SIGNATUREFD

SPRING 2015

# MARKET SENSE: Trends Shift in First Quarter


The first quarter of 2015 ended with fairly significant shifts in market performance. While the last few years have been characterized by strong performance from large-cap U.S.-oriented stocks, the first quarter saw strong performance in many global markets, with Germany, France, Italy, Japan, India and China all posting returns in excess of the U.S. market. While it is too early to know whether this quarter marked the definitive inflection point, we believe that there is room for this global leadership to continue over the longer term.

Across fixed-income markets, interest rates broadly continued their drift lower. The U.S. 10-year Treasury ended the quarter yielding 1.93%, down from 2.17% at the beginning of the year. While these are indeed historically low rates in the United States, interest rates across many other developed sovereigns actually sit much lower. For example, the 10-year rate in Germany ended the quarter at 0.19%; in Japan, 0.41%. Oil prices dropped again, but by the end of the quarter, they appeared to be stabilizing. West Texas Crude ended just under $50, down about $5 per barrel on the quarter. The table below provides more detailed historic performance on a variety of markets, and we will touch more on current markets and our outlook in the last section of this newsletter.

| | 1st Quarter | 52 Weeks |
|---|---|---|
| S&P 500 | 0.95 | 12.73 |
| Dow Jones Industrials | 0.33 | 10.57 |
| MSCI EAFE (International) | 4.88 | -0.92 |
| MSCI EM (Emerging Markets) | 2.24 | 0.44 |
| Bloomberg Commodity | -5.94 | -27.04 |
| Barclays U.S. Aggregate (Taxable Bond) | 1.61 | 5.72 |
| Barclays 5-Year Muni (Tax-Free Bonds) | 0.76 | 2.95 |
| HFRI Fund of Funds Composite Index | 2.50 | 5.36 |


NEARLY SEVEN YEARS REMOVED FROM THE FINANCIAL CRISIS, CENTRAL BANKS CONTINUE TO PLAY AN OVERWHELMING ROLE IN THE MARKETS.

## CENTRAL BANKS CONTINUE TO DRIVE MARKETS

While countless variables ultimately drive capital markets, the most visible and significant players over the past seven years have arguably been global central banks. Global central banks are essentially the organizations that set monetary interest rate policy and have both direct and indirect impact on economic activity, inflation, employment and credit conditions.

Nearly seven years removed from the financial crisis, central banks continue to play an overwhelming role in the markets. However, for the first time in a long time, we are starting to see material divergences on the directionality of global central banks. By and large, the majority of central banks have had an easing bias. However, in 2014 almost the same number of central banks began to tighten policy as those that were still easing policy. The divergence sits at the heart of many of the market and currency moves we have seen play out over the past few quarters and we are likely to see as we move forward. Below, we recap some of the notable central bank actions and follow up with our view on the impact of those actions.

- **Swiss National Bank:** On January 15, the Swiss National Bank (SNB) removed the Swiss franc's link to the euro that had existed since 2011. Contrary to many central bank policy changes that occur gradually, the SNB's sudden move was a surprise to the markets. Within minutes the Swiss franc appreciated by more than 20%. The change will cause a meaningful slowdown for Switzerland's economy since the country is highly reliant on exports, which are now less competitive. Why did the SNB make a move that would cause such pain? The SNB was being squeezed by the actions of the European Central Bank (ECB), which just days later implemented a quantitative-easing program, and continuing the franc's link to a depreciating euro was causing havoc on the financial position of the SNB. In the end, the move was about taking some pain now to ease a longer-term risk.

- **European Central Bank:** As mentioned above, after months of speculation, the ECB announced a massive quantitative-easing (QE) program on January 22. Ultimately, the program is targeting the risks of deflation within the eurozone. The bond buying will be larger and longer lasting than many expected, with more than 1 trillion euro of purchases targeted through at least September 2016. The euro, which had been declining for several months, dropped a further 10% in a matter of weeks after the announcement. However, it has since bounced upward and could be stabilizing near 1.10 to the U.S. dollar.

