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January 20, 2015

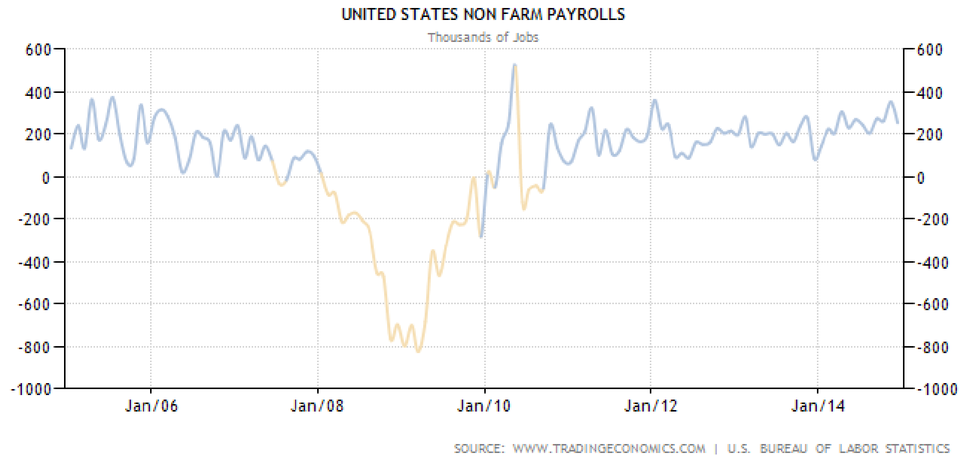
Can the Capital Markets of 2015 Deliver on the Economic Promises of 2014?

As we began 2014 a year ago, we had three expectations of how the year's economic environment would unfold: 1) <u>Acceleration</u> (U.S. GDP/Job Growth would continue to improve); 2) <u>Stabilization</u> (China's deceleration into a slower growing, more consumer-led economy would be largely completed; 3) <u>Emergence</u> (European Union would exit its "double-dip" recession and begin to grow once more). In economic terms, all three of these expectations were met, but the global capital markets did not reflect these developments in a way that was consistent with the economic reality. As we begin 2015, we pose the question: Will 2015's global capital markets reflect the unfolding economic reality that began in 2014 or will externalities and perceptions continue to dominate?

The U.S.: An economic recovery that is starting to look like an ECONOMIC RECOVERY!"

At least part of the disconnect between the global capital markets and the economic environment of 2014 probably can be attributed to the following chart in which the U.S. had a negative GDP reading in the first quarter of negative 2.1% (not something that should happen in a true economic recovery, but something that can happen when you have a very bad winter weather season), but then had a very strong 5% GDP growth reading just 2 quarters later:

Job growth continued at a pace that was comparable to that experienced pre-recession and it even started to accelerate whereby monthly Non Farm Payrolls were growing consistently above 200,000 per month:



Typically, when the economy is growing/accelerating, small cap/cyclical stocks do quite well, if not better than large company stock indices like the S&P 500, but that only occurred during the first quarter of 2014:

Chart of Russell 2000 Small Cap Index vs. the S&P 500 Index during 2014

(Note how the Russell 2000 Index began to underperform in early April, ultimately resulting in over a 10% relative underperformance by mid-October)

We noted this performance divergence in our August 2014 commentary "Have things changed since Jackson Hole?", as well as the view that we felt it was unlikely to continue if the U.S. economy's recovery continued and that some signs were evident in early August that the dynamics had changed.

