On Our Radar – March 2015

The month of February saw volatility continue in a variety of asset classes with many markets reversing the trends experienced in January. For example, following the 3.1 percent decline in January, the S&P 500 index gained 5.48 percent. The yield on the 10-year U.S. Treasury fell from 2.17 percent at year-end, to 1.67 percent as of January 30, 2015. However, by the middle of February the yield rose back to 2.14 percent before closing the month at 2 percent. A barrel of West Texas Intermediate oil rallied from a low of approximately $45 in January to more than $54 in February, before settling in near $50 at month end, and utilities have fallen more than 10 percent from their January highs.

The bigger picture, however, remains that equity markets around the world continue to reward investors. The Dow Jones Industrial Average, S&P 500 index, and the smallcap Russell 2000 index recorded all-time highs. The gains were not limited to domestic markets as new all-time highs were also registered in the German DAX and UK's Financial Times Stock Exchange (FTSE) 100 index. In fact, the FTSE 100 recently exceeded its December 30, 1999 high of 6930.20. Moreover, both the NASDAQ Composite and the Japanese Nikkei 225 indices registered 15-year highs. This is a stark reminder that quantitative easing (QE) was designed to raise asset prices, which is still ongoing today.

The U.S. economy grew at a revised 2.2 percent pace in the fourth quarter, down from the initial estimate of 2.6 percent, primarily due to lower inventories. This compares to a 5 percent growth rate in the third quarter. Nevertheless, Industrial Production increased 0.2 percent in January as did the Leading Economic Index, and Durable Goods orders increased 2.8 percent. In addition, Personal Income rose 0.3 percent in January, and non-farm payrolls increased by 257,000 jobs, capping the largest three-month gain in 17 years.

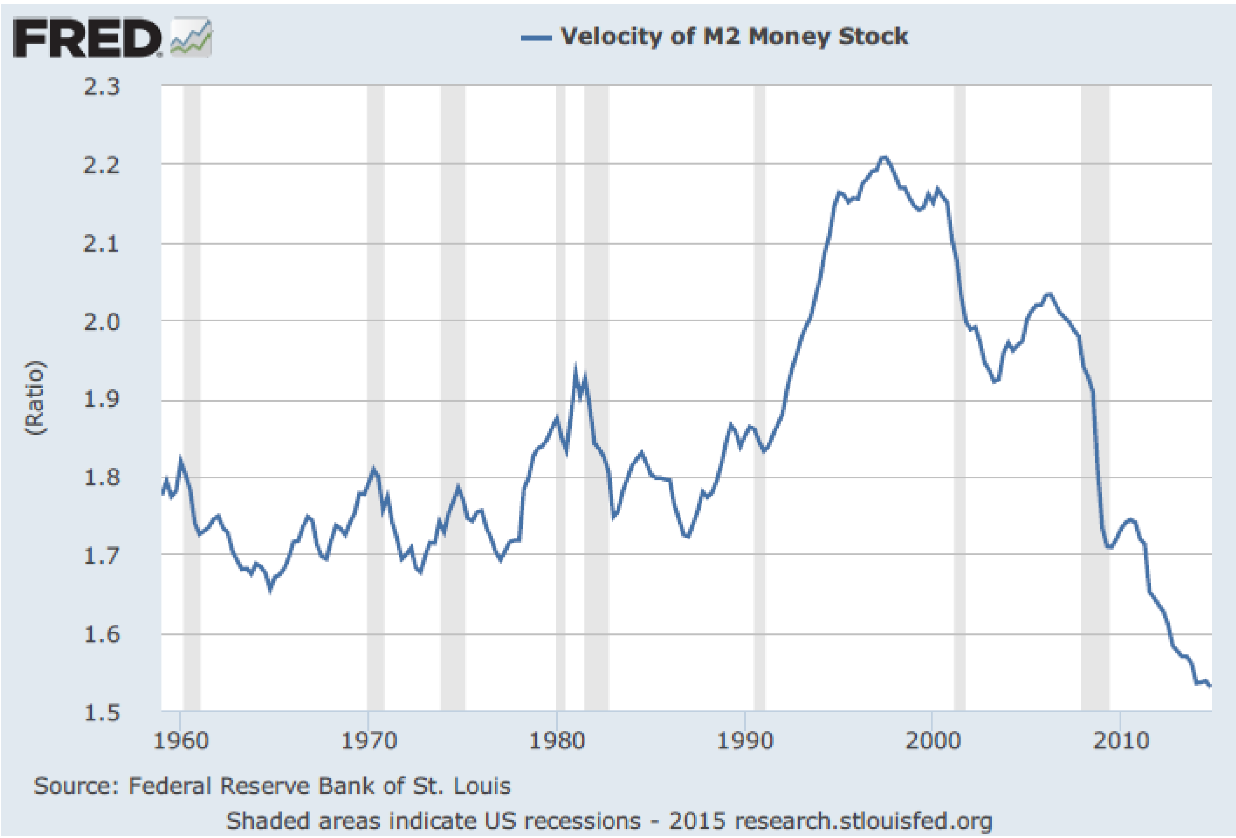
On the other hand, Personal Consumption Expenditures decreased 0.2 percent, and Retail Sales fell 0.8 percent in January following a 0.9 percent decline in December, as falling gasoline prices were a significant factor. The Institute for Supply Management (ISM) Manufacturing index fell slightly to 52.9 percent in February, from 53.5 percent in January, though still above the expansion level of 50.

