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On Our Radar – May 2015

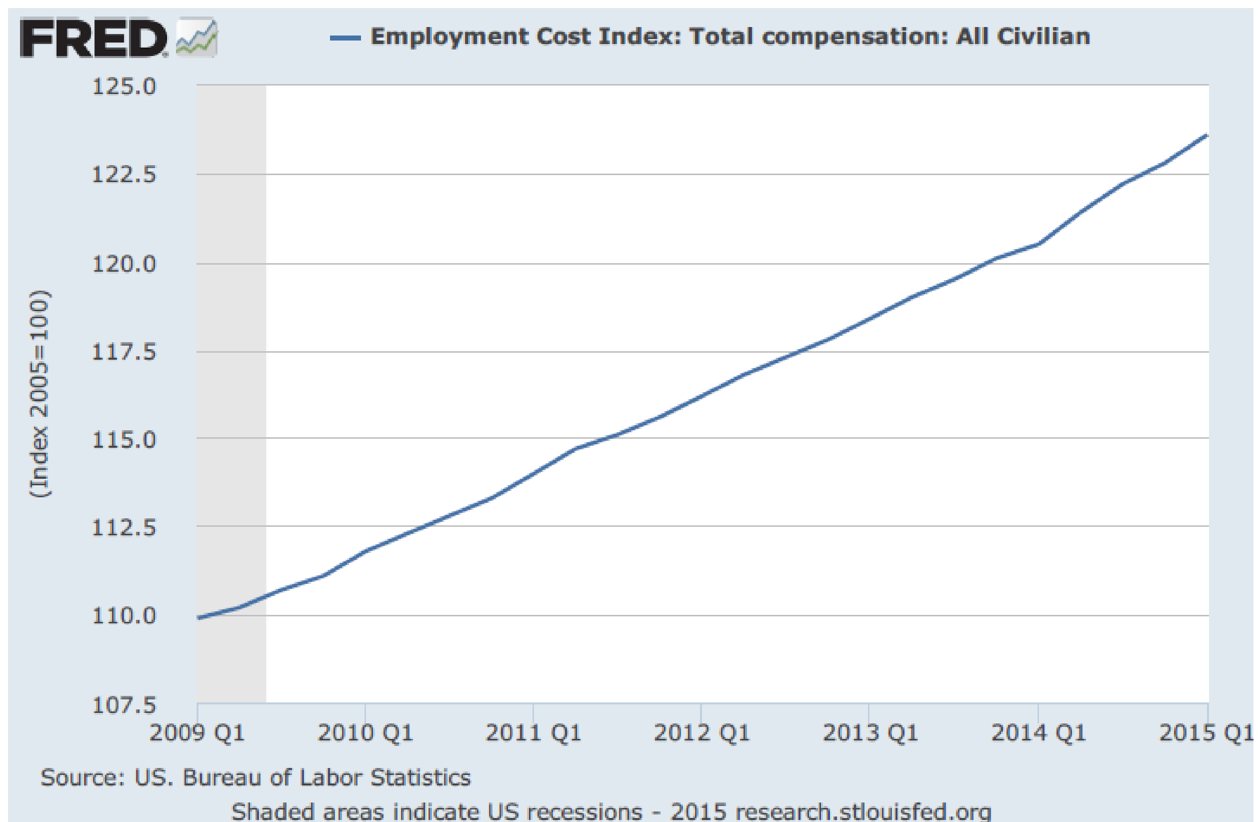
The recent increase in volatility seen in the financial markets over the past few months continued in the month of April. While the Dow Jones Industrial Average (DJIA), S&P 500 index and the NASDAQ Composite gained 0.36 percent, 0.85 percent and 0.82 percent, respectively in April, the U.S. equity markets experienced big swings. For example, on April 17, 2015, the DJIA declined 279 points, only to follow that up with a 208 point gain the next business day. This tug-of-war has been ongoing most of this year with the Dow Jones Industrial Average up 17.45 points year-to-date through April 30, 2015. The Dow Jones index first hit the 18,000 level in December 2014, and has been trading within roughly 4.6 percent of that level for the past five months. On the brighter side, the NASDAQ Composite finally exceeded its March 2000 closing high of 2048.62 after more than 15 years.

