Who Let the Dogs Out?

About

This 2016 annual newsletter has been prepared for advisory clients and friends of **ADK | Wealthcare Partners**.

Independent global sourcing from an assortment of distinguished and reputable sources drive the underlying perspectives.

I take full responsibility for the content and hope you find the material helpful and refreshingly candid.

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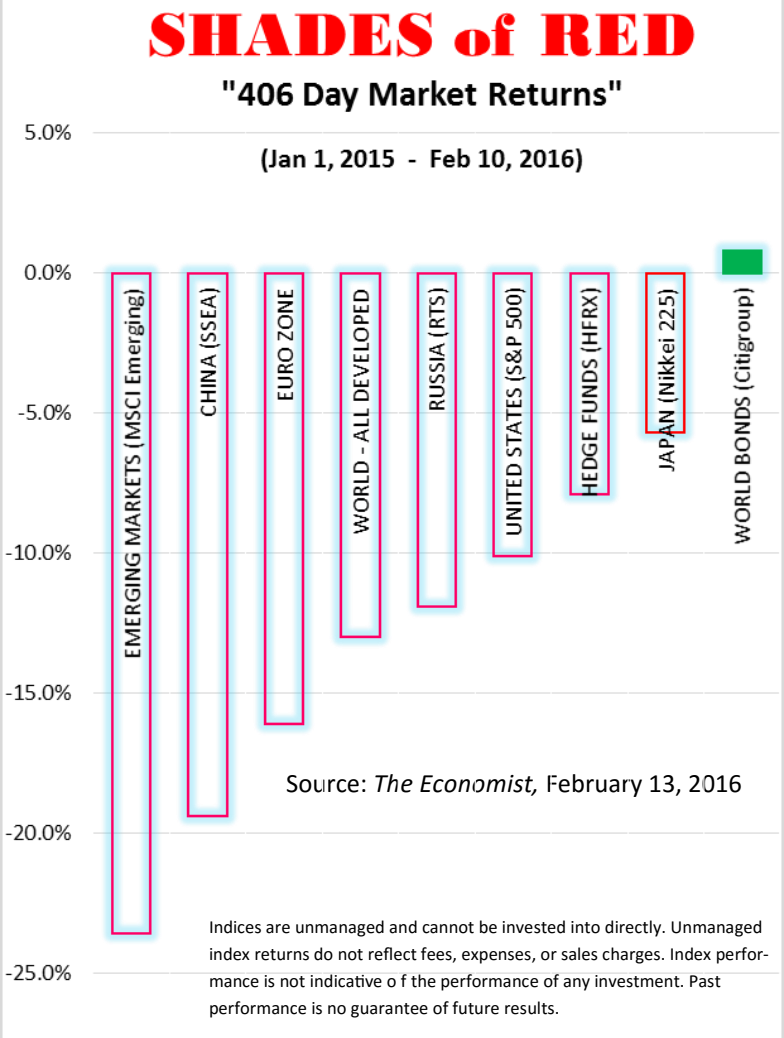
"Houston, we have a problem"

Just about the time when prognostica-tive ink was beginning to dry, financial markets greeted January with declines that few anticipated.

Not-so-confident forecasters quickly returned to the drawing board and reduced their expectations for the year. Pessimists viewed the reversals as recessionary omens, or worse. Oth-ers felt that a correction was overdue, but differed as to its potential depth and breadth. As is customary when markets turn, there was no shortage of opinions and context was generally lacking. Paul Samuelson [an esteemed economist, now deceased] famously noted in 1966, "The stock market has forecast nine of the last five reces-sions." [i]

Economic recovery from the 'Great Contraction' of 2008-2009 has been slow going and is expected to remain so for years to come. With less support from the Fed (U.S. central bank) and China showing signs of sluggishness, short-term drivers of incremental asset demand are now in short supply. **Fi-nancial markets are adjusting to the realities of low economic growth, downward pressure on profit margins, price/earnings multiple resistance (ratio of price-to-earnings), and a more hostile geopolitical environment to work within.**



Larry Summers [Harvard economist and former secretary of the Treasury] uses the concept of secular stagna-tion — too much savings and not enough in-vestment — to define present economic times. [ii] Demographics, excessive debt accu-mulation and unsound regulatory policies also combine to hamper robust economic growth throughout much of the world.