The data since August of last year has supported the validity of that view as small cap stocks (as represented by the Russell 2000) have begun to largely match, and intermittently outperform for brief periods, the S&P 500 Index:

Chart of Russell 2000 Small Cap Index vs. the S&P 500 Index since 8/1/2014

This "rally-slump-rally" pattern of performance of cyclically-sensitive U.S. equities is even more pronounced in the comparison of the Homebuilders ETF (ticker: XHB) vs the S&P 500 where the Homebuilder ETF underperformed by a margin of over 15% through mid-October, only to begin a rally that put the XHB almost 10% higher than the S&P 500 Index over the past 5-6 months:

Chart of Homebuilder ETF (XHB) vs. the S&P 500 Index during 2014

Chart of Homebuilder ETF (XHB) vs. the S&P 500 Index since 8/1/2014

There are several "theories" as to why this erratic pattern of cyclically-sensitive stocks' relative performance occurred (i.e. small cap stock valuation, foreign equity capital seeking "safety" of liquid, mega-cap U.S. stocks, dividend yield "chasing" in the face of low and falling interest rates, reduced confidence in 2014 economic growth due to negative first quarter GDP growth, etc.), but at this point the most important "take-away" is that the U.S. economy is improving, if not accelerating, and that cyclically-sensitive U.S. equity performance is more fully reflecting that unfolding reality.

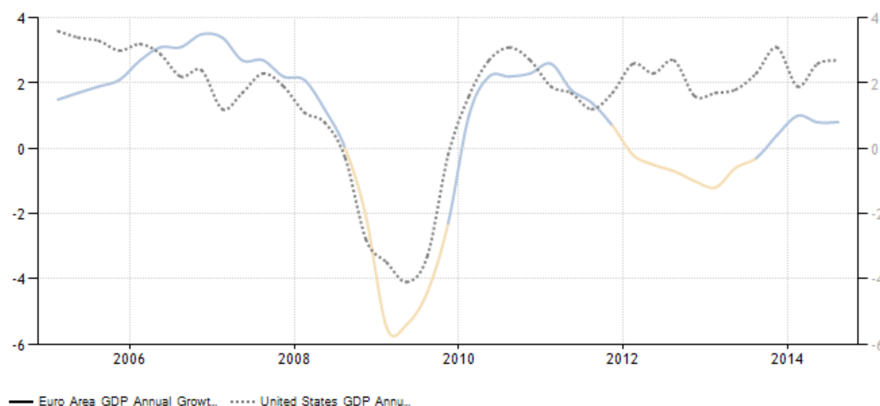
European Union's Emergence from a Double-Dip Recession gets "Putin-ized" and "Dollar-ized"

Almost daily you can hear one of the following statements:

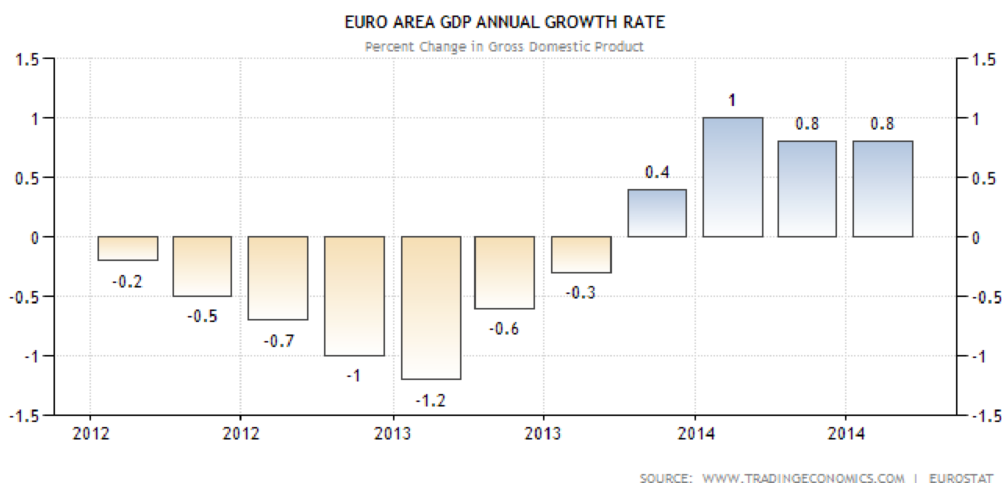
"Europe isn't growing!" *"Europe won't grow!"* *"Europe can't grow!"*
"Europe is still in a recession!" *"Europe is going back into a recession!"* *"Europe is in a Depression!"*

The problem with these statements is the following chart:

