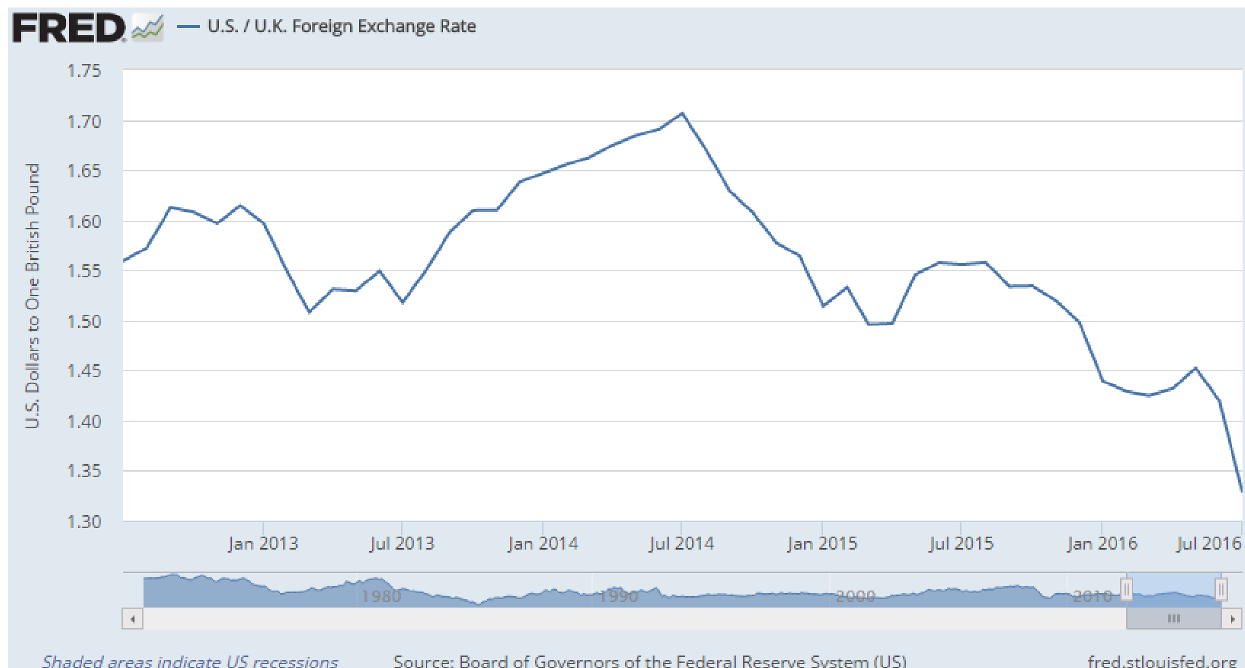
On Our Radar – July 2016

Volatility spiked in markets across the globe in the last week of June as a result of the United Kingdom's referendum on whether to stay in or leave the European Union (EU). On the day prior to the vote the Dow Jones Industrial Average (DJIA) rose 230 points to close at 18,011.07 as many market players viewed a vote to remain in the EU as the heavy favorite despite polls that were relatively close.

As it turns out the "leave" camp won in an upset and stock markets around the globe initially came under heavy selling pressure. The Dow fell more than 870 points in two days to 17,140, down more than 4.8 percent. The British pound – as seen in the chart below - fell from 1.50 to the U.S. dollar to about 1.32 – a massive 12 percent move – in one day to record a new 30-year low



Following two days of heavy selling pressure in a number of markets, central banks were able to circle the wagons and not only stabilize equity markets, but in fact take the UK's FTSE 100 stock index to a level above the pre-"Brexit" vote. The initial shock saw

the FTSE fall 5.6 percent, then rally more than ten percent over the next three days. At first glance it would seem that the only thing more bullish than a “remain” vote was a “leave” vote. There will, however, be potentially significant ramifications depending on UK’s negotiations with the EU. The Dow also gained 4.6 percent over three days.

In a speech on June 30, 2016, Mark Carney, Governor of the Bank of England, said the Bank of England “put in place contingency plans for the initial market shocks. They are working well.” In that same speech he mentioned the word “uncertainty” no less than 36-times and suggested the bank will attempt to reduce uncertainty. Mr. Carney said the Bank has “responsibilities,” and it “will not shrink from those obligations.” He reiterated that the Bank of England “will not hesitate to take any additional measures required to meet our responsibilities.”

The S&P 500 index closed out the second quarter at 2098.86, up 1.89 percent in the quarter and 2.68 percent year-to-date, excluding dividends. While those figures are a stark contrast to the ones seen in early-to-mid February, the S&P 500 index first hit the 2000 level in August 2014.

The U.S. economy continues on its slow growth trajectory as certain sectors gain while others face headwinds. For example, first quarter Gross Domestic Product (GDP) was revised up to 1.1 percent, the Institute for Supply Management (ISM) Manufacturing index rose to 53.2 in June from 51.3, and Consumer Confidence increased to 98 from 92. On the other hand, pending home sales were down 3.7 percent, the trend in Industrial Production has been down year-over-year for the past seven months, and core capital goods orders have declined in four of the past six months.