In my view, the recent price declines [reference **Shades of Red** graph] were healthy adjustments to an over-hyped mar-ket. Additional downside would not neces-sarily signify economic danger. Working your way out of a global financial crisis with a lot of leverage, is difficult to achieve. [iii, iv]

In a global financial crisis, output, trade, equi-ty prices, and other indicators typically be-have much the same way for the world ag-gregates as they do in individual countries. [v] As such, we should not be surprised when global markets trend in the same direction on similar information. Healing should continue, but potential perils remain.

The U.S. still enjoys many legacy-related ad-vantages over much of the world. **A recession is not expected to envelop our country this year**, however energy-oriented states will face localized recessionary pressures.

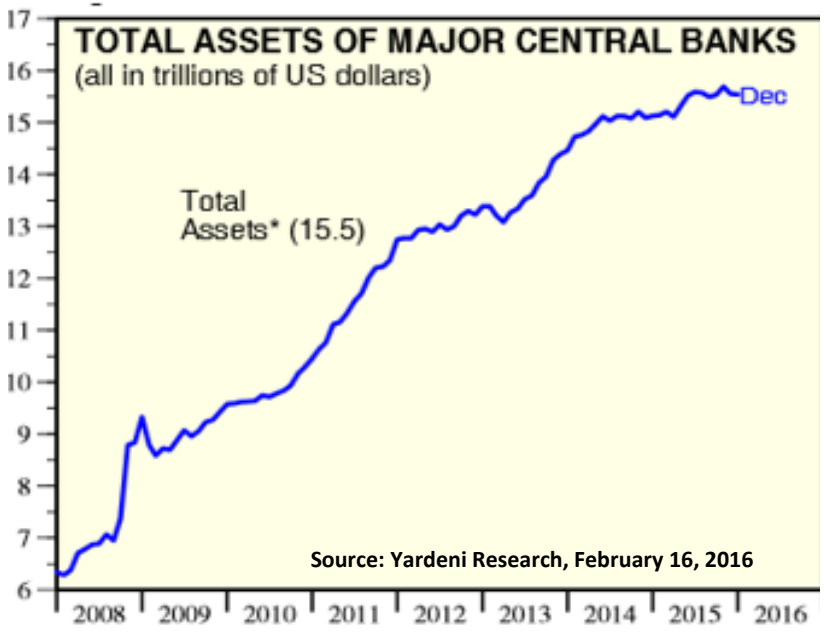
Ponzis among us

Ponzi schemes abound in China. Between 2007 and 2008 the founder of the great ant-farm scam stole $400m from investors in the supposed health benefits of the insects before he was arrested and sentenced to death. [vi]

Ezubao, a peer-to-peer (P2P) lender in China, represents an even larger case of Ponzi schemes in China. When finally uncovered, over 900,000 investors had lost about $7.6 billion (50 billion yuan) between them. Later on, about a third of the 3,600 P2P sites were classified as "problematic" by the China Banking Regulatory Commission at the end of 2015.[vii]

Poor regulation contributed to the problems that China is now dealing with. On a much larger scale, central banks can be viewed in a similar light although their intentions do not revolve around self-enrichment.

