Redstone Advisors

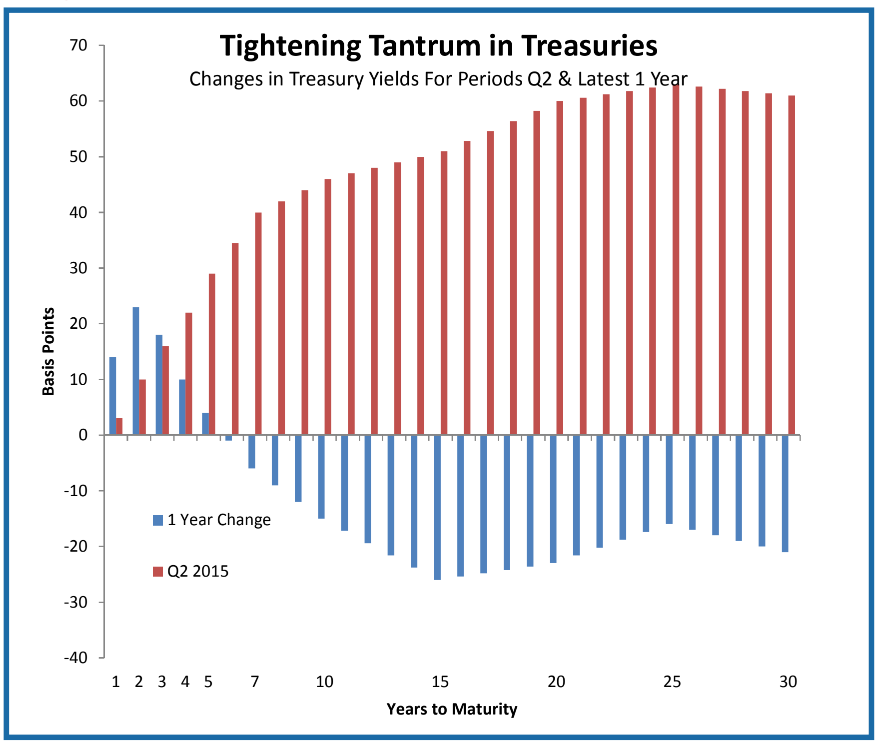
Economic and Market Review

Second Quarter 2015

"If you distort markets for long periods of time and then you remove those distortions, you're subject to unanticipated volatility."
Jerry Cudzil, TCW Group

The second quarter of 2015 saw **global bond yields move off their historic lows** as deflation fears ebbed in Europe and speculation heated up that the Federal Reserve would possibly raise rates sometime later this year. U.S. Treasuries sold off this quarter, ending five straight quarters of gains, which was the longest stretch of quarterly gains since 1998. Treasury yields rose across the yield curve, with the biggest gains concentrated at the longer end of the curve. The average increase was 56 basis points in the 10-to-30 year range. The sell-off brings to mind the so-called "taper tantrum" you might recall from the summer of 2013. One might dub this quarter's correction as the **"tightening tantrum"**. In both cases, no tapering or tightening had actually yet occurred, it was just the bond market repositioning—some would say overreacting—to language from the Fed that seemed to imply monetary policy change was forthcoming. Changes in the Treasury yield curve for the quarter and latest one year period are shown in **Figure 1**. One can see that even with the sharp rise in yields this quarter, most of the Treasury yield curve, specifically the 7-to-30 year range, is currently at lower yields compared to one year ago.

