



## Observations and Outlook

January 20, 2016

### Selected Index Returns 4th Quarter/ Year End 2015

Dow Jones Industrials 7.7%/.21%      S&P 500 7.04%/1.38%      MSCI Europe 2.49%/-2.84%  
Small Cap (Russell 2000) 3.59%/-4.4%      Emerging Mkts -.66%/-14.9%      High Yld Bonds -5.1%/-3.61%  
US Aggregate Bond -.57%/.55%      US Treasury 20+Yr -1.39%/-1.59%      DJ/UBS Commodity -10.5%/-24.6%

2015 turned out to be a less than spectacular year for markets around the globe. Virtually all areas outside the US saw declines in equities and anything 'risk' related did poorly to very poorly. Cash was the best asset class compared to commodities, stocks and bonds. This odd occurrence has only occurred a handful of times in any given year over the past 70 years.

Given the continued slowdown (or collapse?) of the Chinese economy (2<sup>nd</sup> largest in the world), negative earnings growth for the S&P 500, and massive capital flight from emerging markets, it's a wonder that any major league economist is not forecasting recession. But then of course, I do not think they are allowed to forecast anything except perpetual growth and perpetual bull markets until we are in the midst of one or the other.

The areas the permabulls constantly refer to indicate "health" in the economy are near illusions and backward looking at best. Auto sales (and home sales), the Federal Reserve increasing rates, and the 'gas credit' via cheap gas to consumers are the reasons most Wall St economists give as *support* of continued (very low) growth. There are significant details under the surface of each of these areas they leave out, that if included, would paint a near opposite picture of the US economy's health.

### Auto Sales

Let's look at auto sales. Automobile sales in the US hit a record high of 18.55 million in 2015. Also at record highs are loan terms. All these statistics are **record** levels and from first half 2015.

**Average length of new car loan: 67 months**      **Average length of used car loan: 62 months**

**Auto loans with terms 74 to 84 months: 30%**      **Used Auto Loan terms 74 to 84 months: 16%**

**Average New Car Payment: \$488**      **Average amount financed: \$28,711**

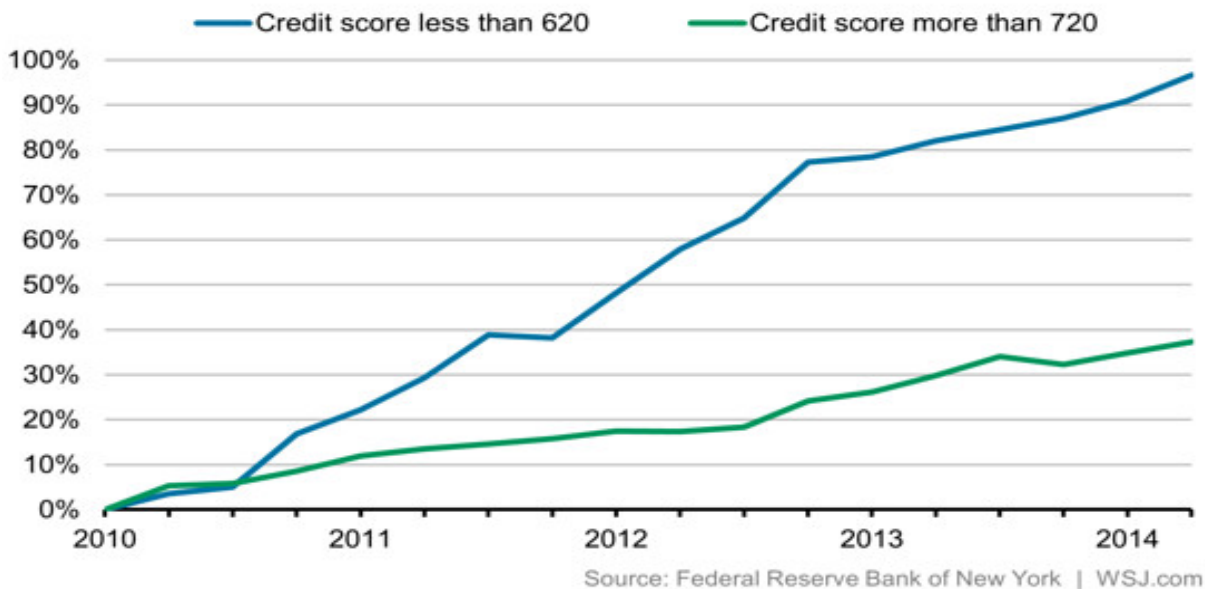
What isn't at record highs is loan quality, and the rate at which people are actually buying rather than leasing a car. Almost 1/3 of all auto loan borrowers had credit scores below 660. Easier credit, longer loan terms, and more leasing are the weak supports of the auto industry.

