NOTTINGHAM ADVISORS
ASSET MANAGEMENT

CHICKEN LITTLE HAS HIS DAY

At Nottingham, we work hard to maintain an optimistic outlook on most things financial. After all, owning equity in American businesses has been a pretty good bet over the past 100 years. Likewise, holding the debt of Uncle Sam or Wal-Mart has proven wise these past 30+ years as interest rates have done little but go lower. Periodic bouts of volatility can and should be greeted with an opportunistic mindset, as things usually work out after a while (mean reversion).

As of late, markets have become a bit unsettled as commodity prices collapse and emerging market economies begin to feel the pinch of a strong U.S. Dollar. The statistic making the rounds today (one that's supposed to make us feel better in the face of today's -358 point decline in the Dow) is that it's been 46 months now since we've had a 10%+ correction in equities, the 3rd longest stretch in the history of the S&P 500 Index. Logic suggests that such a correction is inevitable, almost appropriate; emotion thinks logic is an idiot! No one wants to see their portfolio decline – especially after it hasn't really done so in 4 years.

Why is the market falling? The dog days of summer have something to do with it. This is vacation time here in the U.S. and Europe and volatility can get exaggerated when trading desks are thinly staffed. The continued decline in commodities also has something to do with it. Oil is poised to break below $40 per barrel, a price not seen since the dark days of 2008. Metals, led by copper and nickel are fading fast in the wake of declining demand from China. Emerging market economies, long beneficiaries of the commodity boom, are feeling the pain of falling prices and the strong U.S. Dollar. EM currencies are collapsing and inflation is becoming a problem.

On top of all that, the Federal Reserve is thought to be on the verge of raising interest rates for the first time in nearly 10 years. Corporate earnings have been okay, although revenues lagged admittedly diminished expectations. California's drought is worsening; Hollywood divorces are multiplying; and, here in Buffalo, rumor has it the Bills are about to sign a junior college transfer from West Anchorage State College to start at running back after losing their top 5 candidates to injury! In other words, there's a lot to worry about. It's no wonder Chicken Little thinks the sky truly is falling this time.

We admit to being a little concerned, too. Not so much about the Hollywood divorces, nor the Bills running back situation, but the slowdown in China and the ancillary impact that may have on the broader EM countries, may increase the severity of any correction, however temporal. China's economy is clearly slowing, as reflected in its recent move to unpeg its currency the renminbi from the U.S. Dollar, allowing it to fall in value thereby making exports cheaper. The repercussions of this move echoed throughout equity and currency markets, with stocks falling and neighboring EM country currencies declining further. The prospects for a nasty currency war are rising, and currency wars often end in hyperinflation and/or outright default.

Our concerns around China and its slowing economy are tempered somewhat by the decline (okay, *collapse*) that we've seen in commodities. While detrimental, and soon to be fatal, for a number of energy and mining companies, the reality for the U.S. consumer is that goods and services should get cheaper. As consumers save money on gas and airfare, theory has it they'll inject those savings into the economy by traveling more and spending on other goods and services. This hasn't really happened yet as we've seen a spike in the household savings rate; but the rise in consumer discretionary share prices tells us that we're likely to see this phenomenon play out in time.

Corporate earnings, outside of the energy space, have been okay. Not great, but okay. Do they merit a P/E of 17x? Well, unless we see a 3%+ growth rate here in the third quarter, my answer would be "not really". Does this mean we should sell equities? Not really. First off, where would you go? Bond yields are still low, cash yields nothing, real estate has rebounded and offers little value. So, in what could probably be classified as a lousy reason to own stocks, there isn't anything better out there; so my suggestion is to stick with them. (Now that's putting the old CFA charter to work, huh?)

Seriously though, Chicken Little has a right to be alarmed. The recovery from 2008 has been fast and furious and the low hanging fruit has been picked. Future equity and fixed income returns will likely pale in comparison to those of the past 5-6 years. There are dark clouds on the horizon, from China to Greece to the oil patches of the Bakken. The Fed should raise rates in September, but likely won't. The Dollar should stabilize, but will likely go higher. Europe should continue to rebound, as should Japan. U.S. equities will experience renewed volatility, but will remain a viable and necessary bet. Short-term bond yields should rise a bit, while longer-dated bond yields will likely prove stickier.

Eventually, both commodities and emerging markets will prove oversold and offer an enormous opportunity to those brave enough to venture in. Let's hope the "blood in the streets" will be figurative and not literal. We're not sure when that time will be, but I think we're getting closer. In the meantime, we're getting a little more defensive in our portfolios. Although not necessarily "battening down the hatches", we are making sure the windows are partially closed. Things are moving pretty quickly right now so our thoughts may change at any time. We'll do our best to keep you posted though. Keep in mind, risk management is every bit as important as return generation. Our current apprehension could be misplaced; and if so, we may miss out on some available return. But our work suggests otherwise, and we'll do our best to manage through this volatility with a very mindful eye on protecting your capital.

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