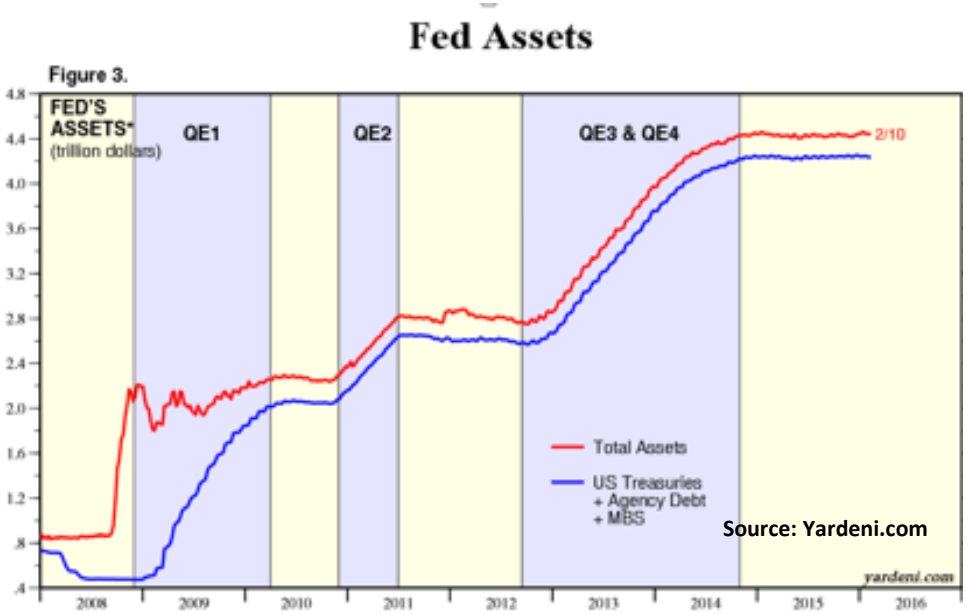
Nothing is wrong with debt, as long as the debt is invested to foster additional economic growth or a means to generate higher future income streams. However, rapidly rising debt-to-GDP levels



are a sign of the growing share of what the late economist Hyman Minsky termed "Ponzi financing" in the global economy. [viii] And debt-to-GDP ratios have continued to rise since 2008. (Please see pg 5.)

With Ponzi financing, the debtor does not have enough cash flow to cover either the principal or the interest. While hoping that the asset will rise faster in value than the total financing cost, he or she must borrow more to service the debt. The ultimate goal is to be "bailed out" by selling the asset to the next buyer. Today the developed world looks for a "next buyer" to take over its excessive debt load. Unfortunately, there is no such buyer in sight. [ix]

As was the case with the P2P lenders, this form of Ponzi scheme will have to be unwound sooner or later. **Until meaningful rebasing takes place, we are apt to experience abnormally low interest rates, misallocations of capital, and economic instability.** [x]



The Good, the Bad, and the Ugly— China, Iran, ISIS and Excessive Debt

Since the 1980s China has experienced one of the greatest economic booms ever witnessed. With annual GDP at $10 trillion, they have quickly become the second largest economy in the world. Situated as the world's largest exporter, and one of the largest importers, what happens in China now affects the rest of the world. However growing pains are surfacing and the world is bracing for change.

China has some of the dirtiest water in the world. Eighty percent is unusable for drinking, washing, and agricultural purposes. [xi]

The people are rebelling and the government has to do something about it. [xii]

China is also growing more slowly than it admits. Recently the country represented nearly 50% of global demand for copper, steel, and aluminum, and 70% of demand for coal. But they are buying less today and commodities are falling accordingly. [xiii] The collapse in commodities prices and sales volumes is still feeding through the system in ways that we probably don't fully understand. [xiv] Although China's current account is probably running a surplus of $300 billion or so, its *capital account is running a deficit of roughly $1 trillion*. [xv] In other words, a lot of money is leaving China despite the fact that it still sells more than it buys. This phenomenon is both disturbing and perplexing.

