

CAPITAL WATCH

Winter 2016 | Volume 1 | Issue 4

UP TO THE MINUTE

It can be helpful to use the changing of the calendar to look ahead for big picture themes. To that end, what do we expect in the financial markets in 2016, and how can that be helpful to your investing?



We'll be keeping an eye on debt.

Specifically, we are watching the debt of emerging market governments, foreign corporations, and oil companies. In the last 20 years, we've gone from \$40 trillion to \$220 trillion in worldwide debt. Much of the growth in global GDP has been fueled by this debt, and it cannot continue.

Across the globe, economies are slowing. Commodities are under huge deflationary pressure. The Federal Reserve has started to raise rates and the U.S. Dollar is strong. These factors are causing problems for the borrowers. It takes more of the local currencies to repay the dollar-denominated debts. Watch for economic stresses to continue and defaults to rise.

We'll be keeping an eye on oil.

The collapse in oil prices has been amazing. Many companies borrowed to invest in the equipment needed to get oil out of shale through fracking. They expected a certain level of oil prices to make these investments profitable. Now, with oil in the \$20s, these investments are causing large losses. Jobs are being cut, the rig count is declining,

and banks are starting to feel the pressure. These are not just short term changes and we expect the ramifications to widen.

It's not just in the U.S. either. You can see the problem clearly in Saudi Arabia. The Saudis recently announced they were willing to sell part of the state-owned oil firm Saudi Aramco. They also increased gas prices by 50% locally. While Saudi Arabia has a much lower cost of oil than the U.S., they cannot support their level of domestic expenditures at current price levels. Financial instability often is a precursor to political instability.

Energy losses will show up first as loan losses for banks. Watch for increased charge-offs and earnings misses.

We'll be keeping an eye on currencies.

Countries that have significant exports benefit when their currency supports those exports. If their currency gets too strong relative to others, they will often adopt policies to weaken it. This "game" has been going on for as long as countries have been trading with each other, but we see a special focus on it in recent years which will continue in 2016.

China is a prime example. Put simply, the Chinese need to devalue their currency further to boost their economy and stem the outflow of reserves. The recent December devaluation had a negative ripple effect on the world's stock markets. However, it was not enough to solve their problems, so we would not be surprised to see additional currency shocks.

The final major theme for 2016 is the increasing likelihood of a recession in the U.S. Economic data has worsened, even though headline numbers for employment seem to tell a different story. From a stock market perspective, the period before a recession is "officially" recognized is the riskiest time. In the past, as recession recognition has become more widespread, the stock market has experienced abrupt declines. We'll be watching for this as 2016 unfolds.

ON THE CLOCK:

WHAT'S YOUR RISK NUMBER?

We aren't big fans of typical risk assessment questionnaires in part because of their well-documented shortcomings. What's more, many portfolio construction models attempt to give an investor a group of holdings designed to experience his or her maximum risk level. That approach has never made sense to us. Still, given that we all perceive investment risk in different ways, is there a better way to quantify risk?

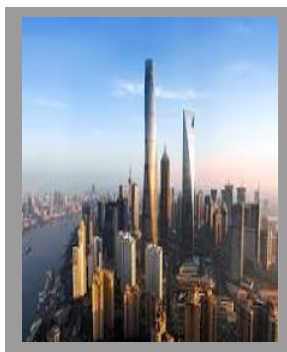
We have recently begun using Riskalyze, an innovative (and short!) questionnaire that gives you a Risk Number. The key is to make choices about hypothetical gains vs. losses to see what matters more to you. We believe the process is fairly easy to walk through, and we invite you to do so. We especially like how Riskalyze uses normal English and also dollar amounts instead of percentages.

The tool can be found on our website, www.montgomerycap.com, under the heading Risk Analysis. Click there, enter your email address, and start answering the short number of questions. We will let you know when we receive the confidential results.

If you prefer, we'd be happy to send you an email with a direct link to our Riskalyze tool. Please call Michele (757-597-9525) to get that started. You are also always welcome to stop by the office and use our computer if that is more convenient.

We look forward to the opportunity for meaningful discussions with you about risk tolerance, and we welcome your comments about our Riskalyze tool.

R-E-W-I-N-D



In January, the Shanghai Tower was officially crowned as the second-tallest building in the world. That happened to be on the same day that the Chinese stock market had to be halted after falling 7%. *The Washington Post* also marked the occasion with a story about the curse of tall skyscrapers. Readers of *Universal Economics* will remember Paul discussing this topic with regularity.

"We consider the oldest story known to man, The Epic of Gilgamesh, also to be one of the most modern and insightful and enthralling. Nearly 5000 years ago, Gilgamesh ruled the known world from his capital, Urk, which still exists today as modern day Warka, in Iraq. This ancient hero is identified with the Nimrod of the Bible, and this ancient city is identified with the city the Bible calls Erech. At one point in the Biblical account the people of ancient Mesopotamia determine "to build a tower whose top may reach unto heaven and let us make a name for ourselves." Genesis 11:4. Many modern skyscrapers likewise have been built in no small part so that some people could "make a name for themselves." And these latter day "towers to heaven" have often presaged sorrow, just as did The Tower of Babel--the first incidence of "The Skyscraper Curse."

UNIVERSAL ECONOMICS, DECEMBER 13, 2010