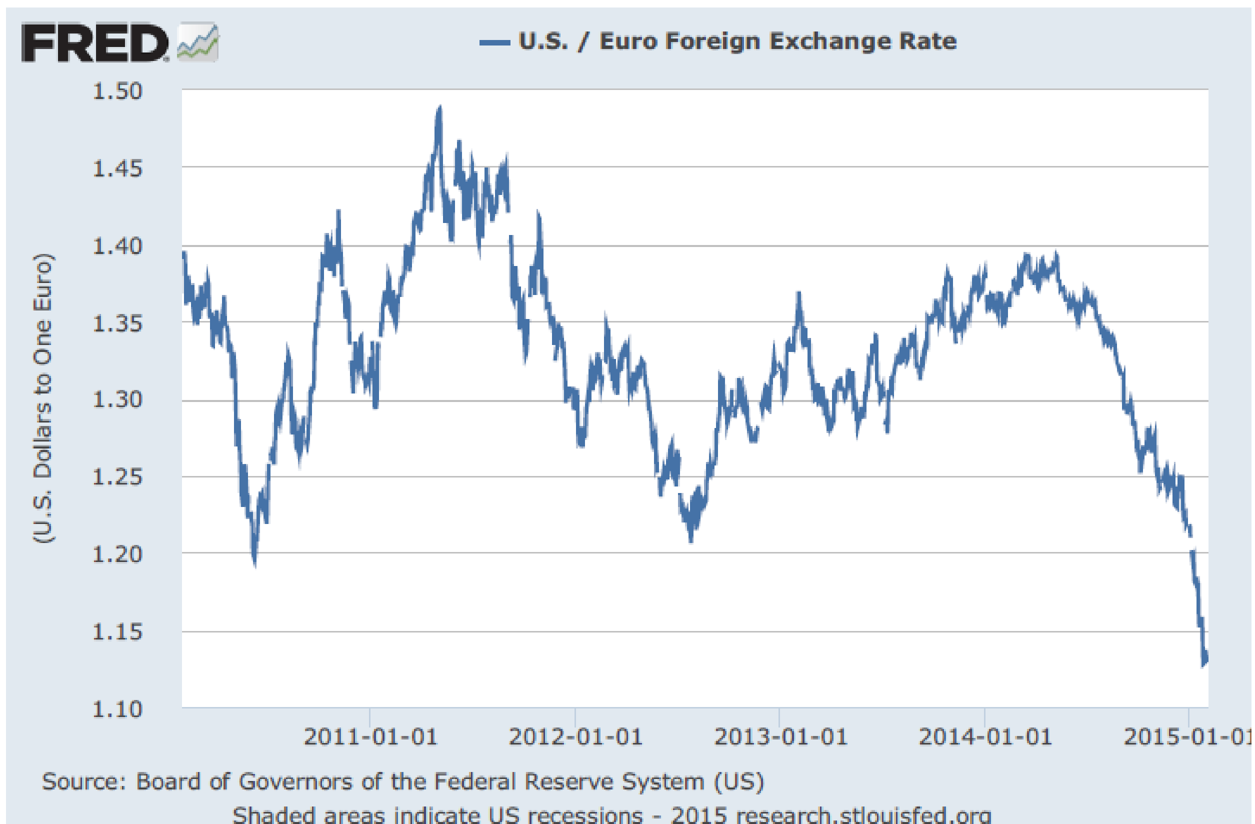
On Our Radar – February 2015

The U.S. stock market ended the month of January on a weak note as volatility rose in most asset classes as a result of central bank policies, the ongoing effects of a stronger dollar and lower energy prices, and the outcome of recent Greek elections. The Dow Jones Industrial Average fell 3.69 percent for the month, while the S&P 500 and NASDAQ Composite declined 3.1 percent and 2.12 percent, respectfully. The small cap Russell 2000 index also dropped 3.26 percent as market weakness was broad based. Bonds, on the other hand, continued to benefit from the "flight to quality" as the yield on the 10-year U.S. Treasury fell to 1.67 percent from 2.17 percent at year-end. The 30-year U.S. Treasury yield fell to an all-time low of 2.25 percent.

