Global Slowdown: “Made In China”

Third Quarter, 2015

SIERRA
MUTUAL FUNDS

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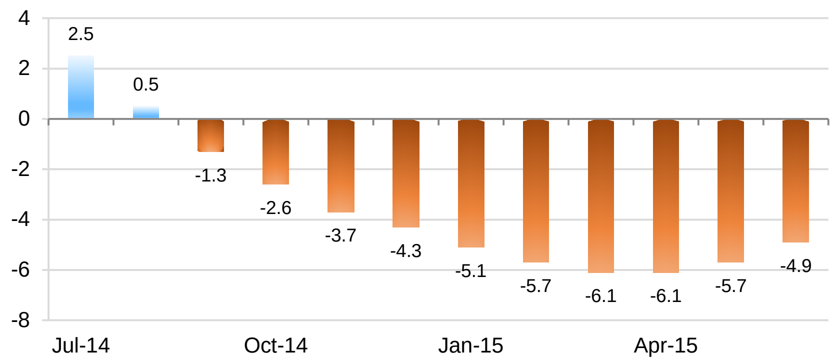
2015 continues to witness a deepening global economic slowdown led by China and the Pacific Rim. The pace of economic growth fell consistently across the continents of Europe, Asia and North America in the first quarter and, by all appearances, deteriorated further in the second quarter, with North America being the only relative bright spot.

In China, GDP, manufacturing output, steel production, electricity usage, and exports all displayed acute weakness in the first quarter and, by the best research, appears to have declined further in the early and middle phases of the second quarter. As China's growth declined to recessionary levels, below the 7.5% baseline, prices for global commodities such as iron ore, crude oil, copper, base metals, and steel rebar collapsed to levels not seen in years, and in some cases, decades.

Despite an aggressive easing of monetary policy initiated by the PBOC (People's Bank of China), the long series of rate cuts appears to be ineffective in slowing the decline. Thus far, the default rate on Chinese debt continues to rise month-after-month, with large bankruptcies now looming in the steel and coal industries.

Will a rising wave of bad loans and defaults in China lead to contagion in the highly leveraged financial sector? It is hard to tell because China is exceptionally opaque in its data reporting. One fact beyond dispute is that the Chinese government, along with Chinese regional lenders and the shadow banking system have created an extraordinarily massive debt load over the last five years. The speed and magnitude in which this was built up is unparalleled by any other country in history.

China Year-over-Year Newly Built Home Prices
July 2014 through June 2015



Source: Trading Economics | National Bureau of Statistics of China: July 2014 through June 2015

In a February 2015 report titled "*Debt and (not much) Deleveraging*", economic consulting firm McKinsey Inc. and its McKinsey Global Institute noted that since 2007, China's debt has quadrupled rising to $28 trillion dollars by mid-2014 from $7 trillion in 2007. At 282% of GDP China's debt is larger than either that of the United States or Germany, with the report noting that "a potentially worrisome factor is the reality that half of all the loans are linked, directly or indirectly to China's overheated real-estate market, and that unregulated shadow banking now accounts for nearly half of all new lending and that the debts of many of China's local governments are probably unsustainable."

While China's housing market has seen the rate of change in its downward pace ease by a modest margin in both May and June, housing prices are still falling at a pace in excess of -4% year-over-year and have now been negative for 10 consecutive months, with the last positive reading in August of 2014.

Elsewhere, in Europe, the fallout from the latest Greek near default has seen yields rising sharply across the southern periphery. For example, Portuguese yields have risen by over 60% from the lows seen earlier this year to the recent highs in July. The fallout of rising interest rates has yet to fully impact the economic data coming from Europe, but overall Eurozone GDP is not expected to be robust in 2015, with the range of estimates spanning a low of 0.80% growth to a high end estimate of just 1.5%.

Our best interpretation of the collapsing Greek economy and the unprecedented levels of uncertainty that the Greek crisis has now injected into the sustainability of the Eurozone project strongly suggests that consumer confidence is falling in Europe. The unemployment and default rates on debt are rising. Italy, Portugal and Spain, in particular, seem poised to move into the crosshairs of the bond bears. Italy in particular is showing clear signs of renewed recession and a substantial increase in debt default rates.