Federal Reserve

Central banks remain the dominant factor in all markets. In a speech in late March Fed Chair Janet Yellen said “the Fed will respond to economic disturbances in a predictable

manner to reduce or offset their potential harmful effects." The fact of the matter is the Fed has no idea what the potential harmful effects of more than $11 trillion in global debt with negative interest rates is because the world has never before seen these levels of debt or their corresponding interest rates. Negative interest rates are, however, a symptom of a system that has not fully recovered from the 2008 financial crisis.

In June Chair Yellen reiterated that monetary policy remains accommodative as economic growth remains uneven and the improvement in the labor market appears to have slowed recently. The Federal Open Market Committee (FOMC) is closely monitoring economic and financial developments and "will adjust policy as appropriate."

Adding to the uncertainty of the Brexit vote is the fact that central bankers have a lot at stake, are not omnipotent, and are prone to mistakes. As a reminder, it was former Fed Chairman Ben Bernanke who said "The Federal Reserve is not currently forecasting a recession" in early 2008 when one had already begun. In July 2007 former Treasury Secretary Henry Paulson said "I think we are at or near the bottom [in housing]" before the real carnage even started.

Europe / Asia

In January 2016, European Central Bank (ECB) President Mario Draghi said the ECB has "the power, the willingness, the determination to act, and the fact that there are no limits to our action…within our mandate." Clearly that was on full display in the last week of June. Following the "Brexit" vote, Mr. Draghi called for greater alignment of policies globally to mitigate the spillover effects, which was further suggestive of central bank intervention.

The Bank of England argued that those who believe that central banks are out of "monetary ammunition are wrong," and that "some monetary policy easing will likely be

required over the summer." Even with talk of more policy intervention to come, the yield on the German 10-year bond fell to minus 0.19 percent, and the Swiss 50-year bond fell to negative 0.02 percent! You have to pay the Swiss government to lend them money for 50-years.

Japanese 10-year government bonds yield minus 0.26 percent and thirty-year bonds yield 0.05 percent. There is quite a bit of evidence that suggests that the low interest rates in Japan are actually a primary cause of persistent deflation. The Japanese yen has actually strengthened from roughly 123 to the U.S dollar in November 2015 to about 100 recently. This strengthening is a reflection of the recent flight to quality and will likely put more pressure on Japanese exports.

China's economy continues to slow and the country has further devalued the yuan to 6.67 to the U.S. dollar, down almost 7 percent from a year ago and the lowest level in more than five years. Clearly China is attempting to boost exports by devaluing their currency. With global economic growth sluggish, some countries, such as China, seem intent on weakening their currency to gain a competitive advantage. Should other countries follow suit, it could produce tariffs potentially escalating to a trade war.

Outlook

While the central banks have “offset” the initial market response to the Brexit vote, the markets now have to deal with the pending divorce between the UK and the EU and its potential economic, political and social implications. Clearly the Brexit vote was a sign of growing government discontent which is on the rise globally.

The dilemma for the Federal Reserve and all central banks is that there is a high likelihood that their policies of low/zero/negative interest rates are actually causing some of the problems of low economic growth and stagnant wages. As we have stated in the past, too much medicine can ultimately kill the patient. The global economic system was not designed to lend a country money for 50-years and have to pay them for that privilege.

One risk in all of this is the Law of Unintended Consequences. As previously mentioned, central banks and bankers are prone to making mistakes. Former Fed Chairman Alan Greenspan did not see the technology bubble. Former Fed Chairman Ben Bernanke did not see the real estate and mortgage bubbles. There is a high probability that the current group of central bankers will not anticipate the next crisis, whenever it comes.

Central banks are attempting to micromanage the economy and markets with what amounts to emergency monetary policies. The bond buying programs are providing an incentive for corporations to issue debt and use the proceeds to buy back stock. While that is terrific for shareholders in the near term, it does very little to encourage long-term economic growth. Nevertheless, until the central banks change policy or the markets force their hand, global monetary policy will likely remain accommodative.

What is ironic is that when QE I (the first round of quantitative easing) was announced, it was met with skepticism. In fact, the U.S. stock market initially declined for a few

months. Now, after several rounds of QE over a period of years, like Pavlov's dogs, the mere hint of more accommodation causes at least an initial rush into risk assets.

What is notable is that a fair number of stock markets peaked a year ago despite more global QE. The German DAX stock index is off more than 20 percent from its 2015 high, China's stock market is down more than 43 percent from its 2015 high, and the Japanese Nikkei 225 stock index is down about 25 percent from a year ago. The U.S. has benefitted from a strong dollar with respect to global capital flows as the Dow and S&P 500 index are within a few percentage points of their all-time highs. However, the major U.S. stock averages have not made much forward progress since the end of QE III in late 2014.

Now that the market has officially entered the second half of 2016, investors will likely begin to discount 2017 earnings. Consensus estimate for 2017 earnings for the S&P 500 are roughly $134. If those earnings come in and the price/earnings ratio remains at current levels, the market could see a low double-digit gain from here. Should that happen it probably would not be in a straight line.

While we expect volatility to remain elevated, with global central banks continuing to dominate the investment landscape, the economy growing slowly, and valuation fair, our risk "Traffic Light" remains in "Green" light territory. We will, nevertheless, remain diligent as the longer-term implications of the Brexit vote come to pass. (7.5.16)

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