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Bubbles in China and Fear in the Media

John Ferguson, Principal

My initial plan for this quarter was to discuss the changes that have been made to social security benefits. However, in the wake of some recent financial events, I feel it would be prudent to address the concerns our clients are having over what's being shown on the news. At the end of this piece I will outline the changes to social security.

China's Economic Woes

Recently, the stock market has been under pressure, in part, due to the uncertainty of the Chinese economies growth-ability. Uncertainty in financial markets is unwelcomed, even feared and leaves some pundits to forecast almost extreme conditions.

This is not a new phenomenon. China is the tail that wags the dog today. Japan was in the same position in the early 1980s. Back then, Japan was our biggest trading partner. The NIKKEI (Japan) index peaked in 1989-90 after rising nearly 200% over the previous five years[1]. In 1989, the market value of land in Japan was estimated to be greater than all the land in the United States[2]. Japan then, is like china today - the big dog in the world's economic game plan.

The NIKKEI bubble-burst of 1990 saw the index fall over 38%[1]. What then followed was double-digit declines in 9 of the next 12 years. Meanwhile, the US markets had a hiccup during 1990, seeing the S&P 500 decline about 20% from top to bottom[3]. This may have been due in small part to Japan, but also because of our own recession. According to experts, Japan's asset bubble was created by a rapid acceleration of asset prices, as well as an uncontrolled money supply and credit expansion[4]. The contraction we are seeing unfold in China today exhibits many of the same qualities. We don't know what will happen to the Chinese economy in the coming years, but we can look at how Japan's decline in the 1990s affected our markets. From Japan's peak in 1990, our S&P 500 index provided a total return of 435% over the next ten years[5]. It would appear that Japan's woes did not have a negative long-term impact on our economy. It is still uncertain what impact the economic turmoil in China will have on our economy, but we don't believe that we are anywhere near a collapse.

Fear in the News

The other side of the coin of this pullback seems to be linked to the fear being perpetuated by the media. As I'm sure many of you are aware, several outlets ran stories that Royal Bank of Scotland has recommended selling everything ahead of certain financial ruin. Despite having an impressive sounding name, Royal Bank of Scotland is a small fish in the world's financial pond. If we look through the news, we can find doomsayers every day. There was a recent article that addresses the role and accuracy of forecasters in financial markets that I'd like to include here. I feel this represents our views on the matter:

2016: Ten Predictions to Count On
Jim Parker, Outside Flags
January 12, 2016

The New Year is a customary time to speculate. In a digital age, when past forecasts are available online, market and media professionals find it harder to hide their blushes when their financial predictions go awry. But there are ways around that.

The ignominy that goes with making bold forecasts was highlighted in a recent newspaper article, which listed many bad calls US economists had made about 2015. These included getting the timing of the Federal Reserve's interest rate increase wrong, incorrectly calling for a rise in long-term bond yields, and assuming an end to the commodity rout.[6]

For the broad US equity market, 22 strategists polled by the Wall Street Journal[7] *estimated an average increase for the S&P 500 of 8.2% for 2015. The most optimistic individual forecast was for a rise of 14%. The least optimistic was 2%. No one picked a fall. As it turned out, the benchmark ended marginally lower for the year.*

In the UK, a poll of 49 fund managers, traders, and strategists published in early January 2015 forecast that the FTSE 100 index would be at 6,800 by midyear and 7,000 points by year-end. As it turned out, the FTSE surpassed that year-end target by late April to hit a record high of 7,103 before retracing to 6,242 by year-end.[8]

Australian economists were little better. The consensus view, according to a January 2015 Fairfax Media poll, was that local official interest rates would stay on hold all year. The Reserve Bank of Australia proved that wrong a month later, before cutting rates again in May.

It shouldn't be a surprise that if economists can't get the broad variables right, it must be tough for stock analysts to pick winners. Even a stock like Apple, which for so many years surprised on the upside, disappointed some forecasters last year with a 4.6% decline.[9]

In Australia, the "Top Picks for 2015" published by one media outlet a year ago included such names as Woodside Petroleum, BHP Billiton, Origin Energy, and Slater & Gordon, all of which suffered double-digit losses in the past year.[10]

It should be evident by now that setting your investment course based on someone's stock picks or expectations for interest rates, the economy, or currencies is not a viable way of building wealth in the long term. Markets have a way of confounding your expectations. So a better option is to stay broadly diversified and, with the help of an advisor, set an asset allocation that matches your own risk appetite, goals, and circumstances.

