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OBSERVATIONS ON THE MARKET

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It all pretty much comes down to this: China is weak, oil is down, is this a predictor of a recession? The market has a relatively good track record of forecasting recessions and recoveries. It tends to be six to twelve months ahead of the economy. There is a saying that the stock market has predicted nine of the last four recessions. It is not always right, however, in a slow growth environment, it is easy to get nervous. *Barron's* has a feature article this week entitled: This Storm Will Pass. Here are a few key points as to why the U.S. will avoid a recession this year.

The three-month average for the unemployment rate in the last 11 recessions has always turned up at least once, and usually several times, before the beginning of a recession. We have yet to see that currently, and employment gains continue to accelerate. The economy has experienced a slow recovery, but employment is still gaining. Claims for unemployment are also trending down and are near 35-year lows. Unemployment claims also turn up before recessions, which seems obvious.

One of the big worries in the market is China's slowing economy. China, now the second largest economy, is going to take the rest of the world down with it. Fortunately, or unfortunately, depending on how you want to look at it, China is still a somewhat closed economy. According to Michael Lewis, there has never been a single recession traced to a foreign economy experiencing problems. As the world markets grow to become more global, this will probably change, but there is no evidence it has changed yet.

Jeremy Grantham writes in his latest quarterly letter to clients that lower oil will eventually be a net gain for the economy. We just have to get through the upfront cost of fewer jobs and bankruptcies in the oil sector. Jamie Dimon of JP Morgan Chase recently states that JP Morgan may have to take a $3 billion charge for energy loan losses. Considering the company has a $208 billion market value, it is less than 2% of the bank's value. The *Barron's* article points out that considering every recession going back to 1975, a recession was always preceded by a spike in oil prices. We sure haven't seen that recently. A simple back of the envelope calculation suggests the economic benefits are coming.

We currently have about 300 million people in the U.S., and the average household is 2.5 people. That leaves 120 million households. If each household drives 12,000 miles and gets 25 mpg, each household buys 800 gallons of gas per year. Assuming a $2 per gallon savings from a few years ago, that implies each household is saving about $1,600 per year, or, 120 million households are saving about $192 billion per year. That gives our $17 trillion economy an extra 1% in spending. This may not sound like much, but considering our economy is struggling to grow by 2%, this is a significant boost.

The 4th quarter earnings season is almost over, 90% have reported. Earnings for 2015 are down about 10%, mostly due to oil. The estimates for 2016 are for earnings to grow by 15%, most of which would just be a recovery from this year's commodity collapse. If they do recover, the market is at 17 times earnings, about what the average level of the last two decades. With the S&P 500 dividend yield at 2.3% vs. the 10-year treasury yielding 1.75%, the market doesn't seem overpriced. If 130 years of history is any guide, the S&P 500 will be paying even more in dividends by the end of 10 years, making it somewhat easy to outperform the treasury bond if your time horizon is more than next month.