MARKET PERSPECTIVE

BY RICHARD SKEPPSTROM

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Total Return Portfolio	
Equities	62%
Bonds	7%
Gold	2%
Cash	29%
Total	**100%**

as of June 27, 2013

Wobbling, shocking and considering

China wobbles

When discussing China, I must admit that the data are sketchy, the country is vast and therefore a comprehensive understanding of what's going on is not possible. However, China's credit markets are experiencing alarming volatility and that could have consequences outside China.

I've often imagined China as a fast-growing retailer: Year after year growth remains stronger than predicted. Stores spring up everywhere. Comparable-store sales remain strong. The business is very large in just a few years. Management acquires a reputation for extreme competence. The company reaches a point where it is adding dozens of stores a year and seemingly can do no wrong. Even the most vocal skeptics are quieted.

Then one Monday morning, out of the blue, the company prereleases a "weather-related sales hiccup." The stock gets pounded but management is reassuring. The stock recovers a little and the bulls are not deterred but the following quarter there is another miss for some other reason. Something's wrong. Eventually, and probably under new management, the company admits a litany of shocking errors. It has added too many stores. It has stores in the wrong locations. The latest-generation store is too small or too big. Old competitors have improved their blunting tactics and new competitors have sprung up. Fixing the problems will take years. A prudent company didn't take on too much debt. If it did, however, the company may not survive.

China has built too much stuff and probably much of it is the wrong stuff. It inflated its growth rate and economy with wasteful investment and a period of adjustment has begun. I believe it will take years and growth will be slower than most expect. A key question will be how much bad debt there is and who will take the losses. The numbers for public U.S. companies are there for all to see and we still have trouble predicting the future. For the Chinese economy, the numbers are definitely not there so imagine the trouble predicting the future. Fitch recently estimated that Chinese credit grew from 125 percent of gross domestic product (GDP) to 200 percent in the last five years. That dwarfs our credit expansion leading up to the subprime collapse. Spikes in overnight lending rates indicate a liquidity problem and the authorities may or may not have a handle on the situation as a significant portion of recent credit creation apparently has happened outside the traditional channels. I don't believe there can be a graceful exit from debt-fueled hyper-investment.

On the plus side, a cooling China takes the heat off commodities and energy, which will cushion the blow to global growth. Further, U.S. exports to China are a small percentage of our economy. However, China is the world's second-largest economy and I would expect a few nasty surprises if they've run off the rails.

Shocked to find gambling at Rick's cafe ...

Traders, pundits and even the chairman of the U.S. Federal Reserve profess to being surprised to see Treasury yields jump from 1.7 percent to 2.5 percent but they shouldn't be. Why would Treasury yields be less than 2 percent with the economy picking up steam? Even with tax hikes and the federal sequester, the economy is growing and as those drags roll off, we could be looking at growth north of 3 percent. The markets sense this. Of course, a rapid rise in rates could choke off the growth but it was always the case that rates would rise and the Fed would taper asset purchases if growth improved. Given the scrum for yield that's gone on for the last few years, many investors understood that there would be a mad dash for the exit when the time came. As for how high Treasury rates can go, I'd be surprised if the economy could tolerate anything north of 3 percent at this time.

Multiple considerations

Earnings growth has slowed to a crawl. Will multiple expansion push equities higher? Earnings, interest rates and Fed policy interact to produce a multiple on the S&P 500 Index that generally looks about right in the moment but is constantly in motion reacting to changes in those inputs. My prediction is that after an adjustment period, U.S. valuations can move higher on improved economic conditions and somewhat higher interest rates. However, I remain concerned about growth in Europe and China. I have added some Treasury exposure after the recent bond rout but I'm still keeping some powder dry.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

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