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CAPITAL INSIGHTS

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The Current Sea

For anyone who has spent time on the open sea, especially in a small craft, you know the sea can be quite the moody mistress. Some days the gale winds are howling. Some days the sea is as smooth as glass. Analogously, the financial markets are quite similar. In late August of this year, the US equity market experienced its first 10% price correction in four years. It's the third longest period in the history of the market without a 10% correction, so in one sense it is long overdue. Because the US stock market has been as "smooth as glass" for years now, it "feels" as if typhoon winds are blowing. The storm clouds of price correction have not only been parked offshore far too long anticipating the inevitability of landfall, they have been double parked, awaiting a corrective downpour that is simply part and parcel of the nature of cycles. Without veering off into a psychoanalytical ditch beside the road, cycles define the markets' very existence. Unfortunately, cycles also define human decision making within the context of financial markets. Is current short term market character really a surprise? It should be an expectation.

Although it is very easy to recite a laundry list of specific protagonists driving former "smooth as glass" market conditions suddenly giving way to the supposedly unexpected squall, let's focus on one theme we believe will be enduring and come to characterize financial market outcomes over the next 6-12 months. That theme is currency.

In past missives, we have discussed the importance of global currency movements to real world economic and financial market outcomes. The issue of currency lies at the heart of the recent uptick in financial market "swell" activity. Specifically, the recent correction in US equities began as China supposedly "devalued" their currency, the Renminbi, relative to the US Dollar.

Before we can look at recent market specifics and why relative global currency movements are so important, we need to step back and set the stage for how we have come to arrive at this now distant shore. It's simply a fact that individual country economies display different character. They do not grow, or contract, at the same rates of change. Some have advantages of low cost labor. Some have the advantage of cheap access to raw materials, etc. No two are exactly alike. Historically, when individual countries felt the need to stimulate (not enough growth) or cool down (too much inflation) their economies, they could raise or lower country specific interest rates. In essence, they could change the price of the "cost" of money. Interest rates have been the traditional "pressure relief valves" between various global economies. Hence, decades-long investor obsession with words and actions of central banks such as the US Fed.

Yet we have maintained for some time now that we exist in a current economic and financial market cycle unlike any we have seen before. Why? Because there has never been a period in the lifetime of any investor today whereby major global developed economy interest rates have been set near academic zero for over half a decade at least, and in Japan multiple decades. That means that the historical interest rate pressure relief valve mechanism has broken, it is virtually non-existent. It has now been replaced by another pressure relief valve. In fact, the only economic pressure relief valve left to individual countries – relative currency movements.

This brings us back to the apparent cause of the present financial market squall - the supposed Chinese currency devaluation that began about three weeks ago. Let's look at the facts and what is to come ahead.

For many years now, China has "linked" their currency to the US Dollar. You'll remember the cries of US politicians from time to time over the last few decades that China is a currency manipulator, this is exactly why. For some time now, China has been quite desirous of their Renminbi being recognized as a currency of global importance – a reserve currency much like the Dollar, Euro and Yen. For that to happen in the eyes of the International Monetary Fund (IMF), China would need to delink their currency from the US Dollar and allow it to float freely (level to be determined by the market, not by a government or central bank). The IMF was to make a decision on Renminbi inclusion in the recognized basket of important global currencies in September of this year. In mid-August, the IMF announced this decision would be put off for one more year as China had more "work to do with its currency." Implied message? China would

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need to allow their currency to float freely. One week later, China took this step, which media reports continue to sensationalize, characterizing China's action as intentionally devaluing their currency.

In linking the Renminbi to the Dollar for many years now, China has "controlled" its value via outright manipulation. It has "allowed" it's currency to trade in a very tight band against the Dollar. The devaluation Wall Street has recently focused upon is nothing more than China allowing the "trading band" in which the Renminbi trades against the Dollar to widen. With any asset whose value has been fixed, or manipulated, for so long, once the fix is broken, price volatility is a virtual guarantee. This is exactly what has occurred. China loosened the band against which the Renminbi trades against the US Dollar by about 4% over the last month. What we believe we are witnessing is the very beginning of China allowing their currency to float freely. This will occur in steps, as opposed to being an event. Again, this is the beginning, not the end, of this process. There is more to come and we believe this will be a very important investment theme over the next 6-12 months.