Figure 1



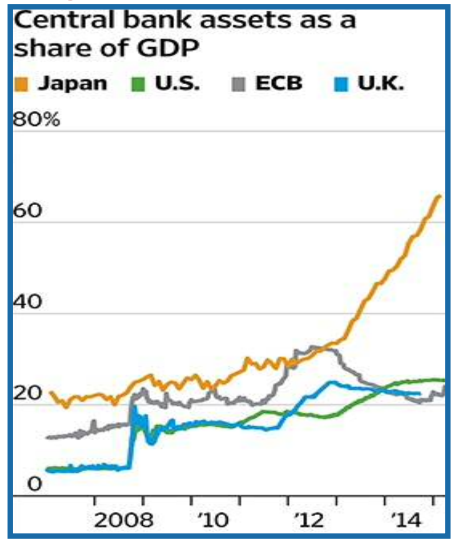
(316)687-2143 jyeskie@redstoneadv.com

Much of the global economy can be currently characterized as a **low-growth, low-inflation, low-rate environment**. The **"new normal"** is a term that many have used to describe this economic climate. The world is oversupplied as never before in commodities like oil and iron ore, but also with capital and labor. In May, crude-oil inventories in America increased to 489 million barrels, an all-time high in records going back to 1982. Back in February, total inventories of manufactured durable goods in the U.S. amounted to $413 billion, the highest level since 1992. In a depressed commodity price environment, producers usually are reluctant to cut back production in an effort to maintain their market share. In some situations, producers even increase their output to compensate for the revenue losses due to lower prices, worsening the problem of oversupply. This surplus presents multiple challenges as policy makers struggle to stoke demand and revive weak economies. Total global wealth, estimated by Credit Suisse to be about $263 trillion, more than double the $117 trillion in 2000, represents a **huge supply of savings and capital that is helping to suppress interest rates, undermining the impact of monetary policy** to a certain extent. European bond yields largely rose from their rock-bottom and sometimes negative yields this past quarter. Still, with roughly $2 trillion of sovereign European debt offering marginally positive yields that pale in comparison to Treasury yields, **demand for U.S. fixed income assets is unlikely to dissipate regardless of what actions the Fed takes later this year.** Meanwhile, public indebtedness in the United States, Japan and Europe has diminished those governments' capacity to spur growth through fiscal policy. That has left the central banks to step in and supply their economies with as much liquidity as possible, despite the fact that recent rounds of quantitative easing have not returned these countries to anywhere near their previous growth paths.

A key catalyst of this oversupply dilemma is a cooling Chinese economy combined with lukewarm demand among many developed countries. For almost a decade, producers struggled to keep up with the strong demand from China. But now its gross domestic product is expected to rise just 7% this year, down from 10.4% five years ago, and no economy has emerged to replace that missing demand. Countries facing a demand shortage often move to jumpstart their economies though deficit spending, especially when interest rates are as low as they are. Yet many nations are uncomfortable adding more to their already high debt burdens. The world's major economies have all continued to add debt in the years since the financial crisis of 2008-2009. John Hancock Financial has calculated that government, business and consumer debt has climbed to $25 trillion in the U.S. from $17 trillion in 2008, a jump to 181% of GDP from 167%. Meanwhile in Europe, debt has climbed to 204% of GDP from 180% and China debts have jumped to 241% of GDP from 134%. Even if governments have the capacity for more fiscal stimulus, few have the political will to enact it.

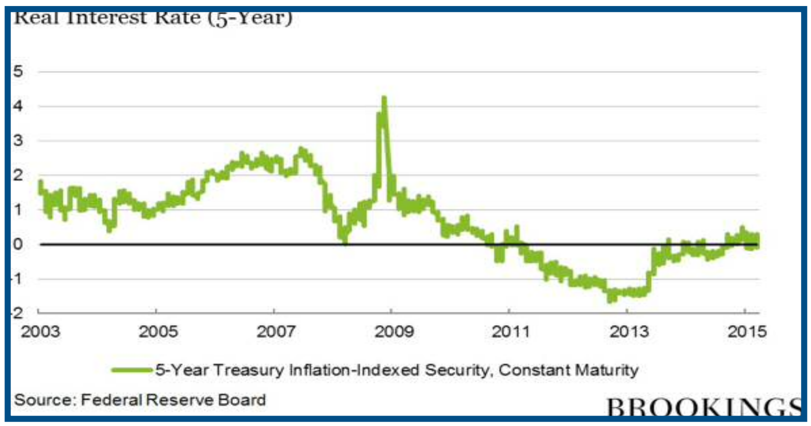
Central banks have thus felt compelled to act and fill the void. The Federal Reserve and Bank of England have both expanded their balance sheets to nearly 25% of annual GDP from around 6% in 2008. The European Central Bank's has climbed to 23% from 14% and the Bank of Japan to nearly 66% from 22%. Central bank assets as a share of GDP can be seen in **Figure 2.** Despite this **unprecedented central bank intervention**, the three strongest developed economies—the U.S., Germany, and the U.K.—all have experienced real growth of 2% or less since the Great Recession. Many wonder how if trillions of dollars of monetary easing have not succeeded here (and in Japan) over the past five years, why should one expect the European Central Bank's massive bond-buying push to fare much differently in the Eurozone? This latest worldwide glut also highlights a challenging global trade environment as the **dollar appreciates against almost all other currencies**. Most analysts continue to see a strong dollar as imposing deflationary pressure on the U.S. economy by making U.S. imports cheaper and reducing overall prices. Consequently, it would also weaken demand for U.S. exports, hurting companies specializing in that business.