Simply put, the markets are adjusting to several crosscurrents, the most prominent being central bank monetary policy. What is unusual about this phase of monetary intervention is that the central banks are indeed behind most of the volatility seen of late. For example, the Swiss National Bank (SNB) decided to remove the Swiss franc currency peg to the euro, a policy that had been in force for roughly three years, which caused a one-day move of almost 16 percent in the Swiss franc/euro exchange rate. Moreover, just two days prior to the move a Swiss National Bank (SNB) Vice President said "we're convinced that the cap on the franc must remain the pillar of our monetary policy." Then, following the shocking move, SNB Chairman Thomas Jordan was quoted as saying "You can only end a policy like this by surprise. It is not something that you can debate for weeks." The abrupt about-face caused reverberations throughout the capital markets, and saw the euro drop from 1.21 to the U.S. dollar as of December 31, 2014, to 1.128 by the end of January, an enormous 6.7 percent move in one month, as seen in the adjacent chart. In 2014, the U.S. dollar appreciated against all major currencies. If currency devaluations happen abruptly, it will inevitably impact corporate profitability as those profits lose value when converted back to U.S. dollars. In addition, with the energy industry weighting of roughly 12 percent in the S&P 500 index, the greater than 50 percent decline in the price of West Texas Intermediate crude oil is

causing 2015 S&P 500 earnings estimates to come down further. While corporate earnings are expected to increase in 2015, the growth rate has been ratcheted down to reflect the new reality.



Part of the new reality is the re-emergence of the European sovereign debt crisis as the recent Greek elections saw the leader of left-wing SYRIZA party, Alexis Tsipras, become the new Prime Minister. He rose to power following the 2010 sovereign debt crisis experienced by Greece, and the burdensome terms of the financial bailout. Mr. Tsipras disagreed fiercely with the terms of the 2010 loan agreement, which has placed incredible hardships on the average citizen as the economy contracted from 2008 to 2013. Incomes have collapsed while debt burdens have risen and deflationary forces weigh on the economy. Prime Minister Tsipras wants to renegotiate the loan agreement and said “Greece’s debt is currently unsustainable and will never be serviced, especially while Greece is being subjected to continuous fiscal