**Percentage of Vehicles Leased: 31.46%**      **Percentage of Auto loans with scores under 620: 19%**

Auto sales have been climbing rapidly the past few years, and recently auto loans that are 30 days late is increasing at a rapid clip, doubling from 1.4% to 2.9% of loans outstanding. That may be due to the rapid increase in the amount of subprime auto lending occurring, as these loans are predestined to fail.

## Subprime lending looks like it has exploded...

Change in auto lending since Q1 2010, four quarter moving average



Auto sales dependent upon easier credit terms can continue as long as there is willingness to lend to lower and lower credit quality borrowers. Once these borrowers live up to their credit scores by defaulting in large numbers, financing will dry up, sales will decline, and lenders, dealers and manufacturers will feel the brunt of it. Given that almost 20% of the \$300billion in auto loans are to <620 borrowers, it's not a stretch to say that financing for \$60billion, or 2.3 million automobiles will disappear before too long.

### Federal Reserve Raising Rates (aka Reducing Liquidity)

Another indicator the permabulls claim to be a positive but is, in fact, a very negative development is the Federal Reserve's plan to raise the Fed Funds rate multiple times over the next year. The origin of this concept is clear. Generally, in the past when the economy is expanding rapidly, market forces push up longer term rates and the Fed follows by raising short term rates to subdue inflationary forces. Currently long term rates remain subdued and the economy has yet to expand anywhere near "rapidly". Furthermore, raising rates reduces liquidity in financial markets. This is the opposite of the QE efforts over the past several years.

The chart below, which I have used in the past and deemed "The Most Important Chart in the World", covers the time period from the onset of QE 3, through its conclusion, and to today. Water and money find their own level. And fresh money pumped into the system by the Fed has found its way into the S&P500. Now that it has stopped, we can see the perpetual 'bid' these funds have placed is gone. By this chart, a reduction of liquidity may have very negative impact on the level of the S&P 500.

If this was the driver of stock prices, what happens now that it is over?



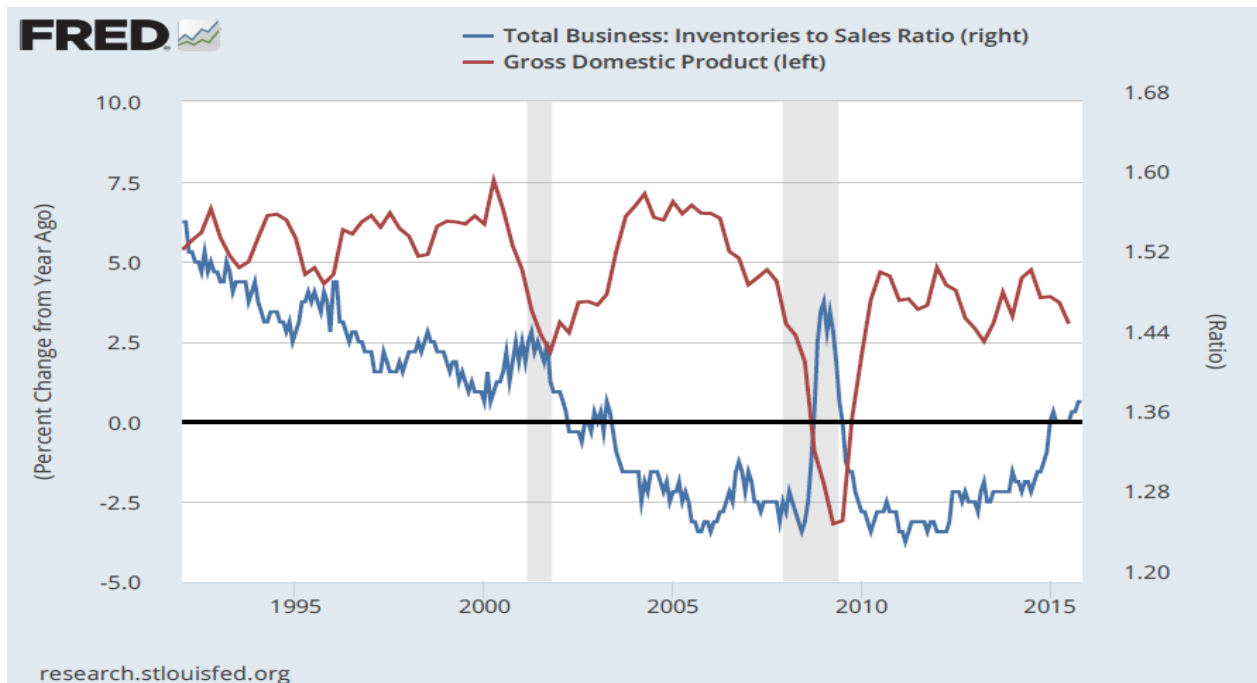
## Gasoline Savings? Sales and Inventories----The Direction is Down