Counter-trend rallies were also seen in the price of a barrel of West Texas Intermediate oil, as it rose from a low of approximately $44 in March to more than $59 at the end of April. The value of the euro relative to the U.S. dollar also rose from a low of nearly $1.04 to about $1.12. And interest rates on the ten-year U.S. Treasury Note recently jumped from 1.85 percent in mid-April to roughly 2.12 percent. A majority of this is a result of the continued unprecedented monetary policy adopted by global central banks, and the uncertainty on the part of global investors as to how it is going to play out. The world has not experienced anything like this in the past 100 years or so, therefore, the range of outcomes is quite large, as are the possibilities for unintended consequences.

With respect to the U.S. economy, Gross Domestic Product (GDP) grew 0.2 percent in the first quarter of 2015, down from 2.2% in the fourth quarter and 5.0 percent in the third quarter of 2014, as exports fell roughly $50 billion primarily due to the effects of a higher U.S. dollar, a west coast port strike and weakness in the energy sector. Lower exports translated into a roughly 1.3 percentage point hit to GDP.

Industrial Production fell 0.6 percent in April, although the New Orders Index increased to 53.5 percent, a 1.7 percentage point increase from March. Again, the decline in oil and gas drilling was the main factor. The Institute for Supply Management (ISM) Manufacturing Index was 51.5 percent in April, unchanged from March. The Conference Board's Consumer Confidence index fell to 95.2 in April, down from March's revised 101.4 figure.

On the positive side, retail sales increased 0.9 percent in March on a month-over-month basis, and weekly unemployment claims fell to 262,000, the lowest figure in any week since April 2000. The decline in the unemployment rate and the gradual pick-up in wages are starting to show up in the Employment Cost Index (ECI). As the adjacent chart indicates, the ECI climbed 0.7 percent in the first quarter, and is up 2.6 percent year-over-year. While still modest by historical standards, the trend seems to be



accelerating. Indeed, private wages jumped 2.8% in the past year, the biggest increase since the third quarter of 2008. While there is no doubt that real wages have been stagnant for quite some time, even a slight pick-up in wage pressures can have an impact on interest rates and the bond market.

Federal Reserve

The Federal Reserve's Federal Open Market Committee met on April 27-28 and acknowledged that "economic growth slowed during the winter months, in part reflecting transitory factors." The FOMC statement went on to say "the Committee continues to expect that, with appropriate policy accommodation, economic activity will expand at a moderate pace." While the Committee did not raise the federal funds rate off the essentially zero lower bound, they are communicating to the markets that an initial rate hike is forthcoming. The exact language was "The Committee anticipates that it will be appropriate to raise the target rate for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the near term." Nevertheless, the Fed continues its policy of reinvesting principal payments from the portfolio of mortgage bonds and is rolling over maturing Treasury securities. Hence the Fed's balance sheet is not shrinking and remains near the peak level. The Fed believes this policy "should help maintain accommodative financial conditions."

The Core Personal Consumption Expenditure (PCE), which measures prices paid by consumers for goods and services excluding volatile food and energy prices, continues to be a favorite inflation gauge of the Fed. Although it was unchanged at 1.3 percent recently on a year-over-year basis – still below the Fed's 2 percent target, a glance at the following chart since the onset of the financial crisis would not suggest that prices are in danger of deflation.