Our view is that growth in both Asia and Europe will be either slow or negative for the balance of 2015, which leaves the world economy very close to the threshold of renewed recession. The relative bright spot has been the U.S. economy, which after an initial negative first quarter reading has seen some positive revisions, which suggests a slow growth environment on the order of 2% to 2.5% for 2015. While it is true that recent updates to U.S. GDP saw substantial downward revisions to the last four years of previously-reported growth, overall current U.S. GDP still seems to be modestly positive.

During 2015, much of the U.S. attention has been towards the anticipated arrival of the long heralded “strong recovery”, and this has kept laser focus on Fed policy and the question of whether the Fed would soon begin a rate normalization campaign. Unfortunately, while U.S. data has managed to remain positive thus far, it is still exceptionally fragile, with clear signs of weakness present in areas such as labor market income and earnings, retail sales and consumer spending data, and now a new and steady trend toward weakening consumer confidence.

In our view, we do not believe the Fed will begin any sustained upward move in interest rates in the balance of 2015, or even 2016. While we cannot rule out a “one off” rate hike on behalf of the ivory-tower academics who manage the Fed, anything more than a “one-and-done” outcome seems remote.

It seems abundantly obvious that neither the U.S. nor the global economy is anywhere close to achieving the type of income growth or high-quality job creation that is required to be able to generate a sustained and accelerating recovery. Presently, this is an even greater problem in both Europe and Asia.

Instead, the world seems increasingly mired in a slowing growth climate which is putting strong downward pressure on prices and inflation, and over time is likely to continue pressing interest rates to new lower lows. Perhaps the biggest story of 2015 thus far is the continued collapse of global commodity markets, which seem to be have been presaged by a collapse in yields in 2014. Combined with a sequentially strengthening dollar, we now have three sets of major capital markets – bonds, commodities and FOREX – all painting a picture of a building final demand shock where demand has come in much lower than expected leaving a glut of global supply.

The long arc of demand shocks appears to be moving along the traditional path, with producers beginning to file bankruptcies and, in turn, kick-starting a chain of potentially serious mass layoffs in commodity and resource centric regions. Hence, the serious declines in GDP in Canada and Australia, and the acute weakness in employment appearing in U.S. energy-producing states, such as Texas, South Dakota and Louisiana.

In our view, this mosaic now strongly suggests that global interest rates, after having backed up on a growth scare in the first half of 2015, are now set to decline in the second half of the year, which should lead to a positive bond environment. Within the Sierra portfolios, we remain overweight in municipal bond funds, where spreads are still historically wide relative to Treasuries. Given the likelihood of a falling rate environment for the second half of 2015, we believe municipal bonds have the potential to perform strongly.

During the first few months of 2015, our portfolios were balanced between "Risk-On" assets such as High Yield Corporate Bonds, Emerging Market Debt, "Risk-off" assets like high grade corporates and municipals, and a modest smattering of equities. As a result of this global economic transition underway, with weakening growth in many areas of the world, our bias is tilting progressively toward "Risk-off" portfolios centered around high grade corporates, treasuries, and municipal bonds.

Overall, we view the second half of 2015 as a more favorable climate for traditional bond categories, in particular long duration paper, which fell by nearly 20% in the first six months of the year.

To this end we are slowly re-examining the intermediate and long-dated high-grade bond space, as well as the Treasury market and long-duration funds, with the goal of trend following a shift in the market toward longer duration assets. Our most recent purchases have been in the 20 to 30 year Treasury bond space. While small, we view these as the initial steps in increasing portfolio duration and potentially adding some positive beta.

We continue to focus heavily on preferred stocks, where tightening of U.S. banking regulation stemming from stricter reserve requirements from the Bank of International Settlements (BIS), is forcing money-center banks to meet more stringent balance-sheet strength requirements. This helps the preferred space tremendously because as the balance sheets improve, many U.S. money center banks receive credit quality upgrades. In addition, we also view high yield municipal bonds, along with other municipal bonds, as having the potential to renew their prior 2014 uptrends into the second half of 2015 following their early year correction.

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Beta is a measure of the volatility, or systematic risk of a security or a portfolio in a comparison to the market as a whole.

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