The country's foreign-exchange reserves fell to $3.3 trillion last year from $4 trillion. If money continues to leave the country at the current rate, China's foreign-exchange reserves would quickly diminish. To prevent this from happening, **China eventually will stop intervening in the currency markets to prop up the value of its currency, the yuan, and let it fall.** [xvi] A 20% devaluation in the yuan could easily occur. China is a little late to the devaluation game among its exporting competitors, but a devaluation of this magnitude could become deflationary in nature as other countries would follow. This could lead to both regional and systemic problems if not contained. China's prominence is akin to the U.S. housing market in the last cycle, so negative developments in Asia could lead to another bout of market volatility and, depending on the nature of the problem, a global recession.

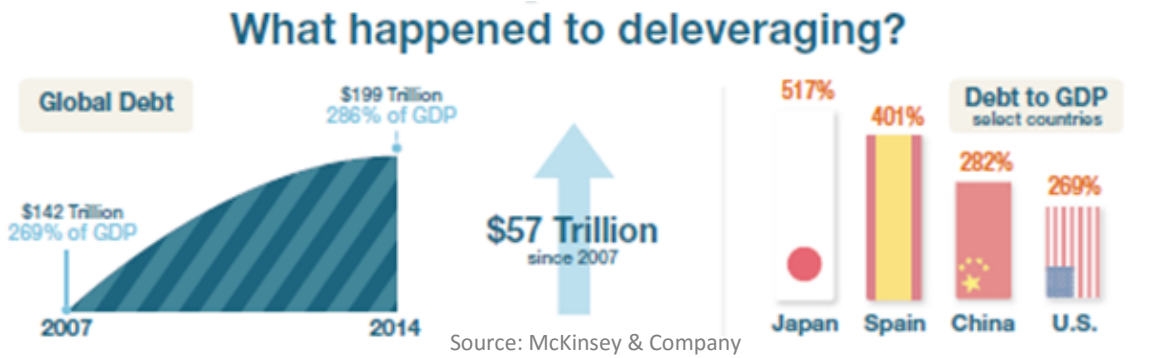
China has a major balance-of-payment crisis which most experts don't understand. And China's currency is likely heading south. [xvii] Nevertheless, China is moving to a more sustainable economic model and has the means to transition successfully.

China is working to push forward significant economic reforms, which include reducing industrial overcapacity and merging key state industries. To do that it is clearing possible opposition from within state agencies and securing control of the media to manage the narrative and maintain public support. An anti-corruption campaign by President Xi Jinping will help to ensure that the news media demonstrates absolute loyalty to the Party and Xi himself. [xviii]

How this plays out will heavily impact emerging markets in Northeast Asia and Latin America in particular – as they are heavily reliant on China as subcontractors and suppliers respectively.

Rebalancing toward a consumer and services model from an industrialized model may not be going as smoothly as hoped, but this is no small undertaking. China is not going away and economic rumblings are to be expected along their journey.

Source: Jerusalem Post



Source: McKinsey & Company

Turning our attention to the 'bad and ugly' elements of this segment, the news is less encouraging. Some of the economic smooth sailing we have enjoyed over the past seven years may become more turbulent in the near future due to geopolitical rumblings.

Relative to the incremental demand that China and central banks have provided the global economy post-crisis, new sources are needed. Moreover, both luck and skill will be required in order for central bankers to slowly release air from the various bubbles they have created. Unfortunately the luck quotient may be diminishing for a number of reasons.

Iran and ISIS are nation states whose senior leaders are driven by apocalyptic beliefs involving world conquest and the destruction of the U.S. and West. As they expand geographically and their weaponry becomes more capable, talk may give way to action on a larger scale. Modern-day borders of the Middle East are falling apart. The bad guys will strive to expand their mischief until defeated. These are clearly threats to the western way of life. Perhaps an equally menacing threat has to do with something of our own making in the form of excessive debt. In the aftermath of the recent financial crisis, almost all countries have increased their overall debt loads. There has been some re-shuffling, but the fact is that deleveraging has not occurred as a whole. God help us if interest rates begin to rise.