Comparison of Annual GDP Growth Rates of the European Union vs. the United States Since 2005



1) The U.S. began its GDP growth decline earlier (2005) than the E.U. (2007)
2) As GDP growth in the U.S. began its decline in 2005, GDP in the E.U. was accelerating
3) In late 2006/2007, the E.U. was growing faster than the U.S.
4) Eventually, the economy of the E.U. did weaken and it ultimately weakened more than the U.S.
5) Both economies rebounded around the same time (which means that the E.U. actually was in an initial decline for a shorter period than the U.S. since it peaked later)
6) In 2011, U.S. GDP growth began to stabilize around 2% as it applied large amounts of liquidity/stimulus while the E.U. began a second economic decline as leaders of the larger Northern European countries chose austerity and imposed strict fiscal discipline on the smaller, fiscally weaker southern European countries.
7) The European Union has shown four consecutive quarters of annual GDP growth:



Despite the problems in Cyprus, Greece, Italian elections, geopolitical risks emanating from the Ukrainian/Russian border, the economic impact of sanctions on Russia (a big customer of Europe), the threat of gas interruptions and the inflexibility of a single currency, the European Union's economy is growing. It should also be pointed out that the European Union is not growing that much slower than the U.S. was at certain points during the past 2-3 years. Also, because the European Union did not begin slowing prior to the Great Recession until a couple of years after the U.S., it should not be surprising that the post recovery levels of GDP growth that the E.U., has achieved thus far are lagging the U.S. especially in light of the fact that it is only now considering liquidity measures that the U.S. not only began much earlier, but has now just ended.

Regardless of the progress the E.U. has made in recovery from its austerity-induced double-dip recession, the impact of Russian/Putin aggression towards Ukraine has undeniably undermined confidence in the region's economic prospects. In addition, anti-E.U. political forces in several southern countries are gaining strength as a direct result of backlash against the ECB/IMF/EU imposed austerity measures. To further add to these negative effects on the price performance of European equities, the U.S. Dollar has had a very strong rally:

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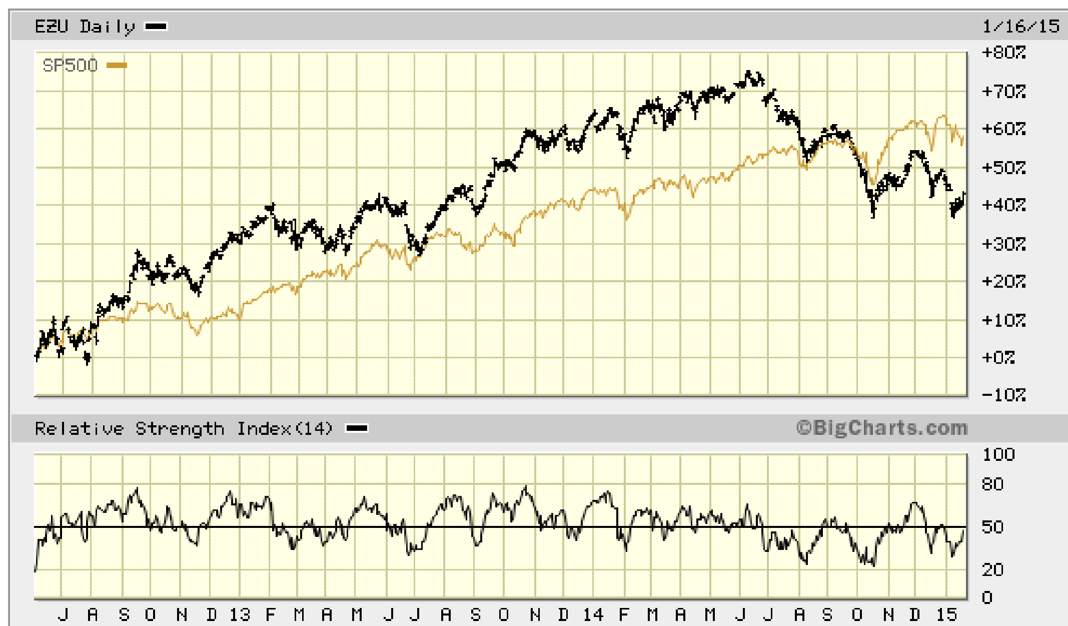
1-Year Chart Comparing the Euro Currency ETF (FXE) vs. the U.S. Dollar Index (DXY)