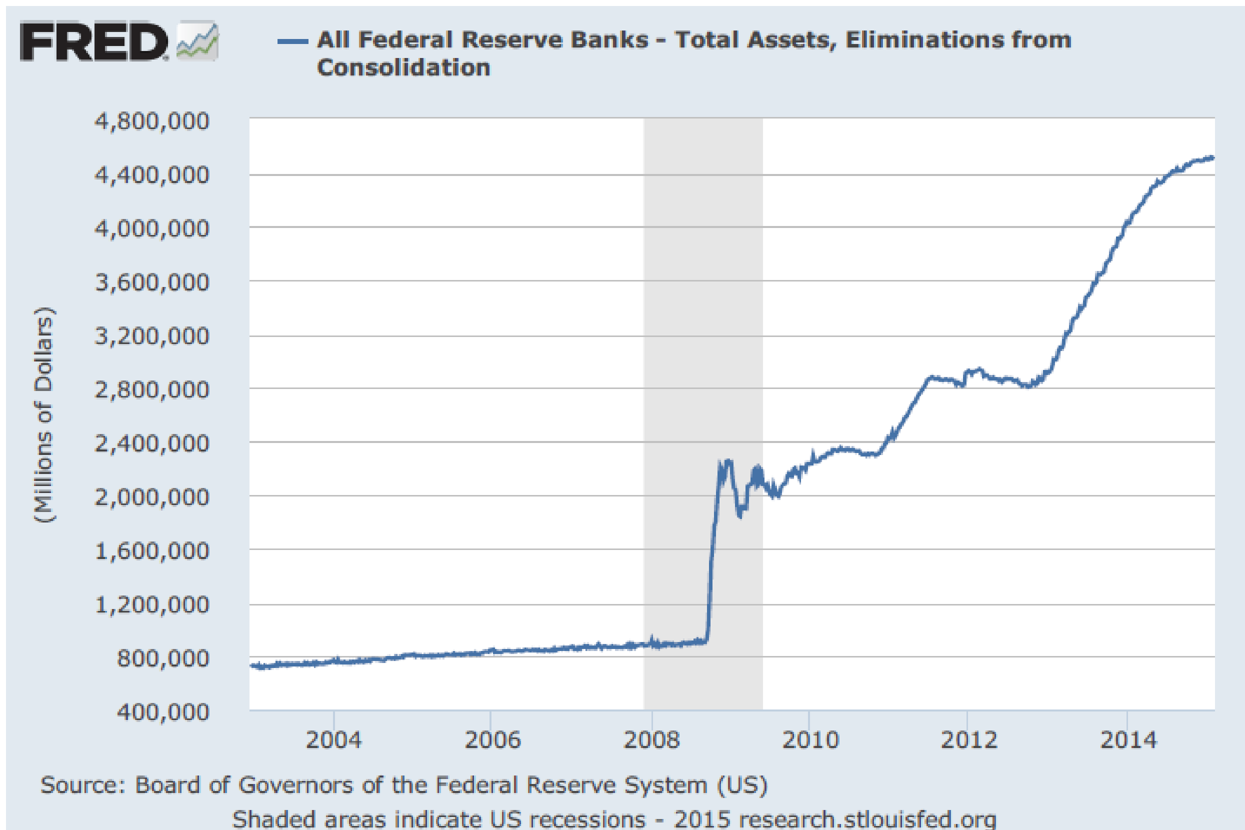
waterboarding." The outcome of negotiations between Greece and the European Union will determine whether Greece stays in the euro or walks away. Clearly the next few weeks will be filled with high drama and intense negotiations.
Meanwhile, the U.S. economy continues to show steady growth as fourth quarter Gross Domestic Product (GDP) was estimated to have expanded at a 2.6 percent pace on an annual basis. The unemployment rate fell to 5.6 percent – the lowest since June 2008, Personal Consumption Expenditures (real consumer spending) rose a healthy 4.3 percent, and the Leading Economic Index advanced 0.5 percent in December. In addition, consumer confidence has been on the rise, and the Small Business Optimism Survey soared to its highest level since October 2006.

On the other hand, new orders for Durable Goods, those expected to last more than three years, fell 3.4 percent in December following a 2.1 percent decline in November, commodity prices have plunged, and retail sales fell 0.9 percent in December. These data points, along with elevated volatility, have added to concerns about the health of the global economy.

Federal Reserve

While many are under the impression that "Quantitative Easing" in the U.S. has ended, the Federal Open Market Committee (FOMC) continues to maintain its "existing policy of reinvesting principal payments from its holdings of agency debt and agency mortgage-backed securities" and of "rolling over maturing Treasury securities at auction." As such, the Fed's balance sheet, as seen in the next chart, remains elevated and monetary policy remains accommodative.Moreover, the Committee acknowledged that "the recovery in housing remains slow," and since housing represents the largest asset for many, and, in aggregate, accounts for a meaningful portion of the U.S. economy, the Fed is in no rush to tighten monetary policy. That sentiment was confirmed several times in the recent statement as "the Committee judges that it can be

patient in beginning to normalize the stance of monetary policy," and "economic conditions may, for some time, warrant keeping target federal funds rate below levels the Committee views as normal in the long run." Federal Reserve Bank of Chicago President Charles Evans expressed his personal views saying "raising rates would be a catastrophe."



The Fed views the decline in energy prices as a positive, on balance, as it acts like a tax cut. Nevertheless, the Fed is well aware of the impact oil and commodity prices in general could have on the global economy, and stated they will take financial and "international developments" into consideration.

Europe / Asia

The European Central Bank (ECB) officially announced an "expanded asset purchase

programme," (also known as quantitative easing) comprised of "monthly purchases of public and private sector securities" in the amount of 60 billion euros "intended to be carried out until end-September 2016." The rationale behind the move was attributed to slow economic growth as real GDP in the euro area rose by 0.2 percent quarter over quarter in the third quarter of 2014, and to attempt to stave off the threat of deflation. The headline Consumer Price Index (CPI) inflation rate in the Eurozone was minus 0.2 percent year-over-year in December. This caused the value of the euro to drop precipitously versus the U.S. dollar, and caused interest rates in many countries to sink further into negative territory. Five-year German bond yields fell to minus 0.5 percent and ten-year Swiss bond yields fell to minus 0.28 percent.

