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CAPITAL INSIGHTS

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THE US ECONOMY ALL FOR ONE AND ONE FOR ALL?

You may have noticed that the latest revision for US GDP in the second quarter registered a 4.6% growth rate. That is one of the largest quarterly growth rate numbers for GDP over the entirety of the current cycle. Is the US economy finally reaching the fabled area of escape velocity? For the current year, context is important. Along with the recent second quarter GDP revision to a 4.6% number came a revised first quarter GDP contraction of 2.9%, largely due to severe winter weather. Given this almost anomalistic range of GDP outcomes over two successive quarters, it's important to look at the first half of the year as an average. The simple math yields an average growth rate of 1.7% for US GDP in the first half of the year, completely in line with the relatively subdued 2% growth the US economy has experienced throughout the current cycle. Set within the context of history, the current cycle has produced the most subdued rate of GDP growth of any cycle dating back to the late 1940's when the Fed began keeping official records. Why has this occurred and what lies ahead?

There are many reasons why US economic growth has been so subdued over the last half decade. Working off the overhang of leverage from the prior cycle is one key reason why meaningfully accelerating growth has remained elusive. Lack of a pronounced job recovery, accompanied by lack of wage growth is another. The list of compare and contrast economic stat items in this relative to prior cycles is extensive. One issue we'd like to highlight in this discussion that we believe receives too little attention in commentary and analysis is quite simply the heightened level of interdependence within the global economy of the moment.

Let's think back to the prior economic cycle of 2002-2007. As that cycle was coming to an end, a key provocateur in its demise was the trouble emanating from US credit markets – mortgage markets specifically. It was the blow up of an exaggerated credit cycle that ultimately brought the US economy to its knees. But as this credit market drama was unfolding in living color in US financial markets, a cry of economic "de-coupling" was sent up globally. The thinking was that the credit market problem was US specific. Economists believed the Chinese, European and Japanese economies would "de-couple" from the troubled US economy and would simply forge ahead while the US took a needed time out for credit market healing. In the stark clarity of hindsight, de-coupling proved to be a pipe dream. The interconnected and interdependent nature of today's global economy and financial markets drew the entire globe into the real economic troubles faced by the US.

Fast forward to the present and for now, the US is the lead sled dog in pulling the real global economy forward. At present, it is the major developed as well as emerging economies that are hurting. 2% GDP growth does not sound like a lot in the US, but it is one of the best growth numbers among the entirety of the global economic landscape. So now the shoe is on the other foot, if you will. The key question being, will the US economy "de-couple" from the issues and problems abroad? Or has the maturity of global economic and financial market interdependence destined the US to be held back from ultimately achieving escape velocity in economic growth in the current cycle?

Unfortunately, levels of expected forward global economic growth today are well below where they stood in January of this year. In fact, numbers have been ratcheted down even since summer. The recent quarter GDP growth in Japan measured a contraction of 7.1%. This is an annualized number and may appear a bit sensational. The unprecedented printing of money by the Bank of Japan, has caused a serious currency devaluation, a rapid rise in inflation and a corresponding decline in consumption. Japan's prescription for solving these ills? Print even more money. The risk of a Japanese recession is all too real.

Russia, likewise, is staring down a potentially nasty recession. The decline in oil/energy prices recently has hurt its economy, as have the international sanctions. Unfortunately sanctions usually accomplish one thing very well – they depress real economic activity. We need to remember that sanctions are a two way street. Russia has banned the importation of fruits and vegetables, very seriously harming the Eastern European agricultural

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community. Their canceling of Boeing aircraft orders is yet another example of how sanctions can reverberate in negative fashion throughout a truly global economy.

Plain and simple, there are few easy answers for Europe. Importantly, Europe is facing heightened deflationary pressures right now. Pressures that we expect will precipitate extraordinary European Central Bank money printing very soon. Area wide GDP has registered 0.6% recently, with periphery Euro area countries having a much tougher time. Lastly, Europe's prescription for recovery has been even more borrowing. Since 2007, Portuguese government debt to GDP has risen from 70% to 130%. For troubled Greece the numbers are 100% to 170%. This is simply unsustainable.

Finally, China has been slowing for years now. From 14% GDP growth rates five or six years ago, China is hoping to achieve 7.5% today. In China, 5% GDP growth can be considered a recession as China has what is increasingly being viewed as a debt and real estate bubble. The crackdown on corruption has caused capital to flee the country. Longer term the very big positive is China is moving toward a mandate for change, but it is going to take time and certainly will not be pain free.