Figure 2



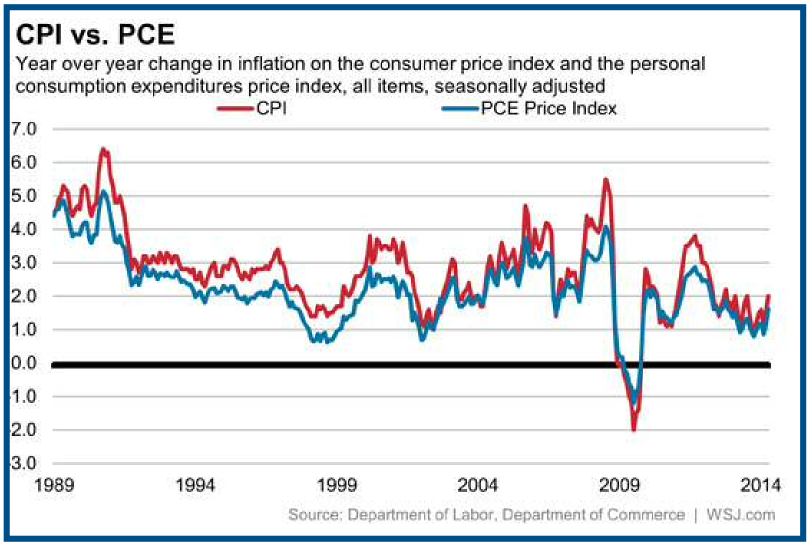
Harvard University's Lawrence Summers is among those economists who say interest rates need to fall even lower to reconcile abundant savings with the more limited opportunities for investment, a scenario defined as **"secular stagnation,"** which implies diminished potential for future growth. Alvin Hansen coined the term "secular stagnation" in his 1938 American Economic Association presidential address, *Economic Progress and Declining Population Growth*. Hansen, during the late stages of the Great Depression, believed that because of apparent slowdowns in population growth and the pace of technological advance, companies were unlikely to see much incentive to invest in new capital goods. His conclusion was that tepid investment spending along with subdued consumption by households, would most likely prevent the attainment of full employment for many years. Hansen's prediction proved to be wrong, as he failed to anticipate the postwar economic boom, which included both strong population growth and rapid technological progress. However, Summers thinks that Hansen's prediction was not incorrect, just premature. For a variety of reasons—including the contemporary decline in population growth, the reduced capital intensity of our leading industries, and the falling relative prices of capital goods—Summers sees Hansen's prediction of limited investment in new capital goods and an economy that chronically fails to reach full employment as relevant today. In a situation where the returns to capital today are very low, then the real interest rate needed to achieve full employment (the equilibrium real interest rate) will likely also be very low. In the minutes of the Fed's meeting on April 28, some Fed members said the equilibrium rate was **"unusually low by historical standards."** Fed officials then asked whether the Fed was providing "sufficient accommodation" to the economy, even after holding its benchmark rate close to zero for more than six years and pumping trillions of dollars into the economy with three rounds of quantitative easing. The recent pattern of slow economic growth, low inflation and low real interest rates (**Figure 3**) is consistent with the secular stagnation hypothesis. This hypothesis also holds true the notion that monetary policy will be chronically unable to push interest rates low enough to achieve full employment. This viewpoint believes that the path to get closer to full employment is through fiscal policy. Some, including Jaime Caruana, general manager of the Bank of International Settlements (BIS) reject the theory of so-called "secular stagnation." They argue that the current configuration of very low rates is neither inevitable, nor does it represent a new equilibrium. The BIS issued a scathing critique of global monetary policy in its annual report as it warned that the world would be unable to fight the next global financial crash as **central banks have used up their ammunition trying to tackle the latest crises**. Low interest rates have flooded cheap credit into the market, encouraging excessive risk taking. Booms have then inevitably turned to busts, which policymakers have responded to with even lower rates. Claudio Borio, head of the organization's monetary and economic department, put it this way: *"Persistent exceptionally low rates reflect the central banks' and market participants' response to the unusually weak post-crisis recovery as they fumble in the dark in search of new certainties. Rather than just reflecting the current weakness, they may in part have contributed to it by fueling costly financial booms and busts and delaying adjustment. The result is too much debt, too little growth and too low interest rates."*

