Asset Management

News or Noise: Markets Get Off to a Wild Start in 2016

By David Fisher, Chief Investment Officer

After a relatively muted period of news and market activity, things got off to a wild start in 2016. To begin this week's report, we touch on the unusual performance of major asset classes in 2015. But we quickly shift gears, covering areas of investor interest in 2016. We recognize that both China and the Middle East are areas of risk and, as such, have the potential to create newsworthy events. In this case, we believe the potential for serious developments exists in Saudi Arabia. However, even though the stories of a 7% drop in China's stock markets on the first day of trading in 2016 are shocking, when looking a little deeper, the move is probably transitory.

No. 1: Markets Violently Flat in 2015

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Markets were *violently flat* in 2015. The major indexes actually posted slight losses excluding dividends—the first time since 2008. However, with dividends, the S&P 500 and Dow achieved small gains (a little over 1%). One report we saw even claimed that 2015 was the "hardest year to make money in 78 years." Though that is a stretch, in our opinion, the fact is that no major market produced outsized gains. Even in 2008, with so many markets down, there were diversifying assets that helped offset those losses, such as Treasury bonds, which posted double-digit gains that year.

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For 2015, the best major asset class was core equities, yet even here the gains were low single digits. Most other major asset classes ended at or slightly below zero, such as U.S. bonds and international stocks. Commodities were the big losers for 2015, with broad indexes covering energy, metals and agriculture posting declines of as much as 30%. The year also showed that many of today's best managers and asset allocators are struggling. Even investing greats like Warren Buffett, David Einhorn and Bill Ackman had very tough years. The U.S. dollar and FANG

(Facebook, Amazon, Netflix, Google) stocks were about the only place to put money and earn more than low single-digit gains.

What does a flat market say about the upcoming year? In previous cases when markets have posted low single-digit results, the markets often have shown positive performance the following year. Though history is limited to just over a handful of cases, the average return was better than 10% and there were no years with major loss. In the end, the flatness of 2015 has eroded a lot of investor confidence and left conventional wisdom relatively cautious. This could be the kind of environment for upside surprises.

No. 2: Multiple Concerns over Saudi Arabia

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With energy prices staying "lower for longer," the economic challenges facing Saudi Arabia are growing. In fact, we would argue that a political or economic crisis in the country is probably one of the bigger "black swan" risks for 2016. The nation released 2016 budget plans and projected a deficit of almost 15% of gross domestic product. The budget assumes that oil will be around current levels during the year and that the country will export about 7 million barrels per day. Saudi Arabia is highly dependent on oil sales, which last year accounted for 90% of state revenues. The large deficit comes even after policymakers are reducing spending by nearly 14%. The expense cuts will come in the form of reduced fuel subsidies and new taxes on cigarettes.

Facing war in Yemen and other military uncertainties, the nation also has the relatively untested leadership of King Salman. Compounding these challenges, the country found itself in a political dispute with Iran over the execution of a Shiite cleric over the weekend. Major protests erupted in Iran, and by Sunday evening Saudi Arabia had cut off diplomatic ties with Iran. We can't forget that the leadership in Saudi Arabia managed to maintain relative calm in the Arab Spring revolutions of 2011. It may very well be able to maintain calm again this year, but the story still deserves attention as we start 2016.

No. 3: China's Markets Start Year with a Bang

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Stock markets in China started the year with a bang by losing 7% and forcing a halt to trading before the session expired. The initial headlines all pointed to a weak purchasing manager index as the trigger. December data showed nearly flat manufacturing with an index reading of 49.7, close to the three-year low of 49.6 registered in November. However, a broader view of the economic data in China is showing stabilization. Included in Monday's data was a 16-month high for the non-manufacturing PMI to 54.4.

Looking for other sources of the volatility, one could turn to the unwinding of some policies implemented last summer. Specifically, a six-month ban on sales by institutional investors is set to expire this week, and some speculated that the selling on Monday was due to investors getting ahead of a likely rush to sell on January 8 when the policy expires.

For now we view this story as transitory and believe that the very weak data will serve as a support when year/year data continues over the coming months. However, China does remain a key risk to global markets in 2016, and data over the next few months will be key to knowing which way the story will break this year.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.