Fear is Overbought

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The stock market is not the economy, and the economy is not the stock market. Nonetheless, many are convinced that the market correction of the past few weeks is a certain sign of impending recession. Never mind that China just reported 6.9% real GDP growth. Never mind that a barrel of oil costs less than $30, which means consumers are saving hundreds of billions of dollars per year on top of what the drop in natural gas prices has saved them.

And in just 10 days, the US will report another quarter of Plow Horse economic growth. Right now we estimate real GDP grew about 1% at an annual rate in Q4. It's below trend, but that's nothing new. Since mid-2009, real GDP has had six other quarters with less than 1% growth. The US economy grew only 0.9% for a full year from mid-2012 to mid-2013.

Inventories were the real challenge for GDP in Q4. Working off those inventories slowed manufacturing, rail traffic and transportation. But "right-sizing" inventories is not likely to be a persistent problem. Excluding inventories, trade, and government – none of which can be counted on for long-term growth – the economy probably grew close to a more respectable 2% rate.

Real ("inflation-adjusted") consumer spending grew at a 1.5 - 2.0% rate in Q4, while home building likely grew at a solid 9% rate. Consumers' financial obligations, the share of their after-tax incomes they need to make recurring payments (mortgages, rents, car payments, student loans…etc.) is hovering at its lowest levels since the early 1980s. Meanwhile, more jobs, mildly accelerating wages, and lower fuel prices mean consumers are in pretty darn good shape.

And as much as home building has recovered, there's still much further to go. Back in 2009-11, housing starts were running at an average annualized pace of about 600,000. Last year, builders started about 1.1 million homes. But fundamentals, like population growth and "scrappage" (voluntary knock-downs, fires, floods, hurricanes, tornadoes, earthquakes…etc.) suggest a "norm" of about 1.5 million.

In other words, Consumer spending and homebuilding look poised for solid growth in 2016.

But, hey, this ain't a perfect world. Over the past several years, some of the world's production facilities focused too much on generating raw materials for China and finding new oil. Now, they face creative destruction. Much of the pain these producers will face is hitting right now.

But stop and think about the rest of the world that now gets to enjoy lower oil prices. Just two years ago, the leading experts were forecasting around $100 oil as far as the eye can see. Non-energy producers are benefiting hugely from cheap oil, and are generating new goods and services that cost less as a result. So, it's not all bad news on the drilling and mining front.

Still, Donald Trump's populism is stirring up support for slapping huge tariffs (maybe 45%) on China. This is a tax that will ultimately be paid by the populace. So much for populism! But, Congress would most likely prevent such an unwise tax.

And don't forget growing geopolitical turmoil. The Spratly Island dispute with China may be a harbinger of ill winds if the US continues to step down from its ability and willingness to project military power. And Russia's economy stinks, so "wagging the dog" and flexing muscles in the Baltics like it did in the Ukraine can't be ruled out. Will the US balk at its NATO obligations if this happens?

Worst of all is the Middle East. There's a whiff of World War I in the air with regional powers picking sides. Who knows what would happen if some young Kurd is able to assassinate the leader of Turkey.

But, chances are that all these scare stories will just be added to the long list of other stories the markets have confronted the past several years. Remember the impending implosion of commercial real estate or the European financial system? Remember Greece leaving the Euro? Remember, the "hidden inventory" of unsold homes about to hit the US market?

US equities were relatively cheap before 2015 started and even cheaper today. We recommend keeping a stiff upper lip, and waiting for pessimistic investors to realize their mistake. Even with more rate hikes coming, the US stock market is still significantly undervalued.

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