Figure 3



Federal Reserve Chair Janet Yellen had a lively conversation with International Monetary Fund (IMF) Managing Director Christine Lagarde back in May at a finance conference in Washington, D.C. Lagarde asked Yellen if near-zero interest rates are *"distorting incentives and leading to a buildup of risk to financial stability."* Yellen responded that *"it is true that a low-interest rate* *environment increases the need to be sensitive and watchful for risks to financial stability."* She added that rock-bottom rates are also leading investors to take more risks and reach for yield on investments. Yellen voiced her view that stock values are *"quite high"* but don't pose excessive risk to the economy and financial system. She also emphasized that financial regulation, not monetary policy, is the Fed's main tool for heading off potentially hazardous bubbles. Later on in June, in its annual review of the U.S. economy, the IMF said the Fed should wait until the first half of 2016 before raising rates because inflation remains too low and there are *"significant uncertainties as to the future resilience of economic growth."* The IMF added that, *"There is a strong case for waiting to raise rates until there are more tangible signs of wage or price inflation than are currently evident. Raising rates too soon could trigger a greater than expected tightening of financial conditions or a bout of financial instability, causing the economy to stall."* One of the Fed's preferred inflation measures, the personal consumption expenditures (PCE) index, increased just 0.1 percent in April from a year earlier, marking the smallest twelve month gain since 2009. That marked the **36th straight month that the index has fallen short of the central bank's stated 2 percent target.** PCE and another popular inflation measure, the Consumer Price Index (CPI) can be seen in data going back to 1989 in **Figure 4.** Also in its annual review, the IMF cut its forecast for U.S. growth this year to 2.5%, down from 3.1% in April. **Persistently low inflation, stagnant wage growth and a strong dollar are certainly giving Yellen reasons to be patient and cautious.**

Figure 4



JPMorgan Chase expects an extra $900 billion of demand for Treasury bills over the next eighteen months. That has put pressure on the $1.4 trillion T-bill market and on the Treasury Department to increase the supply of T-bills. Analysts explain the dearth of T-bills as a result of so many investors wanting to be in liquid, safe assets and as a result they are overwhelming the supply. Consequences extend well beyond the fixed-income market as **rock-bottom rates in the $2.5 trillion money-market fund industry stand to deprive savers of income long after the Federal Reserve starts raising interest rates.** The mismatch between supply and demand has been so sharp that four-week bill rates fell to negative 0.0304 percent on April 29, the lowest on a closing basis since

December 2008. Yields on three-month bills also turned negative. The Treasury responded by saying at its quarterly refunding announcement on May 6 that it would increase issuance to meet the steadily growing demand. Some analysts see the overwhelming demand for T-bills as potentially undermining the Fed's ability to control monetary policy by suppressing short-term market rates well below the central bank's target rate. Thomas Simons, a government-debt economist at Jefferies Group, agreed with that sentiment saying, *"If the Fed can't prove they have control over front-end rates, it's unlikely that they will be effective in any of their monetary policy goals."* Amidst this flight to safety, bond funds are holding about eight percent of their assets as cash-like securities, the highest proportion since at least 1999, according to Investment Company Institute data. Some money managers' reasoning is that as the Fed is moving toward its first interest-rate hike since 2006, the end of record monetary stimulus will rattle the herds of investors who poured cash into risky debt to chase some extra yield.

It can be said the market truism **"don't fight the Fed"** needs to be slightly updated of late into hedge fund manager David Tepper's recent caution against taking on the "four Feds:" The European Central Bank, Bank of Japan, the People's Bank of China and the U.S. Federal Reserve. Many economists see continued loose global monetary policy as being justified given the stubborn low-growth and low-inflation environment. Economists at JP Morgan Chase estimate that global economic growth of 1.2 percent in the first quarter was the second weakest outside of a recession in the past 25 years and that worldwide inflation of 0.4 percent was the lowest. They continue to foresee **U.S. bond yields under downward pressure as a result of massive money printing by foreign central banks**. For years the $12.6 trillion U.S. Treasury market has signaled—correctly—that the Federal Reserve was too optimistic in its outlook for the economy and interest rates. Since 2012, when the Fed started making its forecasts public, policy makers have consistently overestimated the strength of the economy. They have cut their projections in nine out of the past ten meetings and reduced their year-end rate forecasts by at least a half-percentage point from 2015 through 2017. At their latest FOMC meeting in June, Fed officials again lowered expectations for economic growth in 2015 after accounting for the weak start to the year. The Commerce Department reported that Gross domestic product (GDP) fell 0.2 percent in the first quarter of this year, revised from a previously reported 0.7 percent drop. That was the weakest quarter since the first quarter of last year when the economy contracted 2.1 percent. Trade subtracted more from GDP than at any time in 30 years as the stronger dollar was a drag on exports. For the past five years, GDP growth has averaged a subpar 2.2 percent. Regardless of when the initial rate increase comes, futures show traders don't see rates exceeding 1 percent by the end of 2016, versus the Fed's estimate of 1.625 percent. Dana Saporta, economist at

