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Comments

Looking back at economic developments over the past few weeks, it's become increasingly clear to us that this month's global financial market turmoil may have been triggered by comments earlier this month by Stanley Fischer, Vice Chairman of the Federal Reserve, which contradicted Janet Yellen's December remarks concerning the pace of credit tightening. Whereas Yellen suggested rate increases would be gradual, Fischer implied rate hikes could be more aggressive if incoming inflation and employment data suggested the economy was on more solid footing than forecast.

Almost immediately following the Vice Chairman's comments, the US stock market began its sell off. Markets overseas followed. Capital flowed from weaker currencies to stronger ones. Oil prices tanked 30% during the first two weeks of the month. Reflecting some economic data that showed slowing GDP growth in the fourth quarter of last year, bond yields fell as investors sought safe haven investments.

Beyond a possible downtick in US growth, investors' rush to safety may have reflected concerns the huge decline in oil prices was a marker for some larger, unknown issues lurking just over the horizon, or simply the concern the Fed's tightening would trigger a 1937-like recession. Fears of another unscripted devaluation of the Chinese currency probably added to the uncertainties as investors recalled last August's market correction.

There is enough recent anecdotal evidence of a slowdown to mark-down our growth estimates a bit. Most of the slowdown, however, is in the manufacturing area which accounts for less than 15% of the US economy. The strong dollar is a headwind and weak business conditions in Europe and elsewhere are not helping exports. Service businesses, which account for 80%+ of the US economy, seem to be growing, albeit at the moderate pace we have been expecting all along. Housing and autos remain strong. All in all, then, we would expect the first quarter of this year to show GDP growth of 2% -- about 25 basis points less than previously expected-- after little growth in last year's disappointing fourth quarter. For the full

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year, we expect 2.5% GDP growth. Our Economic Model and the LEI support this view. We think the odds of a recession in the US in the next year are less than 25% as we have not seen the kinds of excesses which, in the past, have forced the Fed to aggressively tighten, precipitating a recession.

For investors, the question on the table now is: How much of the above has been discounted? We recommend staying the course. Bond yields have already fallen 25 basis points since the Fed's meeting in December and credit has been sending warning signs for months. From here, there is a good chance of a moderate uptick in yields as the market prices-in less of a chance of a recession. Stock averages have taken a 13% hit from their May 2015 highs with small cap and emerging market indices faring worse than the S&P 500. We think we are nearing the bottom of the global equity market pullback and would be adding to stocks now, particularly depressed financials, industrials and energy in under-committed portfolios. Of course, some unanticipated exogenous shock could upset the apple cart for awhile.

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