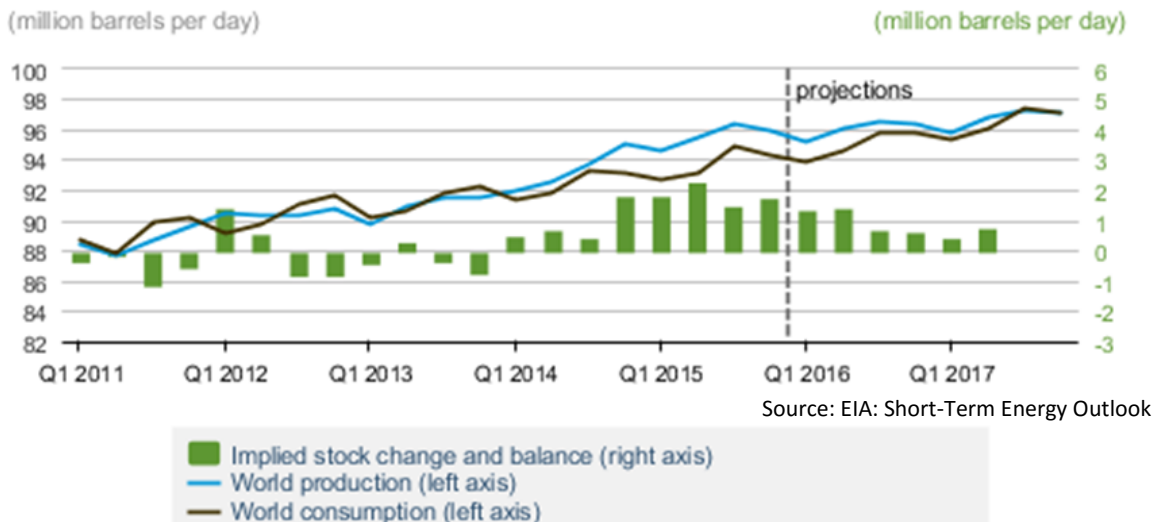
Many participants in the global financial system often dig a debt hole far larger than they can reasonably expect to escape from, most famously the United States and its financial system in the late 2000s. Government and government-guaranteed debt is certainly the most problematic, for it can accumulate massively and for long periods of time without being put in check by markets, especially where regulation prevents them from effectively doing so. Although private debt certainly plays a key role in many crises, government debt is far more often the unifying problem across the wide range of financial crises we examine. [xix] And government debt is growing.

Countries committed to democracy and the market economy (OECD countries) are among the worst offenders. Japan, Greece, Italy, Portugal, Ireland, France, Spain, Euro Area, and the United States all have ratios of Public Debt-to-GDP that exceed 100%. Ranges in the neighborhood of 65% - 90% are often viewed my academics as being detrimental to economic growth.

The point in bringing these various themes to light — China, Iran, ISIS and excessive debt— is to remind readers that some of the support mechanisms and covering we have enjoyed over the past several years are waning. The introduction of negative rates by various central bankers is not a sign of systemic strength. Unfortunately, some of the key challenges at hand are not being discussed or addressed. [xx] **Consequently, secular stagnation will linger for longer and normalized interest rates [interest rates above the rate of inflation with structures common before the financial crisis] are unlikely to materialize anytime soon.**

Risk management and investment considerations will be addressed during advisory account reviews.

