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The Shifting Landscape

Investment Strategy Update

Richard Saperstein
+1 917-286-2770
rsaperstein@treasurypartners.com

Steven Feit
+1 917-286-2793
sfeit@treasurypartners.com

David D'Amico
+1 917-286-2780
ddamico@treasurypartners.com

www.treasurypartners.com

Despite the risks and uncertainties underlying the global investment landscape and increased volatility in the domestic markets, as long-term investors, we intend to continue investing in high quality US equities, and for a number of compelling reasons.

The US economy is in an expansionary phase that will last for several years. Reduced government spending is largely behind us and will stop acting as a drag on growth. Flows into the US dollar and treasuries are resulting in lower interest rates, the manufacturing sector is strong, employment is rising, and household wealth is at record levels.

Consumer debt is low and falling oil and commodity prices will lead to lower inflation and further enhance consumer cash flow. The net result is putting more money into the pockets of US consumers and, to a degree, this serves to insulate the "real economy" from overseas troubles since consumption accounts for approximately 70% of US GDP.

Standing in contrast to these positive factors, significant commodity price declines and a continued strengthening of the US dollar have created massive deflationary forces for the global economy. As a consequence of these and other social, political, and economic trends, including those trends we examine in detail below, we believe the S&P 500 may be subjected to an intra-year correction during the next 12 months.

Nevertheless, while we have adopted a more cautious short-term outlook, we remain confident in our long-term investment strategy. This confidence is based on our positive view of the US economic expansion, which is providing the backdrop for rising corporate profits and a continuation of this current bull market.

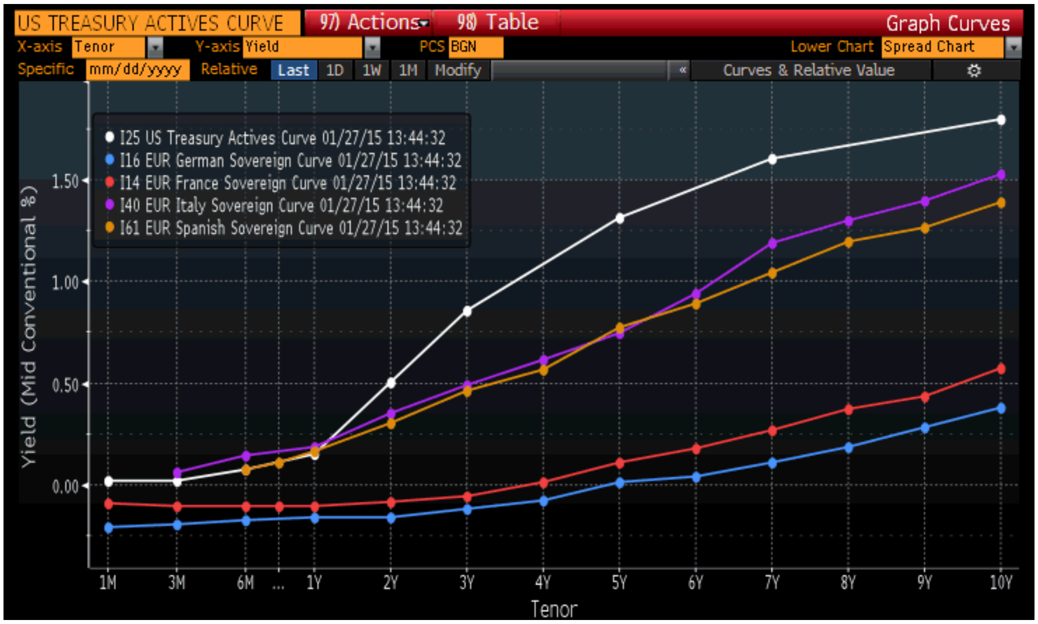
Upside Down Bonds

We've been around long enough to recall when, in 1981, the Volcker Fed raised the overnight rate to 19% in an effort to rein in runaway inflation. That's quite a contrast to the Yellen Fed's attempts to <u>promote</u> inflation with a highly accommodative monetary policy.

The Fed now holds an unprecedented $4.5 trillion in securities, and controls approximately 20% of the entire float of treasuries and 40% of the float with maturities greater than 10 years. Yields are very low, and low yields dramatically increase price risk. With virtually no compensation from the yield, a slight shift upward in rates will lead to outsized declines in bond prices and a negative total return. This is not a favorable risk/return environment for any investor's safe assets.

Events overseas are not helping matters. On January 22nd, the European Central Bank launched its own quantitative easing (QE) program. This massive €1.2 trillion, highly controversial initiative sent the euro plummeting relative to the dollar. The yield on the German 5 year bond fell *below zero,* to -0.05%, and both Italy and Spain saw yields on their government debt fall below US government yields across most maturities. This, despite their respective unemployment rates of 13% and 24%, and credit ratings of Baa2—a full eight notches below the US rating. Clearly, this is a mispricing of risk.

US & European Yield Curves



Even the equity markets show the distortions. At below 2%, the 10 year Treasury is yielding less than the S&P 500, and history would suggest the relationship between stocks and bonds is mispriced.

10 Year Yield and S&P 500 Dividend Yield – Last 20 Years

While we certainly understand why rates are low, the interest rate markets are in an unnatural state. The Fed's massive bond purchases, combined with its zero interest rate policy, enables it to effectively set and anchor the price of all borrowing. In short, the Fed is supplanting what should be the role of the markets and mispricing capital. We believe this could lead to unintended consequences.

