June 2015

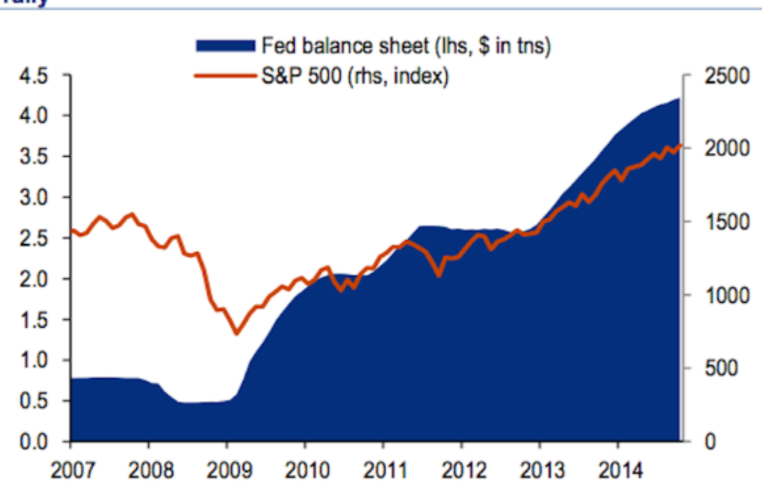
MAKING SENSE OF THE MACRO

So far in 2015, macro headlines have continued to drive global market activity. The biggest factor in 2015 was supposed to be the timing of the U.S. Federal Reserve's (Fed) first interest rate hike. While we all continue to await a sign of a Fed rate hike, global equity market participants have clearly turned their attention to Europe. The European Central Bank's (ECB) massive stimulus program launched in March, combined with the concern of a Greek default, have dominated the headlines over the past two months. In addition, recent global economic data (strongly influenced by energy prices) has created a tight trading range for global markets and an increasingly bumpy ride for investors. Until there is more clarity on the rate of global growth (which has been almost entirely driven by the US in recent years) and Greece stops consuming all the oxygen in Europe, we should expect more market volatility in the short run.

As investors, we run a real risk of letting these short-term macro issues cloud our long-term investment objectives. Emerging markets, Europe, and even parts of the US equity market continue to remain very attractive over the next several years. **We will be using the pullbacks over the next few months as selective buying opportunities, not as reasons to sit on the sidelines.**

Don't Bet Against the Fed… or the ECB

On March 9th, 2015, the European Central Bank (ECB) sent waves around the international financial community when it announced a new quantitative easing initiative. This bond buyback program, similar to what was enacted by the Federal Reserve in the United States in 2009, was billed by ECB President Mario Draghi as the saving grace of the European economy. By buying bonds of 60 billion euro per month (scheduled through September 2016), the ECB's ultimate aim is to provide more liquidity for banks, ramp up export demand and inflation, and in turn, stimulate economic growth and job creation.



Although too soon to measure, early indicators are showing signs that the ECB program is starting to work. Indicators relating to consumer confidence and bank lending activity have increased in Europe since March 9th. Much of the recent economic growth has come, surprisingly, from countries that were hit the hardest during the Great Recession. Spain for example, one of the previously maligned "P.I.G.S." nations, is now expected to grow close to 3% in 2015 after several years of anemic growth.

More importantly, the European equity markets have finally started to turn the corner and have posted impressive gains so far in 2015. As of June 5th, the MSCI EAFE Index is up +6.74% year to date with the DJIA +1.25% and the US S&P 500 index up +2.56%. In light of the ECB's easing stance, we have been methodically adding to our Developed European and Emerging Market equity allocations. **Similar to the US equity market growth spurred by Fed bond buying over the last five years, we expect the ongoing ECB stimulus program to drive European stock markets higher over the next several years.**

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The Never Ending Saga in Greece

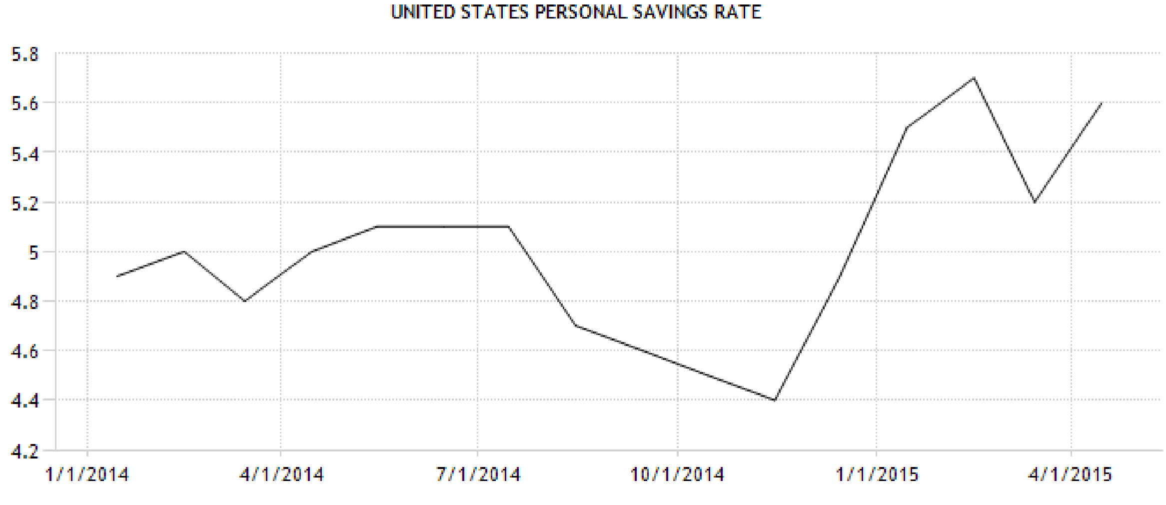
With the election of a new leftist ruling party, Syriza, there has been much rhetoric of Greece departing the European Union (EU). Simply put, the Greek economy has been decimated with current total unemployment rates north of 25% and an unemployment rate for Greeks under 25 years old at close to 50%. The idea of Greece ditching the Euro for the Drachma seemed like a far-fetched idea only a few months ago. However, today, the probability of a Greek exit has increased dramatically.