Of course, this approach doesn't stop you or anyone else from having or expressing an opinion about the future. We are all free to speculate about what might happen in the economy and markets. The danger comes when you base your investment strategy on such opinions. In the *meantime, if you insist on following forecasts, here is a list of 10 predictions you can count on coming true in 2016:*

1. *Markets will go up some of the time and down some of the time.*
2. *There will be unexpected news. Some of this will move prices.*
3. *Acres of newsprint will be devoted to the likely path of interest rates.*
4. *Acres more will speculate on China's growth outlook.*
5. *TV pundits will frequently and loudly debate short-term market direction.*
6. *Some economies will strengthen. Others will weaken. These change year to year.*
7. *Some companies will prosper. Others will falter. These change year to year.*
8. *Parts of your portfolio will do better than other parts. We don't know which.*
9. *A new book will say the rules no longer work and everything has changed.*
10. *Another new book will say nothing has really changed and the old rules still apply.*

You can see from that list that if forecasts are so hard to get right, you are better off keeping them as generic as possible. Like a weather forecaster predicting wind, hail, heat, and cold over a single day, your audience should prepare themselves for all climates.

The future is always uncertain. There are always unexpected events. Some will turn out worse than you expect; others will turn out better. The only sustainable approach to that uncertainty is to focus on what you can control.

Social Security Changes

As you may already be aware, the budget bill that was ratified this past October included some changes to several Social Security claiming strategies. Most notably, two strategies that we often recommend to our clients are being eliminated. The laws as they were written before can be somewhat confusing, so please bear with me a bit as I explain the changes.

File & Suspend

Under this strategy, the higher earner of a couple could file for their benefits at full retirement age and then immediately suspend those benefits allowing the higher-earner to continue to accrue credits on their account. Meanwhile, since the higher earner has filed for their benefits (even if they aren't actually receiving them) the lower-earner could begin claiming a spousal benefit while also continuing to accrue credits on their own account. The net-effect resulted in both individuals being able to accrue credits on their accounts until age 70 while still collecting a benefit from the government.

Under the new law, the lower-earner will no longer be able to draw a spousal benefit if the higher-earner is not receiving their own benefit. This change applies to anyone who is not age 66 as of April 30, 2016.

Restricted Application

This strategy allowed a spouse at full retirement age to choose whether they received their own benefit or a spousal benefit. Similar to part of the File & Suspend strategy, this allowed the younger spouse to claim a lower spousal benefit and defer their own benefit to age 70 and accrue additional credits. The younger spouse would then switch over to their own benefit at age 70 for a greater monthly income.

Under the new law, a spouse receiving any benefits will automatically receive the higher of their own benefit and the spousal benefit. In most cases, their own benefit amount will be higher, so they will receive that instead of the spousal benefit no longer allowing the deferred accrual of credits. The change applies to anyone who did not turn age 62 by January 1, 2016.

We encourage any of our clients that are around full retirement age to allow us to do an analysis of the social security claiming strategies that are still available.

I know periods like this can be scary, but we feel the responsibly allocated portfolios our clients are invested in are the key to helping our clients achieve their goals. Please, if you have any concerns, reach out to us and we will be happy to discuss.

[1] Hongo, Jun. "Tokyo's Stock Bubble: 25 Years on From Nikkei Peak," Wall Street Journal: Japan Realtime, December 29, 2014.
[2] Browning, Michael. "Japan's Land Boom Spilling Across The Sea," The Chicago Tribune, November 19, 1989.
[3] Anderson, Aaron. "Forbes Presents 25 Years of Ken Fisher: The Making of a Market Guru," John Wiley & Sons, Inc. 2010
[4] Okina, Kunio. "The Asset Bubble and Monetary Policy: Japan's Experience in the Late 1980s and Lessons," Bank of Japan: Journal of Monetary and Economic Studies. Volume 19 (2001), Issue S1 (February).
[5] Performance Source: Yahoo Finance
[6] Malcolm Maiden, "The Year Market Economists Failed to See Coming," SMH, December 30, 2015.
[7] "Strategists Expect Stocks to Keep Climbing in 2015," Wall Street Journal, January 2, 2015.
[8] "Five Fund Strategies to Ride Rising Markets," The Times, January 3, 2015.
[9] "Seven Stocks to Buy for 2015," CNN Money, December 31, 2014.
[10] "Top Stock Picks for 2015," Motley Fool.