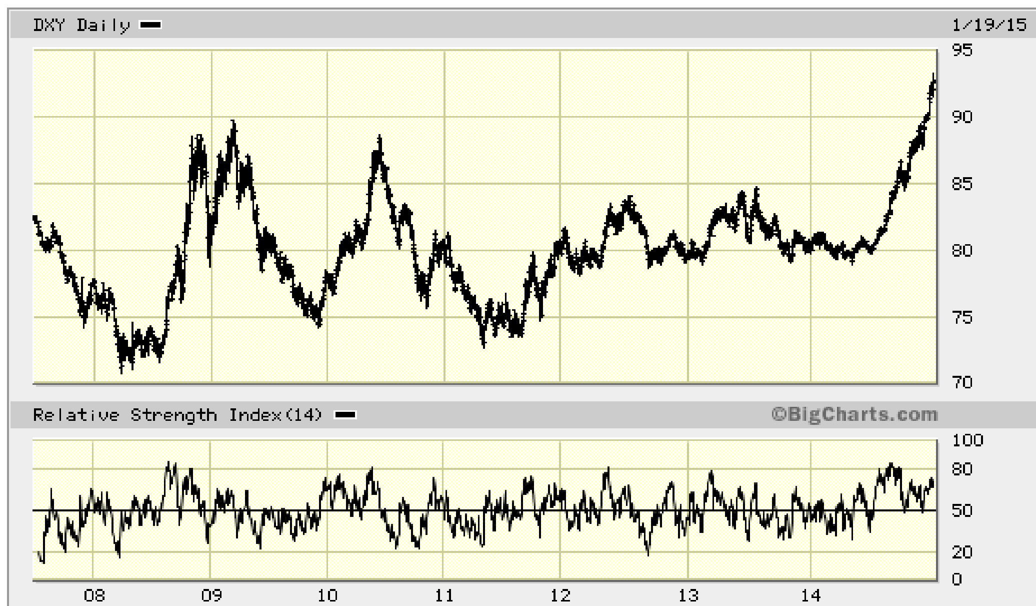
Given the recent decline in the Euro vs. the U.S. Dollar, as well as the other economic/geopolitical factors previously cited, most investors would probably be surprised to know that the European Union Equity ETF (EZU) outperformed the S&P 500 from the summer of 2012 up until about 4-5 months ago:

Chart Comparing the Price Performance of the E.U. Equity ETF (EZU) vs. the S&P 500 since 6/1/2012



That shift in relative performance began in June/July last year in direct response to the rise in the U.S. Dollar on prospects for a stronger U.S. economy, the end of “quantitative easing” by the Federal Reserve, continued low U.S. inflation, reduced importation of oil (reducing the supply of U.S. dollars to the non U.S. oil producing economies), as well as a continued flow of foreign capital into the U.S. as a “safe haven”.

At this point, the threat of anti-E.U. political turmoil is building, Putin is continuing to agitate the Ukrainians, the U.S. dollar has shown little sign of slowing its ascent and the prospect for large scale E.C.B.-variety “quantitative easing” remains unclear. Yet, all of this can change very quickly. The populous of the southern European countries that are supporting anti-E.U. political factions are more “anti-austerity” than “anti-E.U.” and E.U./E.C.B. officials may be willing (more than they are publicly appearing to be presently) to make concessions to appease the disgruntled E.U. members to the south. The E.C.B. President, Mario Draghi, may announce a large scale bond purchase program later this week. The worst of the winter season is quickly passing and Putin’s threat to cutoff gas supplies is losing more of its potential impact as each day of winter passes. The sanctions against Russia, combined with collapsing oil prices, are putting ever increasing pressure on Putin to define a face-saving end game before his popularity with the Russian people begins to wane in response to an ever more likely and severe recession. The last piece of this puzzle that may surprise in the coming quarters is the potential for a reversal in the U.S. Dollar (DXY = U.S. Dollar Index):