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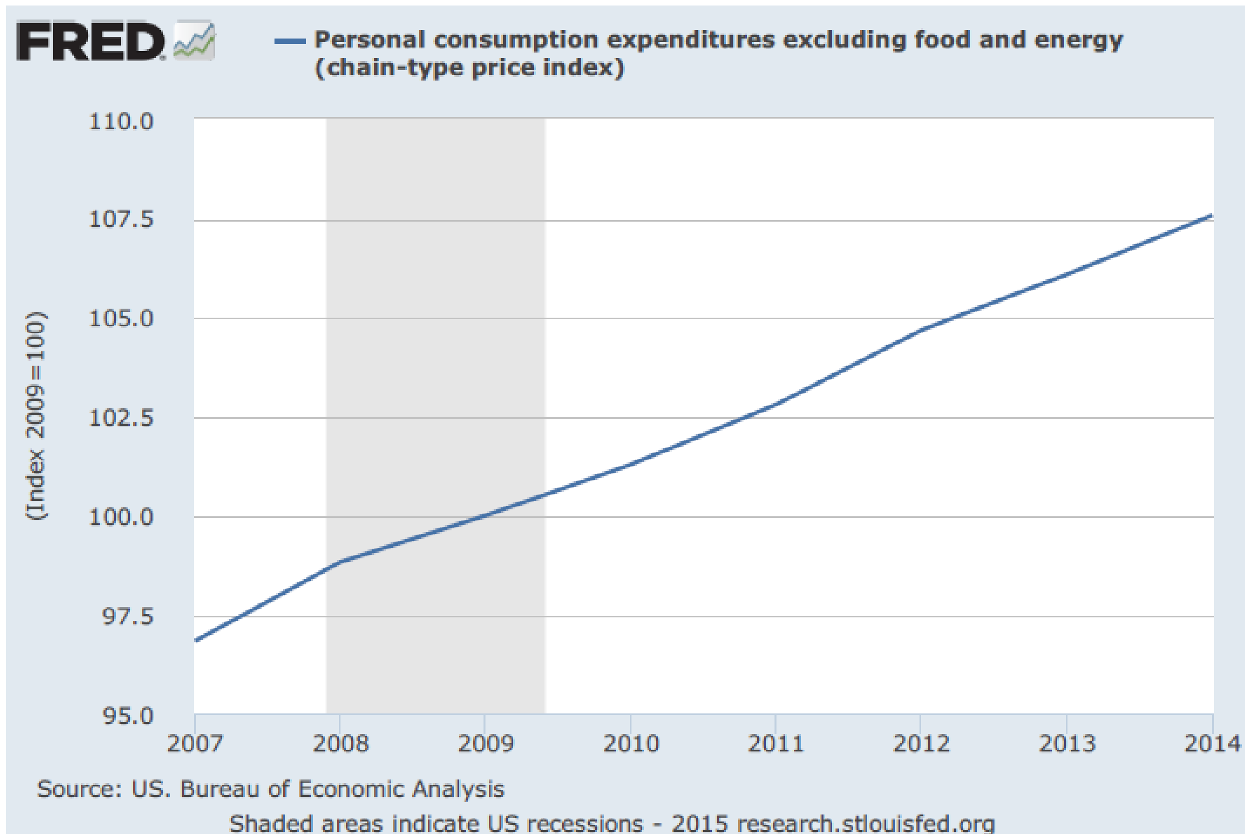


While the Fed believes it is doing its best to communicate its intensions to markets, problems in the stock market generally do not start with the first rate hike but rather the latter ones, especially when they result in an inverted yield curve (short-term interest rates above long-term interest rates). In the past that has signaled an economic recession and problems for the stock market.

The Fed is mindful, however, of what is referred to as a "liquidity mismatch," whereby investors in bond funds expect to have daily liquidity even though the average maturity on the portfolio may be three to five years, or longer. In a speech last month Federal Reserve Vice Chairman Stanley Fischer said "some open-ended mutual funds offer daily withdrawal privileges but invest in assets that take longer to sell and settle." Along similar lines, J.P. Morgan Chairman Jamie Dimon referenced an event that took place on October 15, 2014 when "Treasury securities moved 40 basis points, statistically 7 to 8 standard deviations — an unprecedented move — an event that is supposed to

happen only once in every 3 billion years or so." While Mr. Dimon went on to say "The good news is that almost no one was significantly hurt" due to the resilience in the system, he did infer that regulators have a habit of addressing the last crisis, not the next one, and that recent regulatory changes have increased the cost that dealers face when expanding their balance sheet. One inference is that dealers may be less-willing to do so in the future, causing volatility especially in the bond market to increase.