Broadly speaking, the US consumer is not spending his gas pump savings on more goods. Some might postulate that the significant increases in rents/housing and health insurance costs have more than consumer any discounts at the gas pump. Aggregate sales and business inventories capture this idea. Additionally, inventory levels are directly related to the GDP calculations.

When calculating GDP, the statisticians add increases to inventory to GDP. The inventory to sales ratio tells us if inventory build is occurring faster than final sales. The current trend in this ratio and the fact that S&P 500 sales are stagnant, if not declining year over year indicates that there has been a build up of inventories is beginning to be liquidated via *declining* sales (-3.2% 3Q2014 to 3Q2015)! The inventory liquidation will be a negative to GDP calculations. The best indicators of GDP for 2015 point to about a 1.7% annual growth rate, with a .7% rate in the fourth quarter. The inventory liquidation will pull first quarter GDP down, perhaps significantly.

GDP is not a tool to use for making investment decisions, but it can confirm earlier decisions. GDP growth has been extremely slow compared to all other expansions in the post WW 2 era. The longer the US spends near zero growth, the easier it is to slip into negative territory. Weakness the past couple of years seems to focus on cold weather in the winter. This past year the idea has expanded to include warm weather in the summer. This year there is a significant El Nino which will bring milder weather to the eastern US, and colder wetter weather to the West and South. Currently there is a significant weather system approaching the East Coast and if past if prologue, any weakness we see in the first quarter will surely be blamed on this, along with cool weather in the South, which probably makes people stay up North.

Pundits continue to blame anything and everything except bad monetary policy, lack of income to the working classes and overpriced cars, houses, stocks and bonds; for any market weakness. Consumption, as seen in Sales is in decline.



Prior to 2000, the Inventory to Sales Ratio climbed into the recession, during 2008 recession the seizure in the economy caused a sudden halt in purchases blowing the ratio up dramatically. This time we see a constant rise in the ratio and recent lurch upward indicating final sales are slowing dramatically faster than the reduction in production of goods. A rise always coincides with declining GDP numbers. Given we are starting at anemic GDP numbers; the odds the US economy goes into *negative growth* are significant.

## Going Forward

From this point forward, given a sharp decline in stocks the first few weeks of 2016 investors must make a decision. Ideally, they would have already made a few decisions over the course of the last 15 months, to reduce risk exposure on good market increases. Readers of my Commentary may have done so. Clients of mine did do so. The easy observations are the length of the bull market vs the past, the length of the business expansion, and the reversal of monetary policy by the US Federal Reserve. A little deeper, a strong US dollar has had clear impacts upon S&P500 earnings and sales. Also, we cannot ignore the energy sector collapse and assume (or hope) that there will be no larger impact on the US economy and markets when some 1/8<sup>th</sup> of the economy more or less has collapsed.

The time to employ an Investment Advisor who can do more than buy and hold is now.

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