The U.S. Dollar Index has risen very sharply from an 80 level to just over 93. In the early 2000’s, it rose to levels near 120, so there is certainly the possibility that the U.S. Dollar could rise another 20%+, but a “possibility” is not the same thing as a high “probability”. The U.S. Dollar has risen to well past levels seen during the past few years and sharp reversals are the norm not the exception. The “long dollar, short everything else” trade has become a very “crowded” trade and any sign of a reversal will send currency traders in a panic to sell the U.S. dollar potentially as fast as they bought it. This is especially true due to the popularity of the “short the currency, go long the foreign country equity” strategies that many mutual fund, ETFs and active managers are offering retail investors. If Europe and/or Japan show any convincing signs that they are experiencing a “healthy” level of inflation (reduced threat of deflation), and a corresponding pick-up in economic growth, investors will have to liquidate their holdings (i.e. cause their manger/fund provider to buy Euro and/or Yen) in order to reduce/eliminate their currency hedges as it becomes likely that monetary stimulus will be reduced just as it has been in the U.S. this past year. We may be seeing at least part of that occurring in recent days with regards to the Euro and the E.U. Equity ETF. For the most part, the E.U. Equity ETF (EZU) has followed the Euro down in lockstep, but in in the past 10 days, the EZU ETF has risen over 2% while the Euro has fallen about 3%:

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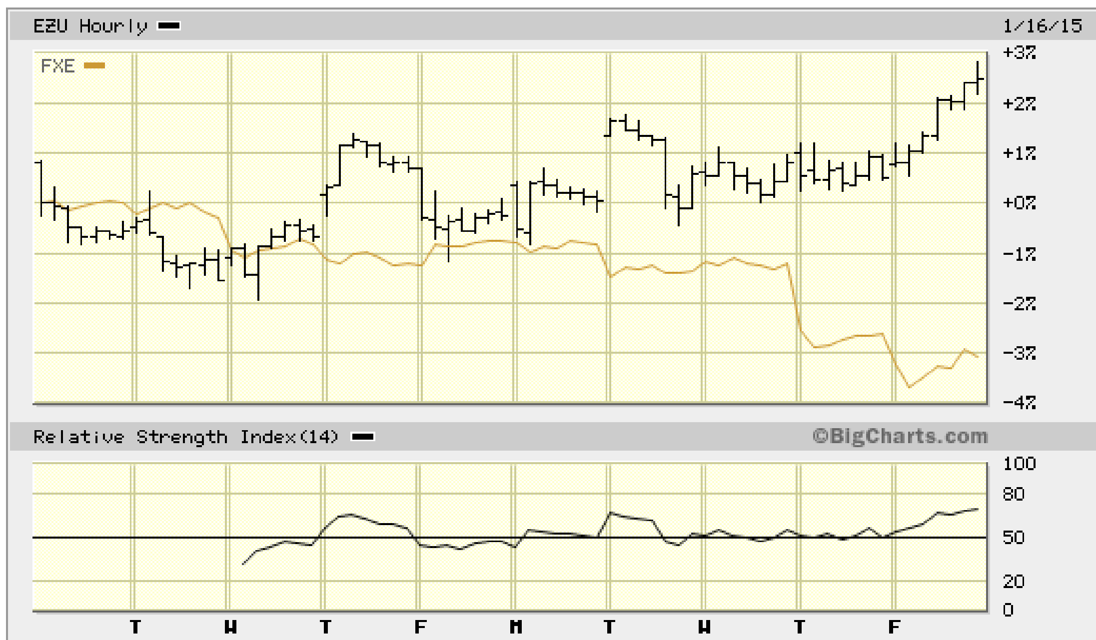
10-Day Chart Showing the Divergence of the E.U. Equity ETF (EZU) vs. the Euro Currency ETF (FXE)



Most investors have heard the old Wall Street adage: "Buy the rumor, sell the news". Perhaps if E.C.B. President Draghi does finally announce a large scale "Q.E. - Euro Style" program, a bottom in the Euro may not be far behind as many investors have already positioned for this anticipated move by the E.C.B. and profit-taking may begin to dominate the Euro/U.S. dollar price relationship once the appreciation in U.S. dollar vs. the Euro begins to show signs of slowing.