Europe / Asia

The European Central Bank (ECB) is set to increase the size of its balance sheet by approximately 53 percent if their recently announced quantitative easing ("QE") program runs from March 2015 to September 2016. The impact on financial markets has been historic as yields on all German government debt were negative through the year 2024 as of mid April. Not to be outdone, the Swiss government became the first ever to issue a 10-Year sovereign bond at a negative interest rate. It is quite remarkable when investors are willing to pay governments for the privilege of buying bonds. However, that may not last as the yields on 5-year German bonds rose from minus 0.16 percent in mid-April to 0.04 percent recently. The German 30-year bond yield has doubled from a low of 0.45 percent to 0.99 percent in just the last few weeks.

The effect of quantitative easing on European stock markets has been equally impressive with the German DAX up 16.8 percent year-to-date in local currency terms. There is no doubt that the depreciating euro has helped exporters become much more competitive around the globe.

In Asia, the Bank of Japan maintained it massive monetary stimulus, although markets were recently expecting the central bank to do even more as the target date for meeting its 2 percent inflation goal was pushed back. Nevertheless, the Japanese Nikkei 225 stock index hit 20,000 for the first time in 15 years. Japan's Government Pension

Investment Fund (GPIF), a $1.5 trillion fund, continues to increase its equity allocation both domestically and internationally.

The Reserve Bank of China cut the reserve requirement by 100 basis points (1.00%) in late April thereby adding more liquidity to offset a slowing economy and a declining real estate sector. In the first quarter China saw its economy grow 7 percent, the slowest pace since December 2008. The central bank cut interest rates 100 basis points for only the second time since the depths of the financial crisis, and it followed a 50 basis point (0.50%) rate cut in February. China's Shanghai Composite stock index is up roughly 38.5 percent year-to-date, as compared to a 1.3 percent decline between December 31, 2009 and December 31, 2014.

Even the Central Bank of Russia cut interest rates for a second time in as many months to offset "considerable economic cooling."