## Federal Reserve

Federal Reserve Chair Janet Yellen's semiannual monetary policy report to Congress said the Federal Open Market Committee (FOMC) judges that "a high degree of policy accommodation remains appropriate to foster further improvement in labor market conditions and to promote a return of inflation toward 2 percent over the medium term." Ms. Yellen went on to say conditions may "warrant keeping the federal funds rate below levels the Committee views as normal" for some time "because the residual effects of the financial crisis may continue to weigh on economic activity." So while the economy is making progress, there is still room for improvement.

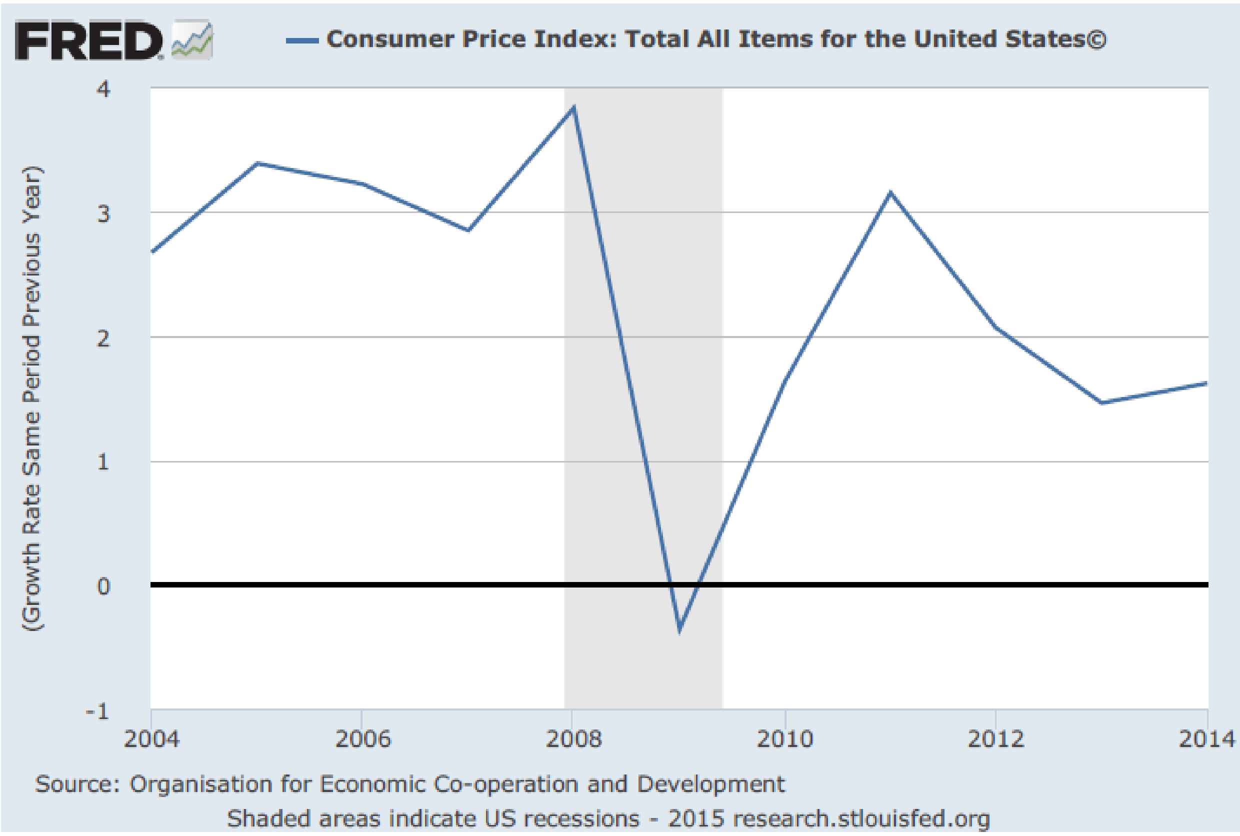
In addition, two very influential Fed members reiterated that not only is U.S. policy of accommodation intact, it is indeed justified due to the lingering effects related to the financial crisis. William Dudley, the President and Chief Executive Officer of the Federal Reserve Bank of New York, in a speech said "inflation is projected to stay for some time below the Fed's objective of 2 percent," therefore, the "process of normalization of monetary policy should proceed cautiously." Mr. Dudley further stated the "U.S. and global markets are integrated to a significant degree," so the "risk of lifting the federal funds rate off the zero lower bound a bit early are higher than the risks of lifting off a bit late." Expanding debt levels and slow economic growth are a global problem. Policy measures taken by one country to improve domestic conditions may have implications on other countries. As a result, global monetary policy needs to be more coordinated.