The fact is the Renminbi has fallen about 4+% against the US Dollar over the last month. What most of the media has failed to mention is that prior to this loosening, the Renminbi was up 10% against most global currencies this year. So now it's still up over 5%. Please remember that over the last 12 months, the Euro has fallen 30% against the US Dollar. Not 4%, 30%, and remarkably enough the lights still go on in Europe. Over the last 2½ years, the Yen has fallen 35% against the US Dollar. Although it may seem hard to believe, the sun still comes up every morning in Japan. What we are looking at in China is economic and financial market evolution. Evolution that will bring change, and we assure you not the end of the world. Financial market squalls very often occur when the markets are attempting to "price in" meaningful change, which is where we find ourselves right now.

What heightens current period investor angst is the weight and magnitude of the Chinese economy, second largest on planet Earth behind the US. With a devalued currency, China can theoretically buy less of foreign goods. All else being equal, a cheaper currency means less global buying power. This is important in that at least over the last few decades, China has been the largest purchaser and user of global commodities and industrial materials. Many a commodity price has collapsed over the last year. Although few may realize this, Europe's largest trading partner is not the US, it's China. European investors are none too happy about recent relative currency movements.

Relative global currency movements are not without consequence, but they do not spell the immediacy of death and destruction. Global central bankers setting rates at zero for so long have created this newfound environment of relative currency movement importance by forcibly removing the interest rate relief valve. The central bankers did this all in the effort of trying to suppress the very natural economic and financial market cycles we referred to at the outset of this letter.

A final component playing into the current market volatility troubling investors is whether the US Fed will take the action of its first interest rate hike in well over half a decade, to potentially occur later this month. Seriously, will a possible .25% short term interest rate vaporize the US economy? Of course not, but the Fed being the only central bank on Earth possibly raising rates again creates a unique currency situation. Academically, when a country raises its interest rates in isolation, it makes its currency stronger and more attractive globally. A stronger Dollar and weaker Chinese Renminbi academically means China can buy less US made goods. Just ask Caterpillar and John Deere how that has been working out for them lately (not well). Similarly, with a recent 20% drop in Apple's stock price are investors jumping to the conclusion that Apple's sales in China will fall off of the proverbial cliff? No more new iPhones sales in China? Really?

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In all sincerity, the issue of relative global currency movements is real and meaningful. It is change that has been occurring for some time now, especially with respect to the Euro and the Yen. But in its latest incidence, it's now the Chinese currency that is the provocateur of global investor angst. Make no mistake about it, China is at the beginning of its currency band loosening process, not the end. This means relative currency movements will continue to be very important to investment outcomes looking immediately ahead. We expect a stronger Dollar, it's virtually intuitive. A stronger Dollar is a double edged sword - Not a major positive for the near term global economic competitiveness of the US, but a huge positive for attracting global capital (attracted to strong currencies) to US shores and assets. We have seen exactly this in real estate, and to a point "blue chip" US equities priced in Dollars, for years now.

In addition to a higher Dollar, we fully expect a lower Chinese Renminbi against the Dollar. If we had to guess, at least another 10% drop in the Renminbi over next 12 months. Again, the price volatility we are seeing right now is the markets attempting to price in this currency development, much as it priced in the falling Euro and Yen during years gone by. Therefore, sector and asset class selectivity becomes paramount, as does ongoing macro risk control.

Much like a sailor away far too long at sea, the shoreline beckons. We simply need to remember that there is a "price" for being free, and for now that "price" is increased volatility. Without question, relative global currency movements have been and will continue to exert meaningful influence over investment outcomes ahead. It is simply the current conditions of the global financial market seas in which we find ourselves.

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