In 2006-2007, the global economic downturn started in the US and spread throughout the global economy. In our present circumstances, the immediate sources of trouble are outside the US. Key question being, can the US escape increasing global slowing, or is global economic interdependence today as systemic as was the case in the prior cycle? What does all of this tell us? It tells us that the most important GDP numbers to watch ahead are those of the large and developing global economies, not necessarily the US economy itself. ■

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INTEREST RATES HANDS ACROSS THE WATER, HEADS ACROSS THE SKY

Leading up to the recent Federal Open Market Committee (the Fed) meeting in September, investors were on their hands and knees praying they would hear two specific words – considerable period. This characterization refers to how long the Fed plans to keep short term interest rates very near 0%. The Fed did not disappoint in their communique. It is very important to remember that the Fed sets what is called the Federal Funds Rate, but usually has little to no control over both the direction and level of longer term interest rates. The academic definition of the Federal Funds Rate is the rate at which financial institutions will lend their deposits with the Fed to another financial institution. The level of the Fed Funds rate is important in that it determines very short term interest rates found in money market funds, commercial paper, etc. And in turn, this rate influences interest rates across the entire US Treasury yield curve from 1 to 30 years of maturity.

Although historically the Fed's primary monetary policy tool has been to set the Federal Funds rate, in recent years they have had a huge impact on longer term interest rates also via their money printing exercises. In Quantitative Easing, the Fed essentially printed money to buy US Treasuries of really any maturity, influencing short and longer term interest rates. So although historically the Fed has been the arbiter of short term interest rates, in unprecedented fashion over the last five years, the Fed has influenced interest rates across the entirety of the Treasury market. Remember, as little as one year ago the Fed was printing $85 billion monthly to buy all maturities of US Treasuries.

We now know that the Fed will cease their Quantitative Easing program in October of this year. Will this harm longer term interest rates as the bond market now loses a very key buyer and provider of price support – the Fed? Not necessarily, at least not yet. Just as in our discussion of the economy, it is imperative to remember that the global financial markets are necessarily joined at the proverbial hip. Nothing happens in isolation. The fact is that financial market conditions in foreign markets are causing global capital to gravitate to the US and US financial markets, necessarily including the bond market. Let's look at some numbers that speak to the importance of global capital movement for US interest rate levels.

As mentioned when discussing the European economy, deflation is a reality. So too are negative interest rates both inside the Euro banking system as well as European capital markets. As hard as this may be to believe, anyone purchasing up to a 3 year maturity German Government bond better be ready for a negative return. Today the yield on a 10 year German Government bond is 0.97%. For comparison, the yield on a 10 year US Treasury bond is 2.54%. The differential in yield spread between the German and US bond is 1.57% - one of the largest yield spreads between these two vehicles in close to three decades. Ignoring currency effects, why would a European investor buy a 10 year German bond when they could pick up and additional 1.57% annually on the 10 year US Treasury? But currency is not to be ignored and is also a key driver of global capital flows. Over the past four months, the Euro has lost close to 10% of its value relative to the US dollar. In currency terms, the European buyer of US Treasury bonds has not only picked up the nominal yield differential, but also the currency gain in the Dollar relative to the Euro. Certainly Euro area capital is one key support to US Treasury prices, helping to keep US interest rates in general very low. This is something that has absolutely nothing to do with the condition of the US economy and everything to do with the condition of the Euro area economy.

We find a very similar situation in Japan. The 10 year JGB (Japanese Government Bond) has a yield near 0.5% relative to the over 2.5% yield found in a like maturity US Government bond. The value of the Japanese yen has fallen close to 30% relative to the Dollar over close to the last two years. A Japanese investor in US Treasury bonds is ahead of the game in terms of yield, but also very heavily ahead of a like investment in Japanese bonds from a currency standpoint.

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We have argued the importance in the current cycle of the major investment theme that is the weight and movement of global capital. That does not apply just to real estate and stocks, but importantly also to US interest rate markets. All else being equal, would US interest rates today be as low as we now experience had it not been for global capital coming to US markets to escape currency debasement and negative interest rates? It's a very good bet the answer is "no."

So as we look ahead into an upcoming period devoid of US Fed sponsored Quantitative Easing, we need to remember that levels of US interest rates will be increasingly influenced by what is occurring abroad, specifically in foreign capital, interest rate and foreign exchange (currency) markets as well as foreign economies as a whole. The popular perception may be that the Fed controls US interest rates, but that perception in large part died at the altar of globalized economies and financial markets many moons ago. We live in a world where nothing occurs in isolation. We live in a world where having a command of global economics and financial markets is not a luxury, but rather a mandate. ■

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THE US STOCK MARKET DOLLAR DAZE?

We all know that many factors work their way into stock valuations over time. Of course earnings growth is very important, as is the tone of the overall economy. Increasing participation by the public and institutions (volume) can support price, and vice versa. Likewise, the actions of the Fed can clearly move equity prices. One of the factors often overlooked, but increasingly meaningful in the world of the moment is what is called currency cross rates – the value of one global currency relative to another or to a basket of global currencies. In a world where global capital movements are increasingly responsible for financial market and real economic outcomes, anticipating and tracking relative global currency movements takes on heightened importance. We suggest to you that relative currency movements will become increasingly important for stock prices over the remainder of this year and into next. In a world of zero percent interest rates, currencies are one of the few pressure release valves for market's adapting to Central Bank policies. We will be monitoring currency movements closely and emphasizing currency movement analysis in our ongoing investment decision making discipline.