Too Much of a Good Thing



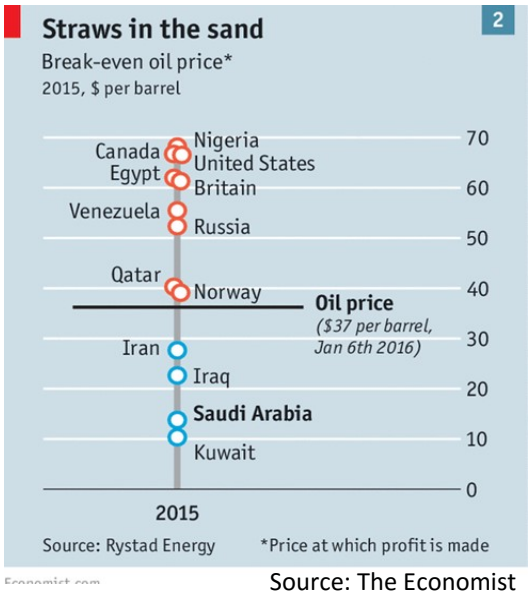
Source: EIA: Short-Term Energy Outlook

Sudden surges in the price of oil can cause economic havoc. The first modern 'oil shock' occurred in 1973 when an assortment of Arab countries initiated an oil embargo. Over a five month period the price of oil rose from $3 per barrel to nearly $12 globally which had negative effects on global politics and the global economy. [xxi] Conversely, when prices have slumped because of a glut, it has served to benefit the world.

Having fallen around 70% over the past 19 months, the benefits are less certain. Perhaps the benefits of ultra-cheap oil still outweigh the costs, but markets have fallen so far so fast that even this is no longer clear. [xxii] A world of winners and losers has quickly emerged leading to piercing economic recalibrations.

Japan, India and China, for example, benefit from low oil prices. Oil-dependent countries, on the other hand, are compelled to make difficult economic decisions. Russia and Saudi Arabia have responded forcefully to price declines, and their leadership will strongly influence the trajectory of oil prices going forward.

EIA projections indicate that demand and supply is likely to keep a lid on oil prices in 2016, however tensions in the Mideast could nudge prices higher. Vladimir Putin also has leverage to influence prices militarily if he chooses. OPEC could 'talk' prices up for a time as well. Given the break-even prices for oil among major producers, and fiscal breakeven prices for oil producing countries—such as $100 in Saudi Arabia [xxiii] —there is a likelihood that oil prices will gravitate higher as the year unfolds due to geopolitical forces. This is not altogether bad. **Moderately higher oil prices could take some pressure off the financial system without crimping a slow motion global economic recovery. This is a likely scenario.**



Source: The Economist

Prominent Voices

The developed economies have had a disappointing recovery since the financial crisis, but the emerging economies had a big boom until a few years ago. That boom went bust in 2012-'13. Now we are in a down cycle that will end with crisis and calamity. China's troubled economy is to the global financial market what the U.S. housing market was in the prior cycle. Many people don't understand this. While the U.S. is widely analyzed, China often is misunderstood, as the economic data published by the Chinese government are of poor quality.

In the past 12 months, China tried to reignite its economy. Debt has risen dramatically, to more than twice gross national product, with almost no impact on the real economy. China has reported annual growth of nearly 7%, but the industrial complex is in a recession, and I estimate the service sector is growing by only 4% a year. In reality, then, growth is probably around 2% and slowing. [xxiv]

- Felix Zulauf [Jan 25, 2016]

The sharp fall in share prices last week [early January] was a reminder of the vulnerabilities crated by years of unconventional monetary policy. While chaos in the Chinese stock market may have been the triggering event, it was inevitable that the artificially high prices of U.S. stocks would eventually decline. Even after last week's market fall, the S&P 500 stock index remains 30% above its historical average. There is no reason to think the correction is finished.

The overpriced share values are a direct result of the Federal Reserve's quantitative easing (QE) policy. . . . Chairman Ben Bernanke explained on several occasions that the Fed's actions were intended to drive up asset prices, thereby increasing household wealth and consumer spending.

. . . There is no doubt that many assets are overpriced, and as the Fed normalizes interest rates these prices will fall. It is difficult to know if this will cause widespread financial and economic declines like those seen in 2008. But the persistence of very low interest rates contributes to that systemic risk and to the possibility of economic instability. [xxv]

- Martin Feldstein [Jan 13, 2016]

The overriding problem for the equity market remains one of valuation – not that we are in bubble territory, but more that the stock market is still quite expensive.

The price action of 2015 failed to resolve one thing, which was to correct the excess valuations that held back the market last year as it likely will this year too. . .