One of those effects has been the massive decline in the velocity of money, as seen in the following chart. Velocity simply refers to the number of times a dollar is spent to buy goods and services within a given period of time. The Fed has created an enormous amount of liquidity, however, it cannot control where it goes.




Another area that is reflective of the impact of the financial crisis is the rate of inflation. According to most central bankers, inflation is the best way to deal with deleveraging. In fact, the whole thrust of central bank initiatives have been designed to generate inflation to offset any risk of deflation taking hold. However, after six years of almost zero percent interest rates and a Federal Reserve balance sheet that has grown to roughly $4.5 trillion, the Fed's favorite inflation gauge – the Personal Consumption Expenditure (PCE) Deflator – fell 0.2 percent year-over-year. The PCE Core index showed a modest 1.3 percent gain. Likewise, the more familiar Consumer Price Index is also below the Fed's target level of 2 percent. For 2014 the CPI was 1.62 percent. In

January, the Consumer Price Index for All Urban Consumers declined 0.7 percent, while excluding food and energy, the CPI rose 0.2 percent.




Federal Reserve Vice Chairman Stanley Fischer acknowledged that asset purchases provide meaningful stimulus to the economy, "and with the Fed continuing to hold these securities they should apply downward pressure on rates for some time." He said that the decline in interest rates has led to "higher equity valuations. Thus, the asset purchases have helped make financial conditions overall more accommodative." He went on to say that the Fed "does not anticipate sales of agency mortgage-backed securities," so the Fed's balance sheet is not expected to contract anytime soon. Investors should be reminded that the Federal Reserve earns substantial interest on its portfolio, and by law remits the profits after administrative expenses back to the U.S. Treasury. That Quantitative Easing has been a huge windfall for the government is yet another reason why the Fed is in no rush to sell securities.

Europe /Asia

Central banks around the globe have adopted the “Bernanke Doctrine.” That is, they believe that deflation is caused by inadequate demand, so their policies are geared toward lowering interest rates through asset purchases (Quantitative Easing), devaluing currencies, and generating a so-called wealth effect by supporting asset prices. While the Federal Reserve has increased the size of their balance sheet to roughly 26 percent of nominal Gross Domestic Product (GDP), a number of central banks have significantly exceeded that level. For example, the Bank of Japan has increased assets on its balance sheet to roughly 60 percent of Gross Domestic Product (GDP), the Swiss National Bank increased assets to more than 80 percent of GDP, and the European Central Bank’s quantitative easing (QE) program has yet to begin. This has brought interest rates on five-year government bonds in Germany to minus 0.09 percent and five-year Swiss government bonds to minus 0.35 percent. While actually paying governments money for the privilege of holding cash might be hard to fathom in theory, it is alive and well in the world of financial reality. Concern regarding Greece’s ability to service their massive debt load and falling consumer prices in the Eurozone for three straight months in February has caused a flight to safety. Meanwhile, Eurozone unemployment was recently 11.2 percent, putting further pressure on policy makers to ensure deflation does not take hold.

Since the beginning of the year twenty central banks have cut interest rates, including The Bank of Israel and the People’s Bank of China, which did so for the second time in three months. China’s yuan fell to the lowest level against the U.S. dollar since October 2012, and more easing moves can be expected in an effort to stem a decline in the world’s second largest economy. Janet Yellen acknowledged China’s “economic growth could slow more than anticipated,” and that in the Euro area “recovery remains slow” and downside risks remain.

## Outlook

Central bank policy includes flooding the markets with liquidity, discouraging savings using low and negative interest rates, and devaluing currencies in an all-out attempt to encourage economic growth. What is interesting is that despite record highs in some indices, research suggests that individuals, pensions and endowments are underinvested in equities. Given that the federal funds rate is currently at an “emergency” rate of roughly zero and that the yield on the two-year U.S. Treasury is well-below the levels seen at the height of the financial crisis in the fall of 2008, some trepidation may be understandable, especially when you consider roughly $3.6 trillion in global debt is trading at negative yields.

The financial system and a majority of investors cannot live on negative interest rates for an extended period of time. Although we expect the volatility in a variety of asset classes to continue this year, we will rely on our Tactical Allocation Market Composite (TAMC) for direction. With monetary policy still accommodative, the economy growing, and the equity risk premium “relatively wide,” according to Janet Yellen, we are still constructive and view weakness as an opportunity. Furthermore, quality stocks have provided a growing income stream over the past few years as the dividends on the 30 stocks in the Dow Jones Industrial Average have increased roughly 60 percent over the past six years. With some dividends well north of the yield on the 30-year U.S. Treasury, equities may actually see inflows should interest rates rise.

While we believe that equity markets can surely decline, just as they have at times over the past 12 months, we expect the upward bias to continue until the Fed changes policy, the economy enters a recession, or the market loses confidence in central banks. The Fed seems determined not to repeat the mistake of 1937 whereby a premature tightening caused the economy to turn down. Furthermore, Former Fed

Chairman Ben Bernanke suggested the target inflation rate should be closer to 3 percent as 2 percent may be too low. (3.3.15)