Don't panic

"People panic for a reason; there's generally no shortage of reasons and happily there are very few good ones."

The market's momentum was ebbing with the slowing of global growth. The return of volatility was inevitable and corrections are a fact. People panic for a reason; there's generally no shortage of reasons and happily there are very few good ones. Unfortunately, in the last 15 years, we've had two wrenching stock collapses and they remain fresh in everyone's minds. In the first, the U.S. Federal Reserve tightened to rein in the tech bubble (that it had ignored/blessed) and associated nonsense but there'd been too much excess and the economy fell into recession. In the second, the Fed tightened to rein in the housing bubble (that it created) and associated nonsense but there'd been too much excess and the banking system nearly collapsed, dragging the economy into the Great Recession. In fact, the last bubble was so magnificent, so perfect – Who is genius enough to bet the banking system's capital on a housing bubble? – that people actually have resisted borrowing. So, try as it might, the Fed has failed to ignite another significant spending bubble in the U.S. economy. The Fed has no bubble to pop and we are in no danger of a recession. It only wants to raise rates (a little) because zero is ridiculous and it's afraid of what will happen if it can't ever lower them to save us from the collapse of the next bubble it is, so far, failing to inflate. It's just that simple.

More Chinese problems

As for China, it is attempting to rebalance an economy dangerously dependent upon debt-financed fixed investment but it simply has borrowed and built too much useless stuff to accomplish a smooth transition. How would an inscrutable, corrupt bureaucracy with absolute control, a plague of hubris and a hunger for power and prestige spend its riches? Somewhere between wastefully and foolishly is my bet. Tens of trillions conjured and spent at a pace never before seen is finally mashing up against the realities of markets, compound growth and debt. Thousands of gleaming towers, dozens of new cities, countless factories, new interstates, rail ... you name it, they bought or built it: Who's to say what's real and what will go to the weeds? A tsunami of growth swamps all before it. But the tide, as they say, is turning and in time it's likely to uncover considerable unpleasantness.

As if on cue, the Chinese currency is suddenly a problem. It's pegged to the dollar, which has been relatively strong reflecting higher U.S. growth and interest rates. This has hurt Chinese export competitiveness so the recent modest Chinese devaluation of few percent should not have come as a major surprise but markets reacted violently ... and probably more to the fear of further devaluation (15 percent to 20 percent more), currency warfare and an irresistible pulse of global deflation. I'd rank that high on my list of issues to monitor. I'm persuaded that the United States can shoulder a modest amount of Chinese devaluation but more would be a game-changer.

China also has a capital-flight problem. Wealthy individuals and companies are moving significant sums out of the country. I can't speak to their motives but I can guess and it ain't good news. Weakening the currency won't help with this and neither will lower interest rates that they were forced to announce along with lower reserve requirements. And lower rates hit consumption (their primary economic imbalance) through the reduction in savings. They are in a tight spot and prospects for higher rates in the United States will only exacerbate these difficulties.

And the problems go far beyond China's borders. Commodity businesses that bulked up in anticipation of much stronger global demand are imploding. This is especially painful for developing markets where Chinese demand for materials had lit economic fires around the world. No more. We will be dealing with a sputtering China for the foreseeable future. Lower commodity prices aren't a bad thing and the U.S. economy is resilient enough to deal with it just like we did with Japan.

I have no particularly strong views about the direction of the market. I don't see any reason for a sharp move in either direction. Earnings will grind higher (and eventually drag stocks with them) but it does seem to me that the global economy has slowed a touch and there's a price to pay for that. I've believed for months now that we are range-bound with more volatility and I still believe that. Where we were in a market that leapt ahead of earnings we may now be in a market that staggers along behind.

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

Strategic Return Portfolio	
Equities	68%
Bonds	14%
Gold	2%
Cash & similar	16%
Total	**100%**

as of Aug. 27, 2015

Richard, an investment professional with more than two decades of experience, manages Eagle's Strategic Return Portfolio. His views are his own and may not reflect those of other Eagle portfolio managers.

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