- **Japanese Central Bank:** The Japanese Central Bank (BOJ) implemented a massive QE program in late 2013. Last fall, the central bank surprised the market by significantly expanding the program and broadening asset purchases to incorporate stocks and real estate funds. At the time, BOJ Governor Haruhiko Kuroda said the move came at a critical time for the markets, as Japan's economy was showing signs of slowing growth and easing inflation.

Of all the world's central banks, the BOJ has been the most aggressive, doubling the assets it holds over the past two years. During the first quarter of 2015, the BOJ recommitted to pushing inflation expectations higher, even though it recognized a near-term softening of the country's outlook. At this point the BOJ is basically all in, and it has no path but to continue increasing its actions until the country reverses its 25-year malaise or implodes under the pressure of high debt levels.

- **Federal Reserve Board:** With a U.S. economy that is outrunning most others in the world, the Fed is in a different quandary than other central banks. Questions about when to start normalizing rates have been the focus. With several quarters of solid employment growth in the U.S., many analysts are suggesting that the time to raise rates is now. Others point out that inflation remains low and that, until wage pressures start to build, the Fed should maintain rates near zero. With expectations that the Fed will raise rates at some point in 2015 and with other central banks aggressively going in the opposite direction, the currency markets have seen increasing volatility. The most consequential move has been the near 20% move in the dollar since July—one of the sharpest moves on record. During its March meeting, the Fed also moved away from the policy of forward guidance, which it had been using in some capacity for 20 years. The change results in future policy actions being tied to data, not date. Though a more flexible approach, it could lead to increased volatility in markets as each piece of data is parsed for significance.

- **People's Bank of China:** Policymakers in China had been notably modest in providing stimulus to their economy the last few years, as the government is focused on structural reform to transition the economy toward consumer spending and on fighting corruption. But the slowdown seems to have intensified over the past few quarters, pressuring the People's Bank of China (PBOC) to adjust course. In recent weeks the PBOC has provided more stimulus, including reduced down payments for second homes, and more relaxed policies regarding financial flows between Hong Kong and the mainland. The governor of the PBOC also has highlighted concerns about the growth rate and indicated that further monetary policy stimulus could be forthcoming.

We spotlight the above policy actions to make a point that much is happening in the central banking realm—most of the above changes happened in just the first quarter. What are the long-term consequences of all this central bank activity? It seems trite to say it, but nobody knows. We are in uncharted waters. Thus far, the results have been relatively large currency moves and general reinforcement of global deflationary tendencies. Over the long term, the policies may continue to help rebalance the global financial system, but they could also degenerate into currency wars and other mercantilist activities.

The top debate in central banking in recent years has been over the concept of secular stagnation. If that is in reality where we are heading, the temptations to fight for a bigger slice of a pie that is not growing could create long-term problems. We are not to this spot yet, but the risks remain, especially if Chinese growth slows too fast or if several commodity-dependent emerging countries devolve into crisis.

BASED ON CURRENT EVIDENCE, WE CONSIDER OURSELVES RATHER OPTIMISTIC ABOUT GLOBAL ECONOMIC CONDITIONS.

## ECONOMIC OVERVIEW: POTENTIAL FOR GLOBAL SYNCHRONIZED GROWTH

Based on current evidence, we consider ourselves rather optimistic about global economic conditions. In fact, we believe the opportunity exists globally for a synchronized growth spurt to occur over the next few years. Even after a quarter of disappointing results in the United States, we believe momentum is relatively well established. Outside the U.S.—especially in Europe, Japan and, to a degree, China—aggressive stimulus could begin to pay dividends over the second half of 2015 and into 2016.

