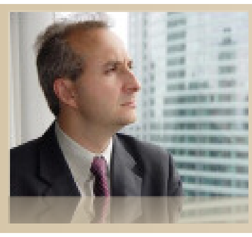
Redstone Advisors



Economic and Market Review

Third Quarter 2014

"Draghi wants inflation in the Euro zone. He will not stop. It's the beginning of the end of the bond market rally. We are done."

David Tepper, Appaloosa Management LP

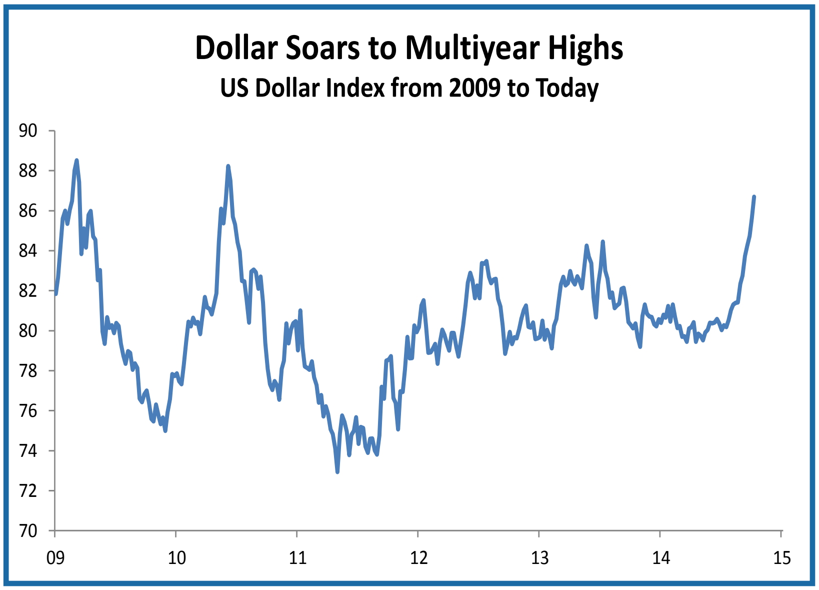
"The Federal Reserve is removing the punch bowl, and it is time to be defensive in your bond portfolio."

David Kotok, Cumberland Advisors

To the valued clients and readership of Redstone Advisors. In an effort to deliver our quarterly reporting to our clients in a more timely manner, beginning with this third quarter publication of our Quarterly Review and Outlook, we will be transferring the primary responsibility for writing and producing our Quarterly Review to new authorship. As a result, you may notice that the focus going forward will be more market-oriented and less philosophical. This does not in any way reflect a change in our fundamental worldview or outlook but rather reflects our belief that a more timely delivery of our quarterly reporting will be of value to our clients. And besides, from time to time, and as conditions warrant, we will include a contributed monograph from the "old guard."

This past quarter the financial markets have been supported by a continuation of very accommodative monetary policy. One main theme has been the divergence of U.S. Treasury and European bond yields, which can be largely explained by contrasting recent policy actions by the Federal Reserve and European Central Bank. Deflation and recession in the major economies of the Eurozone are pushing long-term interest rates to be lower not only in Europe but all across the global bond market. In response, this September the European Central Bank unexpectedly cut all interest-rate targets to fresh record lows and announced new stimulus plans in its **fight against deflation**. The main lending rate of the ECB was decreased to 0.05% and a separate rate on bank deposits was lowered deeper into negative territory, to -0.2%. As you may recall, in June the ECB became the biggest central bank in history to implement a **negative rate on bank deposits**. In the aftermath of the rate cut, the Euro dropped more than 1% against the dollar, below $1.30, to a 14-month low. For certain, a noteworthy development in the third quarter was U.S. dollar strength. Beginning in early July, the dollar has staged a strong rally against most major foreign currencies. By the end of September, the dollar had risen an impressive 7.7% in the third quarter to a **four-year high**, largely due to the aforementioned decline in foreign interest rates and the consensus market expectation of Federal Reserve tightening sometime in the middle of next year. This was the largest quarterly gain for the dollar since 2008. **Figure 1** shows the dollar index, a measure of the greenback against a basket of six major foreign currencies, dating back to the middle of 2009.