What is interesting is that the ECB is using quantitative easing to generate inflation, yet empirical evidence suggests it does not accomplish that outcome. The Federal Reserve has engaged in quantitative easing since the onset of the financial crisis, yet recently admitted "Inflation has declined further below the Committee's longer-run objective." What QE does do is support asset prices; its stimulative impact on Gross Domestic Product (GDP) is debatable.

While the ECB is attempting to support the economies of the 19 countries in the Eurozone, other central banks are doing so as well. In 2015, fourteen countries have cut interest rates including Canada, Switzerland, Denmark, Singapore, India, Turkey and Russia, to name a few. Each of these actions have collective impacts on capital flows, the most obvious is in exchange rates. The Canadian dollar, for example, has fallen approximately 16 percent relative to the U.S. dollar since July. The Monetary Authority of Singapore (MAS) issued a surprise statement which effectively gave its blessing to the devaluation of the Singapore dollar versus the U.S. dollar, which has fallen roughly 9 percent. The Russian ruble has fallen over 50 percent in the last twelve months and more than 6% in one day as S&P cut Russia debt to junk status and the Russian central bank unexpectedly cut interest rates by 2 percentage points to 15

percent.

Outlook

It is clear that each central bank is trying desperately to offset a weakening economy, stave off deflation, and support an increase in employment. We believe central banks are using what we refer to as the Bernanke Doctrine, in which former Federal Reserve Chairman Ben Bernanke said “sufficient injections of money will ultimately always reverse a deflation.” Ben Bernanke and his central bank fraternity brothers and sisters believe that “Deflation is in almost all cases a side effect of a collapse of aggregate demand.” Therefore, their goal is to increase aggregate demand by encouraging spending (using the so-called “wealth effect”), discouraging savings (negative interest rates), and currency devaluation. Recently the Dutch central bank has gone so far as to cut deposit rates to minus 0.5 percent.

While that may be their goal, there is no guarantee that it will be achieved. We live in a dynamic world and each action has other consequences. For example, the manipulation of forcing interest rates lower has put more and more pressure on pensions that have made long-term promises to retirees. Currency devaluations will impact other markets; copper prices fell 5 percent in one day. The 50 percent decline in the price of crude oil will inevitably cause supply to be curtailed, which will impact employment in oil producing states.

What is interesting is that when quantitative easing began in the U.S., it was due to credit markets being frozen, the U.S. economy in a severe recession, and concern about the solvency of many of the largest financial institutions in the world. Today, however, after years of economic growth, the two-year U.S. Treasury note yields 0.49 percent, well below the level it hit during the peak of the financial crisis. It should be obvious that global central bank policy is no longer about bringing interest rates down,

as many 10-year yields are currently at or near historical lows, but about generating particular economic outcomes. What is different is that this phase of monetary intervention and activism is actually adding to financial market volatility.

It seems to us that the central banks are determined not to lose the deflation fight. Just after the ECB announced its more than 1.1 trillion euro asset purchase program, European Central Bank Executive Board member Benoit Coeure said it “could be expanded or extended” if the impact on inflation is not sufficient. Former Treasury Secretary Lawrence Summers has warned of a deflationary crisis if the Fed tightens too soon.

It is important to keep in mind that there will be winners and losers. Nevertheless, we will continue to rely on our Tactical Allocation Market Composite (TAMC) for guidance. With monetary policy still accommodative, the economy growing, and valuation relatively attractive – the Equity Risk Premium (calculation of excess return over riskfree rate) is over 6 percent – the highest since early 2013, we are still constructive. However, as we have seen over the last few months, it will be a bumpy ride. If competitive currency devaluations escalate into outright currency wars, or if Greece is unsuccessful in negotiating more favorable terms without leaving the euro, markets will undoubtedly come under pressure. We will, however, continue to advocate buying into weakness as long as our risk outlook is in “green light” territory.

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