The problem is that we do not have the clarity, certainty or visibility across the globe, whether it comes to policy, oil prices, regional conflicts or China, to warrant multiples being this far above the norm, if at all.

So, 2016 is likely going to be a year of transition and one where uncertainty is going to dominate the macro and investing landscape. .

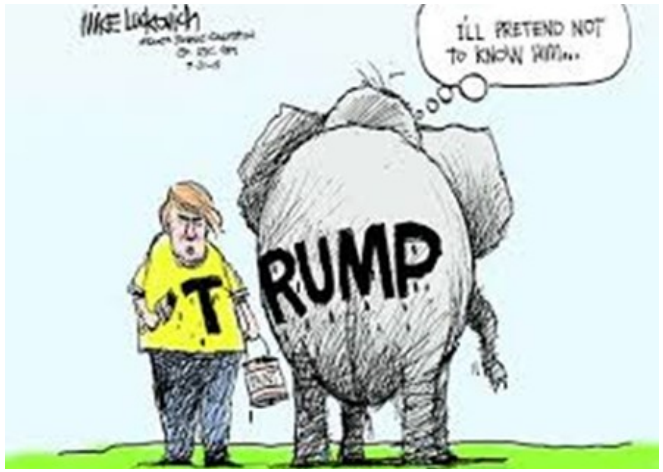
While I am not personally bearish on the [Chinese] economy, it remains a "show me" situation and many pundits are becoming concerned over possible capital flight from any additional yuan devaluation. . .

As for the [U.S.] economy, I think we will be just fine, and there will be more of the "neither boom nor bust" cycle. [xxvi]

- David Rosenberg [Jan 14, 2016]

Advisory clients will find a discussion outline and account metric reports provided with this newsletter. I will review this material with you soon in order to help you better understand how we are managing your resources and responding to these unique and challenging times.

Thank you for your business and the opportunity to assist with your endeavors. Please let us know how we can better serve you and others.



They sow the wind,

And reap the whirlwind.

The stalk has no bud;

It shall never produce meal.

If it should produce,

Aliens would swallow it up.

— Hosea 8:7

No strategy assures success or protects against loss. The opinions expressed in this material do not necessarily reflect the views of LPL Financial. They are for general information only and are not intended to provide specific advice for any individual. Economic forecasts set forth may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Investing involves risk including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price. Because of its narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies. Quantitative easing is a government monetary policy occasionally used to increase the money by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings. There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Endnotes

[i] Samuelson (1966).
[ii] Cited by Bill Priest, "Barron's Roundtable," Barron's, January 18, 2016, page S6.
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[iv] Carmen Reinhart and Kenneth Rogoff, This Time is Different, (Princeton: Princeton University Press, 2009) Preface.
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[xiii] Jeffrey Gundlach, "Barron's Roundtable," Barron's, January 18, 2016, page S10.
[xiv] William Priest, "Barron's Roundtable," Barron's, January 18, 2016, page S11.
[xv] Felix Zulauf, "Barron's Roundtable," Barron's, January 18, 2016, page S11.
[xvi] Felix Zulauf, "Barron's Roundtable," Barron's, January 25, 2016, page R6.
[xvii] Felix Zulauf, "Barron's Roundtable," Barron's, January 18, 2016, page S10.
[xviii] Stratfor Intelligence, In China, Ulterior Motives in the Fight Against Corruption, February 26, 2016 https://www.stratfor.com/analysis/china-ulterior-motives-fight-against-corruption
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[xxi] 1973 oil crisis. https://en.wikipedia.org/wiki/1973_oil_crisis

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[xxv] Martin Feldstein, "A Federal Reserve Oblivious to Its Effect on Financial Markets," The Wall Street Journal, January 13, 2016, Opinion|Commentary.
[xxvi] David Rosenberg, "What Is Really Bugging the Market," Business Insider, January 14, 2016.
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