Earlier in the week, Greece informed the International Monetary Fund (IMF) that it would delay the scheduled June 5th 300 million euro debt repayment and bundle all four of its June repayments together (totaling 1.5 billion euro). So the stage is set for a showdown. If no deal is reached and Greece is unable to make the lump payment at the end of the month, the global equity markets will likely react negatively. However, we still believe that the potential short term pressure on the markets would provide an impetus for a negotiated solution.

We continue to view recent and further weakness in international equities as a great opportunity to reduce our large overweight to US multinational equities in favor of more attractively valued global equity markets with favorable stimulus packages in play. **Greece is a headline, not a systemic risk to global equity markets.**

The Energy "Tax" Cut is Just Starting to Appear

Energy prices dropped precipitously last year (over 50%), however, the impact on the consumer is yet to be seen. Most experts thought the money would immediately be pumped back into the economy, but many consumers have chosen to save their money instead.



As you can see over the last year, lower energy prices have yielded a significant spike in the consumer savings rate. **As the economy continues to improve, however, we believe that consumer savings will be replaced by an increase in consumer spending.** One important sign of a rebounding consumer is that truck and auto sales are at the highest levels since before the 2008 financial crisis. In fact, in May, the industry's annual selling rate reached 17.8 million vehicles, the strongest monthly pace since 2005.

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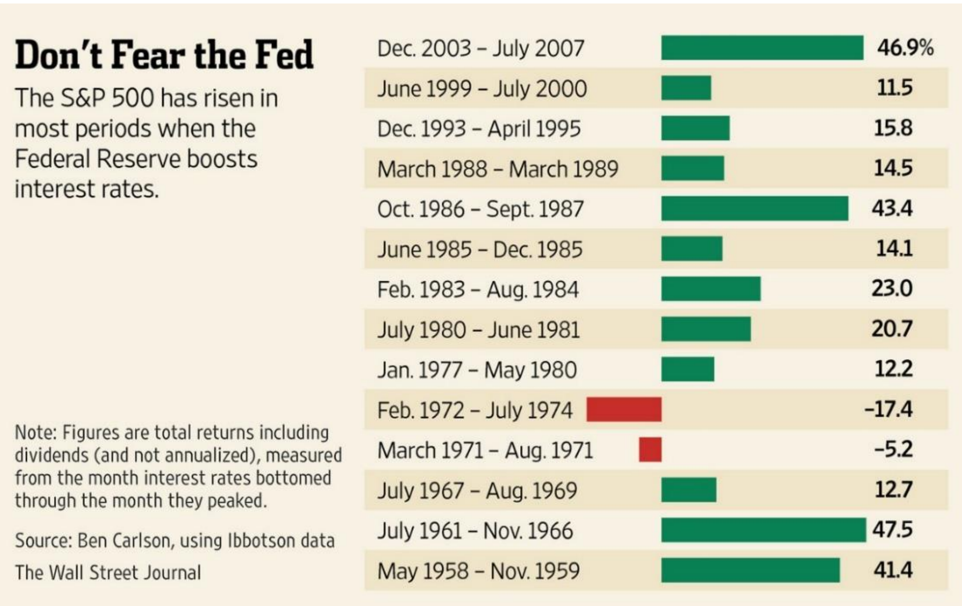
The Fed Hike Waiting Game

Each year, industry pundits have confidently predicted that “this will finally be the year” the Fed actually begins raising short term rates. Although these pundits have been consistently wrong, we feel that 2015 could be their year of redemption. Many economists are predicting a September rate hike of ¼ percent. Although a ¼ point hike still leaves rates near all-time lows, we still should expect significant market volatility when the first rate increase actually occurs. In May of 2013, when then Fed Chairman Ben Bernanke first mentioned the word “taper”, the bond market promptly had a “tantrum” (forever referred to as the taper tantrum) with the 10 Year Treasury rate spiking up 65% in two months. Fast forward to May of 2015 and the 10 Year Treasury has recently risen from 1.87% on April 1st to 2.35% June 5th (a 25% increase).



The last time the Fed reversed from an accommodative stance to a tightening cycle of rate increases was in June 2004 (Fed Funds was at 1%). From June 2004 through June 2006, the Fed raised the Fed Funds rate 17 times. Over that same two year period, the S&P 500 rose +11.3% while the Russell 2000 rose +22.5%. Simply stated, rising rates do not signal the end of positive equity returns. In fact, history has shown us that until interest rates move dramatically higher (US 10 Year Treasury rate above 5%), we should not be too concerned with the impact of rising rates on equity returns.

So What Do We Do Now?

We clearly recognize that there is a potential for greater downside volatility in the short run driven by further Greek related news or the first Federal Reserve rate hike. However, economic data in the US continues to reinforce the view that the economy is much healthier than the first quarter GDP data implies. We have a European Central Bank that is committed to an aggressive quantitative easing program and we are experiencing a noticeable shift in equity market leadership performance towards non-US equities for the first time in several years. In the coming months, we will look to use excess cash in our portfolios to tactically purchase oversold US sectors and to strategically increase our long term exposure to international equities based both on attractive fundamentals and ECB actions.

“Whether markets are roaring ahead or stumbling off a cliff, good, solid advice is always needed to restrain the euphoria or soothe the panic attack.” – John Bogle

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