.4 and the 2009 low, marking the end of that bear market, was at 30.9. Based on these technical measures the market could rally, but there might be a retest at lower levels. We are definitely in bottoming territory and some stocks are undoubtedly attractive here, particularly if a recession were unlikely.

>From a fundamental point of view, knowing what forces can drive the market forward is important. Based on what’s happening around the world, exports are not likely to be a major positive factor. Capital spending should also prove to be a weak part of the outlook. We know that oil and gas producers have seriously cut back on a number of projects. With operating rates at 77%, there is little reason for anyone to build a new plant, even though the average age of American private sector capital equipment is 22 years, making it the oldest on record. The one area that does stand out as a positive driving force is housing. Starts exceeded two million in 2005 before they collapsed with the subprime mortgage crisis. At the low starts were just over 500,000. Now they have climbed back above one million. New home sales are trending higher, and existing home sales have recently experienced a sharp upturn. Employment has been improving for those in the 25–34 age bracket, the primary period for family formations, so we should expect to see better numbers for the housing sector, even though some recent housing data has been soft. The
question is whether that boost will be sufficient to offset weakness elsewhere in the economy. Another area that looks good is consumer discretionary spending. Average hourly earnings increases have improved to 2.2% year-over-year and the unemployment rate is down to 5.1%, placing consumers, who account for 71% of GDP, in a position to spend. The year-over-year drop in gasoline prices should also help consumer spending. Because it usually takes a year after the gasoline price drop before the economy reflects the benefits in consumer spending, we should start to see the impact about now.

Abroad, the fundamental outlook seems to be improving. Central banks in Europe and Japan are providing liquidity. Real GDP in Japan was .8% in the second quarter and 1.5% in Europe, but exports were down in August in Japan and the refugee crisis in Europe could create economic problems there. Industrial production in both regions has been flat this year. Nominal retail sales surged recently to 1.9% in Japan and real retail sales were up 1.3% in Europe. Housing starts rose in Japan and have been trending higher in Germany, but they were weak in France. Unemployment data looks favorable in Japan, Germany and the United Kingdom, but is at 10% in France. Germany and Japan are running trade surpluses, but France and the United Kingdom are running deficits. Inflation is not a problem anywhere and wages do not appear to be accelerating. We don’t know yet what impact the Volkswagen scandal will have on Germany and the rest of Europe. Overall, my assessment is that the economies of the major developed economies still have positive outlooks. Maybe this is all about to change, but, for now, the markets seem to be overreacting to what may turn out to be only a moderate slowdown in China.

Sorting through all these crosscurrents, I still believe the data will show that the U.S. economy in the second half of 2015 will exceed the growth shown in the first half and that 2016 will be another year in the 2%–3% real growth range. At the beginning of the year I thought the S&P 500 could end 2015 with double-digit appreciation and, while that may prove to be too optimistic, I still believe the index will show a gain for the year. Throughout 2015 I have thought that earnings would be disappointing as a result of weak oil prices and the strong dollar, but I still expected a slight increase. Earnings for 2016 will improve about 5% from operations and share buybacks with dividends adding another 2%, for a total return of 7%. I do not expect any multiple expansion over the next year.

I am aware of the numerous serious long-term problems facing the world. These include huge sovereign debt obligations, margins peaking, increasing pressure on middle class workers (both blue and white collar) caused by technology and globalization, decaying infrastructure, rising social welfare costs, geopolitical conflicts, Middle East uncertainty and a dysfunctional government in Washington. All of these factors should weigh on multiples over time, but they do not turn me bearish. I recognize the best recent period for investing in equities may have been 1982–1999, but I still think reasonable risk-adjusted returns for equities are likely in the years ahead, and that Treasurys and high-quality corporate bonds are less attractive.

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