We have been talking for some time about the volume of global capital flows being unprecedented in our lifetimes during this current cycle. For now, Asian, Japanese and European capital are coming to US dollar denominated markets to escape confiscation and debasement, as well as seeking out higher rates of return. This movement influences the value of hard assets like real estate, interest rates (as discussed) and stocks. Capital moving to US dollar denominated markets is not only caused by, but helps reinforce these global flows.

The reason we want to address this subject now is that we have experienced some very meaningful moves in global currencies as of late. What do these movements portend and what are the longer term risks of near one way flows into the US dollar as of late? It just so happens that over the last three to four months, the Japanese Yen has moved to a 7 year low against the dollar, the Euro has moved to a 2+ year low against the Dollar, as the Dollar has risen to a five year high against a basket of key global currencies. What does this mean for investors?

Let's start with a look at the Dollar, as recently it is very much the reciprocal of the movement of the Yen and Euro. In just the last quarter, the Dollar has increased over 8% relative to key global currencies. What does this mean for investors in the global stock market?

To a US Dollar investor, an 8% increase in the value of the currency in and of itself does not mean too much over a short space of time. But to a Yen or Euro based investor, this movement is very important. Investors in global stock markets derive return from their investments in foreign markets in two ways – price appreciation and relative currency movement. If a foreign currency based investor bought a US dollar denominated stock at the outset of the third quarter, that foreign investor would have experienced an 8% return based on the appreciation of the dollar alone relative to their home currency, regardless of the price movement of the specific stock. Through late September, the US S&P 500 was basically flat for the third quarter. A US investor would not have earned much, if anything. But again a

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foreign investor in US Dollar denominated markets would be up 8% on currency alone in just this three month period. For reference, the Dow isn't even up 3% for the entirety of 2014 so far. You can see just how meaningful the relative movement in currency cross rates is to global investing. Rising relative currency values attract global capital.

But this relationship also works in reverse. FEZ is the exchange traded fund for the largest 50 European stocks. As you'd guess, these are very large multinationals that are anything but completely levered to the Euro economy. They much more resemble global US blue chips whose operations are global. But the key is that these large European stocks are "priced" in the Euro. As mentioned, the Euro has fallen close to 10% since June of this year. What has this meant for European stocks? The next chart shows us both the value of the Euro and the top 50 Euro area stocks. Since mid-July, these top 50 Euro stocks have lost 10% of their value on a price basis, close to the level of decline in the Euro currency itself. Over this same time the US S&P 500 is flat. Is it because the Euro economy is weak? Not at all as these are blue-chip multinationals. Rather, it is because they are "priced" in Euros. They are priced in a declining currency. Global capital tends to gravitate toward rising currencies at the expense of falling currencies.

These are two very simple examples of how relative global currency movements influence investment outcomes for global investors. These examples show us why currency movements should be considered in allocating investment capital.

So what can we expect ahead? As we have been writing about for some time, capital is flowing to the US Dollar and US Dollar denominated assets. We expect this to continue for a while to come. As mentioned, the Fed will stop QE in October, essentially no longer academically debasing the Dollar. In contrast, the Bank of Japan, People's Bank of China and European Central Bank are set to print ever larger amounts of money/currency. This set of circumstances in isolation suggests an even stronger Dollar and weaker Yen, Euro and Renminbi. If indeed these trends continue, we would expect some level of support to the US Dollar and Dollar denominated assets such as US stocks. The weaker global economies and currencies become, the more we will see global capital gravitate toward the Dollar. Looking into the latter part of this year and into next, strength in the US Dollar could be a continued attractor of additional capital to US markets.

Will it simply be one big party for US Dollar denominated financial assets such as stocks ahead? Initially a rising currency is a capital attractor. But very importantly, a continually rising Dollar is not good for large company profits. We need to remember that very large multi-nationals have meaningful offshore revenues. A company like a Microsoft has over 50% of its revenues coming from foreign currency sources. If foreign currencies decline against the Dollar, the large multi-nationals will see their foreign earnings decline on a currency adjusted basis. So although a rising currency can initially and very favorably attract global capital, a rising currency also sows the seeds of its own demise in terms of the foreign earnings of corporations domiciled in the strong currency geography. Of course this all plays out over a period of

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time. For now, US stock investors can enjoy the rising Dollar and the global capital it further attracts to Dollar based assets such as stocks. We just need to be very mindful of how currency strength can negatively impact corporate earnings down the road. We're not there yet as we currently rest in the sweet spot of a rising currency amidst the sea of global capital. As with many things in life, we simply need to be mindful of enjoying too much of a good thing. As you'd guess, we'll be revisiting this very topic as we move ahead. For now, relative currency and global capital movements are key drivers of global investment outcomes and should be considered within the analysis of ongoing portfolio construction and management. ■

Please let us know if you have any questions about the topics we have covered in this discussion and how they might apply to your investment circumstances. We appreciate your confidence and trust in our investment management services.

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