"Europe isn't growing and China is still slowing!"

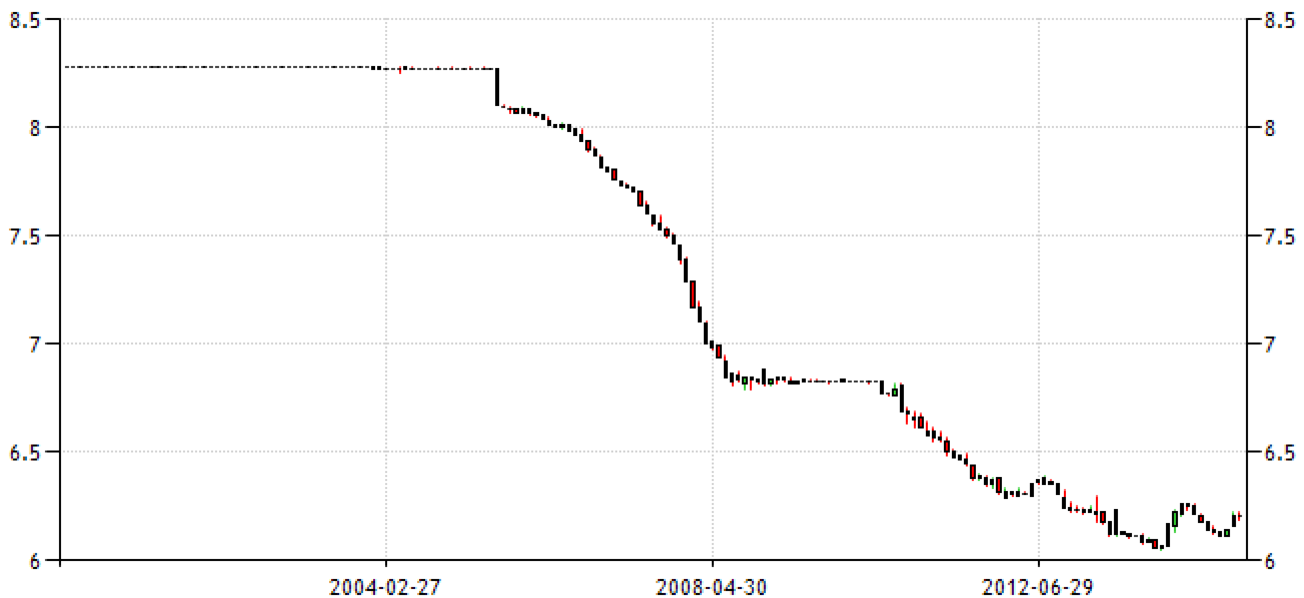
Perhaps no drumbeat is louder than "Europe isn't growing!", but a very close second is "China is still slowing!'" Once again, a single chart offers a contrarian viewpoint:

Chart of China's Annual GDP Growth Rate since 2005

There is no denying that the decline in China's GDP growth rate from over 12% to now around 7-7.5% was a dramatic swing in economic fortune. Nonetheless, a quick visual review shows that the rate of decline has moderated significantly and has been hovering around the same range for almost 2 years. Yes, there is a perceptible remaining downward bias to the data and, yes, it could certainly fall below the 7% level onto a 5-6% range in GDP growth that some are predicting, but to deny that the volatility has greatly subsided and that the initial signs of stabilization are present is simply difficult to defend if you consider the "data". Of course, the "data" is part of the problem as many, who are justified in their skepticism, do not believe any data that comes out of the communist-controlled country. I have no doubt that the data is inaccurate, but the fact is that the above chart is just plain "ugly" and if China is trying to manipulate the data to give a completely "rosy" picture then they have certainly done a fairly poor job for any self-respecting totalitarian state. Just this week, the Chinese government curbed margin lending and caused a sharp sell-off in Chinese share prices. Not something you do if you are trying to fill the economy with false-optimism. The Chinese government has also continued to allow the Yuan's value to become a more market-based currency, and as a result, appreciate against the U.S. Dollar causing Chinese exports to become less competitive:

