Forbes http://onforb.es/1SSyHUg

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INVESTING 1/15/2016 @ 4:00PM | 344 views

Extreme Volatility Without A Recession

Volatility has taken on a whole new definition in 2016. It's no longer one narrative that's driving it, such as interest rate hikes. No, volatility today means a confluence of global market miscues and complexities. These complexities are driven by:

1. Strong US dollar
2. Weak Chinese manufacturing sector
3. Global commodity selloff, especially oil
4. The US Federal Reserve on track to slowly raise rates

Foreign influences are having a greater impact than at any time since the 1997 Asian Currency Flu contagion. Why? Because we've been fueling growth for the rest of the world for the last several years. In December, the Fed joined the fray, under pressure, to raise interest rates which has a direct effect on the US dollar. The direct effect of interest rate increases strengthens the US dollar even more. In turn this puts pressure on many emerging economies currency.

Normally, when we look at currencies, the US dollar, Euro, Yen all float against each other, such that when the dollar strengthens the Euro weakens. The relationship is not a prediction, but rather a direct fact type of relationship.

However, many emerging economies, including China and Hong Kong peg their currency to the dollar, although the Chinese "peg" is a loose peg that moves quite a bit. This means that their central bank maintains a constant exchange rate between the two currencies. So, if the US dollar is strengthening, then emerging economies

currencies that are pegged must also strengthen. This is not good for many emerging economies, especially China and Hong Kong.

Chinese yuan vs US Dollar showing Chinese curren while US currency is strengthening vs other floating Euro. A double hit to the Chinese manufacturing sec

A stronger Chinese currency makes it more difficult for China to export their manufactured goods to Europe, Japan, and any other country without a US dollar currency peg.

When emerging economies are already struggling, the knockout punch is to also have their currencies strengthen (again, this weakens their ability to export).

Whether the HK dollar loses its peg, or if China continues its slide just about the same time Brazil enters the abyss with its worst recession in decades, one thing is for certain…volatility got a makeover and it now resembles the face of the Earth.

What's a US investor to do about these developments?

Realizing that the US Federal reserve is exacerbating the problem, we might infer that the Fed will slow down any interest rate increases. If rate increases slow or stop, the dollar will not be pushed higher against other floating currencies. Since oil is a dollar denominated commodity globally, a weaker dollar will slow the decent of oil prices as well.

If oil finds a bottom. If China finds a bottom. If the US dollar finds a top. Then it's RISK ON. This means that growth companies of all types will fare well and that defensive names will not fare as well.

Investors can safely go back into names such as Facebook (FB), Amazon (AMZN), Netflix (NFLX), and Alphabet (GOOG).

Investors can buy biotechnology again (IBB), Celgene (CELG), Regeneron (REGN), and Dexcom (DXCM).

Technology stocks can also be purchased, Alphabet (GOOG), Semiconductors (SOXX) (SMH).

The entire energy complex of stocks has been beaten to a pulp. It may be time to start buying. Again, based on the idea that the dollar stops rising, the Fed slows rate increases, the emerging market economies get some pressure relief, and global demand stabilizes and begins to increase. The oil problem is certainly centered around the supply side, but it doesn't help to have a strong dollar and weak global demand. The supply side won't look so out-of-balance if the demand side picks up strength. Specifically, names should be based on Balance Sheet strength, refer to our recent Forbes article: http://www.forbes.com/sites/randywarren/2015/12/31/sifting-through-the-energy-wreckage-for-2016-golden-nuggets/#2715e4857a0b2df334ec7f69

And most importantly the Consumer Discretionary names should turn around and begin to fare well. Names such as Under Armour (UA), Nike (NKE), Ulta Salons (ULTA), Starbucks (SBUX), and perhaps even Chipotle Mexican Grill (CMG) can be bought at deep discounts if their e-coli problems are fixed.

***Disclosures**: Warren Financial has long positions in some of the stocks mentioned in this article including Goog, UA, CELG, DXCM, REGN, SMH, SOXX, FB, AMZN, NFLX, ULTA, CNG, and SBUX, both for our clients and our own portfolios. We may be starting new long positions in some of these companies in the future. The fact that a company is mentioned is not a recommendation or offer to buy or sell that stock or bond. Investors should always seek advice from an advisor that knows their particular financial situation and not assume that general information such as the information in this article will always apply directly to their portfolio. Investing includes the risk of loss.*

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