Credit Suisse Group, said *"It's clearly going to be one of the most dovish tightenings you'll ever see, when it comes, because the Fed wants to make clear they'll still be very accommodative."* Yellen has repeatedly stressed that the Fed policy is data dependent and not on a pre-set course and that the Fed may tighten more quickly if the economy performs better than expected or raise rates at a slower pace if it disappoints. In addition, she said it would be best to proceed "cautiously," which means taking "several years" before policy makers lift the federal funds rate back to its normal, longer-run level. Analysts see **structural factors—which include aging global populations, institutional demand for bonds and a lack of supply—as keeping long-term yields relatively low even as the Fed begins to raise rates.** After the initial rate hike, the markets will still be benefitting from historically low rates and aggressive monetary stimulus from most of the world's central banks. For better or worse, investors are still in a world in which market returns are heavily influenced by central banks.

The Bureau of Labor Statistics (BLS) reported that nonfarm payrolls increased by 223,000 jobs for the month of June, roughly in line with what Wall Street was predicting. The unemployment rate fell two tenths of a percent to 5.3%, the lowest level since April 2008. The drop in the unemployment rate can largely be explained by the 432,000 people who dropped out of the labor force. The shrinking work force pushed down the labor force participation rate to 62.6 percent, the lowest it has been since October of 1977. Another discouraging note in the report was that average hourly earnings were unchanged, putting the year-on-year increase at a meager two percent. Some analysts saw this relatively weak report as buying the Fed a little more time before their first rate hike. As of early July, based on Fed funds futures contracts, traders see just a 12% chance that the first Fed rate hike will come in September. The odds increase to 26% that an increase will come in October and Wall Street puts the odds of a December rate hike at 48%.

A continuing major topic of discussion in the financial markets this past quarter has been the Federal Reserve and speculation regarding when it might finally start to raise the benchmark Federal funds rate it controls. The Federal Open Market Committee (FOMC) statement release in June stated that, "*The committee continues to judge that the first increase in the federal funds rate will be appropriate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium-term."* A quick recap of the latest Fed meeting is that the Fed signaled what it sees as improving economic data is keeping it on track to raise interest rates at some point later this year, and that subsequent increases are likely to be more gradual than anticipated earlier. New forecasts issued by the FOMC implied two quarter-point rate increases this year but a shallower pace of increases in 2016. Yellen stressed that the date of the first rate increase is less important than the trajectory of subsequent ones. She said she wanted "more decisive evidence" that labor markets were healing, and that wages would increase beyond their current "subdued pace." Yellen acknowledged that "some cyclical weakness in the labor market remains" pointing to the low labor force participation rate and the high level of part-time employment. **The Fed maintained their projection that the benchmark rate would rise to 0.625 percent in 2015, while lowering their forecast to 1.625 percent for 2016**.

One should remember that the first rate hike is an acknowledgement that the emergency measures enacted by policymakers in 2008 are no longer warranted. In taking this first step, **the Fed is making a move toward "normal," not reacting to an overheating economy as might be more typical of a central bank.** The last time the Fed raised rates in June 2006, the federal funds rate rose from 5% to 5.25%. **This time it will shift from zero to still very low and accommodative**. The effective federal funds rate going back to 1990 can be seen in **Figure 5.** Financial markets have been going through an adjustment in preparation for a move away from zero interest rate policy (ZIRP). While the actual event will most certainly create short-term volatility, we believe **investors should tune out the noise and look towards the longer-term implications which should be more benign**. The Fed has pledged that subsequent rate increases will be measured and gradual. Central bankers have gone as far as to say the so-called terminal federal funds rate—where they'll stop hiking—will be well below that of previous tightening cycles. That being said, there is no preset path to "normal" and there is of course uncertainty surrounding what happens when the Fed does what everyone is expecting it to do.

Figure 5