Chart showing the U.S. Dollar vs. the Yuan since 2000

(Declining price trend indicates an appreciating Yuan)



The point of these examples is that the Chinese government appears to be very committed to reorienting the economy towards a more free/market-based, less corrupt, less government-driven economic model. That in no way means that they will do it within anyone else's timeframe other than their own, and they reserve the right to use the "red fist" to enforce their will if need be, but a more sustainable growth rate and economic model does appear to be emerging. As stabilization in China's GDP growth rate began to become more evident, the China Large Cap ETF (FXI) began to also stabilize, eventually rallied, and briefly began to outperform the S&P 500 Index during September of last year. This did not last long and the FXI fell back below the S&P 500, but it has once again begun to overtake the S&P:

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Chart Comparing the China Large Cap ETF (FXI) vs. the S&P 500 Index since 12/31/2013

The improved stability in Chinese GDP growth was not reflected as fully as we had hoped in 2014, but we do feel that the "new normal" for China's economy will likely be determined, and potentially widely accepted by the global investing public in a positive way, during 2015.

<u>Strategy Implications</u>

Our view of the likely global economic environment for 2015 remains quite similar to that of 2014: Acceleration (U.S.), Emergence (E.U.) and Stabilization (China). During the last few months of 2014, and during the past few weeks of 2015, we have been encouraged by the improved relative performance of U.S. cyclically-sensitive stocks and the continued reforms in China. Europe is going to have a very exciting week with the potential for a large scale E.C.B. bond buying program (one that perhaps is a bit more likely given the recent abandonment of the cap on the Swiss Franc by the Swiss National Bank). We did some minor trimming of our cyclically-sensitive exposure via a reduction in our Homebuilder ETF during the 2014 "dip", but we are comfortable retaining the remaining positions as the U.S. economic data continues to improve and consumer confidence hits pre-recession levels. As the U.S. dollar began its recent ascent, we migrated much of our European exposure into global indices and sector ETFs. This had the effect of reducing our non U.S. currency and equity exposure, as well as diversifying our non U.S. currency exposure away from the Euro. We will remain in this posture until there is significant evidence that this run in the U.S dollar has potentially begun a reversal of some variety. We remain underweighted in the emerging markets, but the more pro-business political environment in India, and the GDP growth stabilization in China, has resulted in enough positive equity performance to result in the B.R.I.C. ETF (Brazil, Russia, India and China) being flat for the past 12 months despite the failure to elect a similarly pro-business government in Brazil last year, and the continued geopolitical drama in Russia:

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1-Year Chart of the B.R.I.C. ETF (BKF) vs. the S&P 500 Index

The U.S. stock market has enjoyed exceptional returns over much of the past 5-6 years due to the resiliency of the American people and the businesses that they manage/contribute to, but also due to very accommodative fiscal/monetary policies that have ended, or are likely to begin to be ended this year and next. The rise in the U.S. dollar has put non U.S. assets "on sale", but we don't know if we have seen the "final markdown". Southern European politics, Russian foreign policy and the domino effects of plummeting oil prices all remain wildcards, but the odds are building for non U.S. stock markets to begin to perform at least as well, if not much better than, U.S. equities. There is never a bright and visible "green light" for such inflection points, but as the evidence builds so will our positions to take advantage of the next part of this global economic/capital market cycle.

"Look to the Future, be Optimistic…but Hedge."

(We want to keep these commentaries brief and focused so as to provide a good "information-to-text-length ratio", but if you have specific questions/topics you want me to address, please let us know.)

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