The Cost of the Oil Dividend

For many years, we've lived with the threat that already high oil and gas prices would move even higher. Turmoil in the Middle East, it was said, coupled with the inexorable rise of Chinese demand, would eventually push Brent crude, the global benchmark, well above $100/barrel average and toward the $144 high mark set in 2008.

Instead, the exact opposite has occurred. Over slightly more than six months, the Brent oil price dropped 57% from $115 to $49 per barrel. The precise reasons for this dramatic decrease remain open for debate. What is not open for debate is that falling oil prices creates winners and losers. The winners will be the oil importers such as the United States and Japan; the losers will be the oil exporters, such as Russia, Venezuela, and Nigeria.

Brent Crude (Since the End of the Last Recession)

In the long run, lower oil and gas prices will be a positive for the US economy and for global growth. However, we are concerned one or more of the "losers" may experience serious economic difficulties. One such example would be for one of these counties to run short of the hard currency required to service its external dollar-denominated debt. The resulting crisis could impact the US, as was the case in 1998.

Strong US Dollar

As we've mentioned, central banks around the world, including the Bank of Japan and the European Central Bank, have embarked on their own QE programs while the Fed is now considering raising the Fed Funds rate.

Partly as a result of the Fed's actions, the US dollar has risen by 22% against the euro and by 16% against the Japanese yen over the past eight months. At the same time, the dollar also has strengthened against the currencies of the oil producing nations –18% against the Brazilian real, for example, and a whopping 98% versus the Russian ruble.

This rapid ascent of the dollar could create problems. Since global trade is conducted in dollars, emerging market countries suffer as their imports become more costly, and servicing external dollar-denominated debt becomes more problematic. We don't know where or when such a crisis might occur or in what form, but the conditions exist for an event which may have a short-term impact on the US markets.

Junk Bonds, Junk Bonds Everywhere

Five years of low interest rates have created a landscape littered with mispriced indebtedness. High yield bond investors flush with cash and desperate for yield have plunged into the market and, as a result, weak borrowers have been able to extract low absolute rates on weak (covenant light) terms.

The oil patch has been especially popular with these investors, and energy related companies – drillers, servicers, and pipelines – now account for fully 15% of the US high yield market. As plummeting oil prices cause cash flows to decrease for many of these borrowers, we expect to see some stress and, potentially, defaults. The high yield bond market is correlated with the equity market, and how investors—particularly more conservative investors who have been pushed into the high yield space in search of yield—will react, is uncertain.

European Politics

Again, as we've pointed out, the QE program upon which the European Central Bank (ECB) has embarked is highly controversial. We liken this initiative to what we call "dog walker's syndrome" – one leash, yet multiple speeds. The controversy, however, does not so much revolve around economics as it does politics.

There is serious concern as to whether the ECB has overstepped its authority in undertaking QE. A large segment of the German population apparently believes this to be the case as evidenced by the recent electoral gains made by the new anti-euro Alternatif für Deutschland (AfD) party. Similar concerns, mostly rooted in the idea that the ECB is debasing the currency to help debtor nations at the expense of creditors, have been raised in Holland, Austria and Finland.

At the same time, many in the debtor nations believe the EU has not done enough, and that the ECB has acceded to German demands for labor market "rationalization" and hard money at the expense of the average citizen. This has led to a rise in the popularity of non-mainstream parties of all descriptions, ranging from the aforementioned AfD, to the nationalist-right Front Nationale in France, to the populist Movimento Cinque Stelle in Italy, to the left-wing Podemos in Spain. The only thing these parties seem to have in common is a general dislike for the "European project."

Until recently, the rogue parties in these and other countries could be dismissed as little more than protest movements because the governments remained in the hands of the traditional centrist parties of post-war Europe. This all changed when SYRIZA won a sweeping victory in the Greek parliamentary elections, coming just two seats short of an outright majority in the parliament. This party, whose name is a Greek acronym for "coalition of the radical left," unites Marxist, Maoist, and Socialist elements on a platform of debt relief and opposition to EU dictates.

The prolonged slump in Eurozone growth appears to be pushing voters away from the center and toward the edges of the political spectrum, and it is at the edges where opposition to the common currency is the strongest. While the current concern remains focused on the prospect of Greece exiting the Eurozone, a flare up in the stability of the entire Eurozone is quite possible.

The China Question

China, the world's second largest economy, remains a wild card. Years of excessive capital investment have led to an unbalanced economic structure tilted away from the consumer. Inadequate consumption appears to be slowing China's economy—but by how much is unclear due to doubts as to the accuracy of the government's economic statistics.

At the same time, low official interest rates have caused trillions of renminbi to be invested in the shadow banking system by way of so-called "wealth-products." Because they are widely held by individual Chinese investors, these products could be the source of large-scale defaults as well as economic loss. In addition, the government's capital spending binge had caused Chinese commodity consumption to skyrocket. As capital spending declines, so will China's demand for commodities. This will impact commodity-producing nations such as Australia, Chile, and Brazil who have tied their growth to Chinese investment over the past 15 years.

Our Views Going Forward

We have warned of increased market volatility in the past, including in 2013 and 2014 but at the same time, we advised our clients to stay the course with full allocations to US equities. This latest warning comes with the same advice.

In our opinion, US equity prices should perform better than most global asset prices over the next 12 months, although, as we've said, the equity markets may be subjected to a short-term correction.

Nevertheless, we believe strong fundamentals will enable the resilient US economy to continue on its growth trajectory, that the structural bull market dating to March 2009 will remain intact, and that the S&P 500 will continue to achieve all-time highs.

Richard Saperstein, Chief Investment Officer

CONTACT US

info@treasurypartners.com
+1 917-286-2770