Let's first take a more detailed look at the U.S. situation. It is likely that first quarter gross domestic product will come in under 1%. As we are writing this Market Sense report, the March employment report has just been released and came in well below expectations. Total job creation slowed significantly, prior months' gains were revised lower, and earnings growth remained relatively tepid. While this Q1 "soft patch" is being attributed to factors both transient (poor weather, West Coast port disruptions) and longer lasting (currency strength, oil sector weakness), we believe that the slowdown is mostly temporary and that growth should reaccelerate in the second quarter. Anecdotally, we highlight below a few indicators that point to a pickup in activity:

- The Conference Board Consumer Confidence Index continues to trend higher and is at levels not seen since before the financial crisis.
- The Job Openings and Labor Turnover Survey (JOLTS) report provides some nuanced labor indicators. As of last month, it showed more job openings than at any point in 15 years, and the quit rate was approaching levels of the last cycle peak. The quit rate is especially insightful as it relates to the confidence of job seekers to find employment at higher wage rates.
- Finally, confidence surrounding large-ticket purchases is strong. Auto sales, at 17 million per year, are running near record levels. A report by Zillow in late March indicated that 5.2 million renters anticipate buying a home in 2015, up 1 million from last year.

Our base-case scenario is that the U.S. economy continues to progress, and with the Fed committed to being slow at raising rates, the potential for an early rate shock is low in our opinion. Thus, the question now is "Can the rest of the world close the gap with the U.S.?" We believe the answer is yes.

During the past year the U.S. has seen two positive macro forces (lower energy and declining interest rates) and two negative forces (higher currency and moderating central bank policy). To put it simplistically, these forces neutralize each other and would seem to indicate that the U.S. economy is progressing on its own force with limited net stimulus. However, that is not the case for economies in Europe and Japan. Those economies have seen major stimulus from all four of these forces over the past six months.

In our opinion, this is likely to lead to surprising strength over the next several quarters. We believe that the evidence of this is just now starting, with high and rising manufacturing and confidence data coming out of Europe. Japan appears to be stalling out again, but with last year's ill-timed consumption tax increase now more than 12 months in the rear-view mirror, better results are very possible. In both the case of Europe and of Japan, our views do not necessarily lead us to optimism over a time period beyond two or three years, but the positive surprises should help to drive intermediate-term asset prices in those markets.

## OUTLOOK AND PORTFOLIO POSITIONING

It is obviously important to translate the above observations into forward-looking information and actionable ideas. Much of our investment process revolves around the premise that markets don't move on actual information but rather the gap between expected and actual results. On this count, we continue to believe that expectations for the U.S. risk assets have become very high in recent years while at the same time expectations for Europe, Japan and, later, China have become quite bleak. The self-correcting forces of a global system can allow these divergences to become only so wide. As we enumerated above, our views of the U.S. economy are by no means negative, but with asset prices already reflecting many of the positives, disappointment can lead to a relatively flat market.

We believe that over the first quarter we have started to witness a change in which investors are starting to be more cautious on U.S. asset prices and more optimistic on those outside the United States, especially in Europe. Fund flows have certainly gone in that direction. Though we are monitoring the speed at which the change has occurred, we believe the shift likely has some time to go. We can summarize our desired portfolio allocations as being relatively fully allocated to equities, with targets of close to 50% each in U.S. and international markets. As we referenced in our last Market Sense report, the current allocation has resulted from a gradual evolution of the portfolio from more than 80% U.S. equities three years ago. We believe the current allocation to U.S. is as low as we will go this cycle, and as a result, our allocation to international is not likely to materially increase from here.

Within the balance of the portfolio, we continue to have a strong underweight to core bonds, with a portion allocated to alternative investments—mostly nonmarket directional, absolute-return-oriented strategies—and more credit-sensitive fixed-income holdings. Our views on rising rates are not as extreme as some others, but we do believe investment-grade bonds will remain range bound for some time. As such, assuming our views that the economy can avoid recession for the next few years, higher-credit-risk investments are likely to outperform.

We must always remind our clients that individual circumstances can result in differing portfolio designs, and we welcome a more detailed conversation with any of our clients or supporters. If we can provide additional information, please don't hesitate to reach out to your contact at SignatureFD, or send an email to the investment team at invest@signaturefd.com.