DECLARATION OF INTERDEPENDENCE

In Peter Wohlleben’s book *The Secret Life of Trees*, we learn that all in nature is interdependent: Trees in a group are less vulnerable to wind than a single tree, as they receive support from touching one another. Trees can feel pain and have memory, the older trees can help younger ones in their midst, for example an old oak tree can communicate by means of chemical scents with other oak trees if it is suffering from an insect infestation, sending out a signal to other oaks in the vicinity that helps them prepare their system and store compounds to fight off the bugs. It would seem we must admit our fundamental societal and economic interdependence if we are to make the correct judgements in the case of our investments.

Let’s set the scene:

Janet Yellen’s Federal Reserve has embarked on an uncertain path of higher interest rates while the rest of the world is fostering low, near zero, and in some instances, less than zero yields. Yields are low primarily because global growth is weak as a consequence of the 2007-09 credit crisis and from the slowing effects of a debt burden overhang. But there is more. The interdependence of the global economy brings linkages between the weak and the strong; namely, the current weakness in China and its economic rebalancing programs has precipitated weakness to the broader, so called, emerging market countries. Global economic channels spread this weakness to the developed economies. What was once the greatest source of global growth (selling commodities and manufactured goods to China) is now in contraction. In particular, the commodity countries like Brazil, Russia, Australia, Canada, Indonesia and several African nations are selling less, investing less and earning less income with which to buy what they need. Coincidentally, many of these countries borrowed externally in US Dollars during the boom times and are now laboring under the effects of a weakened currency to service the debt. *In the US we are worried about an “infestation” of deflation emanating from the emerging economies.* In charts #1 and #2 below, one can be see graphically the decline in the growth rate of a group of economies that make up close to 40% of global GDP.
The higher interest rates in the US compared to the rest of the world we trade with, boost the Dollar as a currency. This is why the recent hike from the Fed is more than a domestic affair. Weakened currencies and economic contraction in emerging market countries mean fewer imports from US companies. As I have noted before, this is a bigger deal to those corporations than the US economy as a whole. Weaker sales and smaller profits from those sales do not bring the US growth. Slow growth in emerging markets has the effect of keeping debt burdens high and dampening demand for US goods. We are concerned that emerging market weakness stems also from overcapacity built up to supply China during its highly intensive capital investment phase. That phase is over and will not come back to former levels as China is restructuring the enormous percentage of their economy dedicated to investment. This may have to happen more or less quickly as current investment levels are unsustainable and only adds to current overcapacity problems. China’s growth has slowed from over 12% a year to a level thought to be less than 6%. Slow growth means deflation is still the biggest risk. Meanwhile, Japan and Europe continue to struggle.

Against a weak backdrop of global trade we hope our domestically oriented consumption based economy can remain uninfected, or at least not lethally. This seems wishful thinking, however, as there is nowhere to hide. Economic interdependency is systematic. It certainly seems the Fed will be forced to defer further tightening measures lest the US follow in a downtrend to recession.
Investment implications:
Looking at the year to date equity sector returns in the US, there are two sectors that stand out for a reversal in 2016: Industrials and Energy/Materials.

Prices can move to extremes of optimism and pessimism and with it there is a tendency for a reversal when prices are extended. Oil and gas stocks are trading today with a similar lack of confidence as the financial stocks back in 2008-09. Certainly it can pay to be contrary if you bet against the crowd when it has lost sight of facts and is gripped by fear or greed. Is this a time for oil & gas stocks? Perhaps it could be for oil, but less certainly for gas. Natural gas is oversupplied to North America and it will remain so despite ideas for liquefaction and export as the low price means companies can’t afford the capital projects. Oil is different where the price differential between US and world oil supports exports if they are to be permitted. Geopolitical risks can mean supply cuts most any time and current low prices mean high cost producers will leave the business. The fly in the ointment, however, remains weak end-user demand given the weak global picture. Opportunity seems best with buying exploration companies where the exploration risk is small, since the oil has already been located and is only waiting for prices to improve so as to make production profitable. Many smaller companies are selling at distressed prices, some below tangible book value. They can improve from oil price rises and from takeovers.
The industrial manufacturing stocks in the US like MMM, Emerson Electric, Praxair, GE, Rockwell Automation etc. are some of the strongest and best managed companies in the world. Their sales are hurt by the strong Dollar and a slump in emerging markets; many are ‘A’ rated and pay dividends in the 3-5% range. As opposed to many oil and gas stocks, they have positive cash flows supporting their dividends. Price retrenchments of 30% or more is common since mid-2014 and picking the time to buy these stocks will be rewarded with a good yield and the optionality for meaningful price appreciation. We see this as an indirect play on improvement to emerging markets, since it is the sales shortfall from there that has hurt sales most. To time this investment, one would need to believe the US Dollar would not rise much further and to wait for the signal of improvement in emerging market currencies and stock markets. I don’t know if the signal will come in 2016 to position energy or industrials on the buy-list, however each is priced a good distance from long term trends. Figuring out the interdependency with the rest of the world for these sectors will be required to assess timing and risk. Maybe the trees have something to teach us. For now the defensive and domestically-focused sectors and industries continue to hold the upper hand.

J.T. Underwood
Chief Investment Strategist