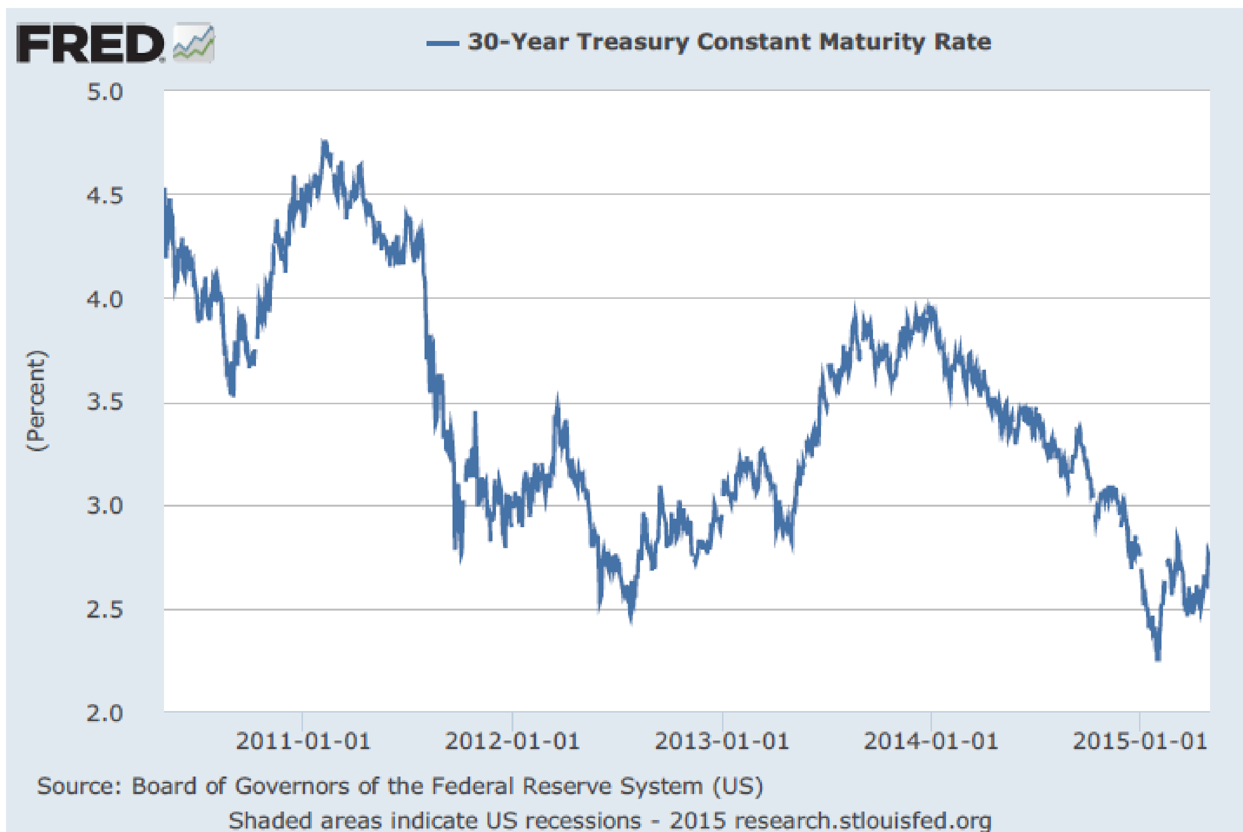
Outlook

At a minimum, markets are witnessing a unique course of events certainly with respect to scope and magnitude of central bank intervention. In many investment circles there is uncertainty not just with respect to how events may unfold, but also how investors may react to possible unintended consequences. Negative interest rates are essentially a tax on money, and untested policies are affecting a variety of asset classes such as stocks, bonds, commodities and currencies.

The Fed is well aware that the Bank of Japan tightened policy in 2000, and then had to reverse course. In 2009 the Swedish National Bank raised interest rates, only to have to reverse course. And in 2011, the European Central Bank (ECB) led by Jean-Claude Trichet also raised interest rates, only to have Mario Draghi need to reverse policy. Nevertheless, the Fed seems determined to get off the emergency "zero lower bound"

policy that they have had in effect since December 2008.

To date, the negative adjustment process has been felt in a couple of major currency markets and in the commodity markets – especially gold and energy. Recently, the three-year U.S. Treasury note yielded more than the 30-year German bund. There is no doubt that the influence of central bank policies has been historic. On some levels the outcome has been predictable; following major financial crises it is not unusual for central banks to become more influential and regulation to increase. On the other hand, however, outcomes such as negative interest rates and the sheer size of central banks' balance sheets are unprecedented. As a result, the range of possible outcomes is wide. For example, the yield on the 30-year U.S. Treasury bond hit an all-time low of 2.23 percent at the end of January. At present, the yield is approximately 2.86 percent.



Over the years we have learned to filter out the noise, seemingly endless predictions, and even crowd psychology in order to focus more clearly on the variables that historically have impacted markets most, We combine those factors into what we refer to as our "Traffic Light" indicator, or what is officially known as our Tactical Allocation Market Composite, to determine market conditions. The combination of those factors tells us whether financial conditions are in "green light, yellow light or red light" territory.

Since our risk "traffic light" is still in "green light" territory, notwithstanding the recent volatility, we are constructive and expect to buy on dips. Nevertheless, investors should be mindful that volatility could increase further as the Greek debt situations remains unresolved, earnings reports continue to be announced – with some companies exceeding estimates being generously rewarded while those disappointing investors are equally penalized, and the old adage "sell in May and go away" could influence participants despite that strategy not working in the previous three years.

Investors should be reminded not to get too caught up in the latest market chatter or consensus expectations. Investments that the market seemingly hated just a few months ago, such as oil and the euro, have rallied the most of late, while others that were loved, such as bonds, have been under the greatest pressure. As Berkshire Hathaway Vice Chairman Charlie Munger said recently, "If people weren't wrong so often, we wouldn't be so rich." (5.4.15)

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