Figure 1

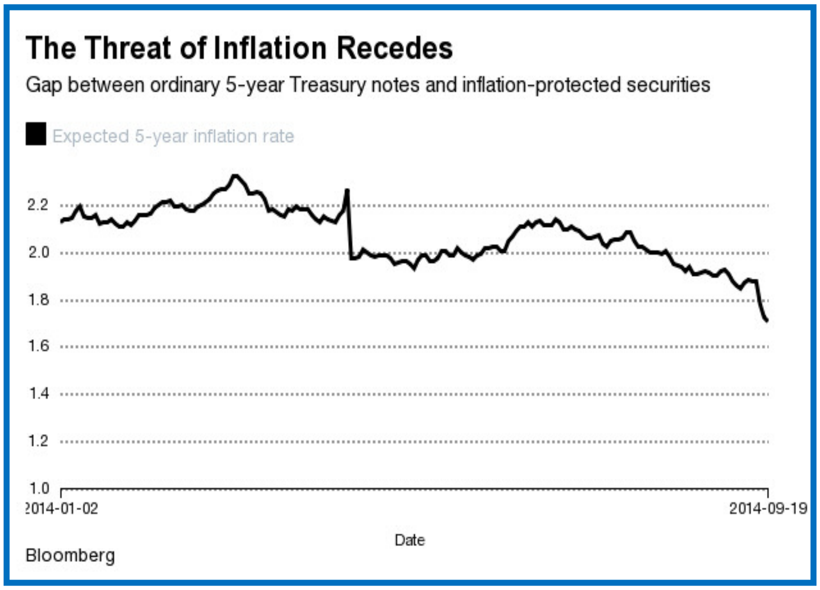


ECB President Mario Draghi described at a news conference how stagnant growth and weakening inflation had forced the central bank to act. Euro-area inflation was an anemic 0.3 percent in August, well below the ECB's stated 2 percent target. Bond yields in the Eurozone have dived lower as a result and have made **U.S. Treasuries relatively attractive**. Indeed, the U.S. 10-year Treasury note yields more than a government 10-year bond from Germany, Italy, or Spain. European and Japanese investors have flocked to the U.S. Treasury market, **lured by higher rates**. Many analysts have noted that this surge in buying from foreign investors has been more than sufficient to offset any amount of tapering that has been enacted by the Federal Reserve. Notably, international purchases of Treasuries are up $600 billion year-to-date versus last year. Deutsche Bank put out a report in September about the **historic boom in government bonds**. For some perspective, the Dutch 10-year bond yield is at a ***500 year low***. In September the spread between the 10-year U.S. Treasury bond and the 10-year German Bund reached **150 basis points**, the **widest in fifteen years**. On October 1, Germany issued 10-year notes at a yield of 0.93%, the **lowest rate ever for the Bund**. Looking at the shorter end of the yield curve, German two-year yields dipped into negative territory in September while their U.S. Treasury counterpart yielded 0.57%, their highest level since 2011. Remarkably, ECB policy has helped push **two-year yields below zero in eight Eurozone countries** as of September. Mr. Draghi also pledged to "significantly steer" the ECB's balance sheet back toward the 2.7 trillion euros circa early 2012 from the current 2 trillion euros now. That means at least **700 billion euros** or **$906 billion in stimulus** for the stagnant Eurozone economy.

As a matter of comparison, the Federal Reserve's balance sheet **swelled** from less than $1 trillion in 2008 to its current level of roughly **$4.4 trillion** following the infamous trilogy of QE1, QE2 and QE3. Full-scale quantitative easing as seen in the U.S. and Japan wasn't enacted just yet after a split on the ECB's 24-member Governing Council, with the German Bundesbank President notably opposing. Draghi conceded this latest rate cut marked the lower bound of conventional monetary policy, and, declaring the ECB can reduce them no more, he committed the central bank to buying upwards of 700 billion euros worth of asset backed securities and covered bonds. Draghi said more details of the program would be announced in October and stressed that *"we want to make sure that these asset backed securities (ABS) are being used to extend credit to the real economy. The measures are predominantly oriented to credit easing."* Jens Weidmann, the Bundesbank President who opposed the policy measures, referred to ABS purchases as **"problematic"** back in July and has **warned against supporting bank profits while socializing the losses**. Weidmann's dissent underscores how difficult it might be to secure approval for quantitative easing in Europe. Germany has pushed the notion that large-scale sovereign-bond purchases could constitute monetary financing of governments, which is in fact **banned under European Union law**. Clearly, Draghi and the ECB's concern is that an extended period of low inflation will slash forecasts of future price growth and put the Eurozone at the brink of a debilitating deflationary spiral. Unfortunately the European malaise seems set to drag on as its governments continue to delay action on unpopular structural reforms and fiscal policy. Many analysts see the policy divergence between the U.S. and Europe as only beginning, as the ECB has not yet commenced quantitative easing, while the Fed is issuing forward guidance on rate hikes.

The September U.S. jobs report provided a mixed bag of data for the Federal Reserve to analyze as it monitors labor-market slack and plots future monetary policy. The good news was that non-farm payrolls added a robust 248,000 jobs in September and August's disappointing numbers were revised up to 180,000. The nation's unemployment rate fell to **5.9%, a six-year low**. However, a weak spot in the report was average hourly earnings, which remained unchanged for the month at $24.53 and have risen just a meager 2% over the last twelve months. Also discouraging was that the labor force participation rate ticked down to 62.7%, the lowest level since 1978. Many analysts see the Fed being hesitant to raise interest rates until there is a noticeable pickup in wage growth. The Fed's policy statement released after their September 16-17 meeting reiterated a pledge to keep interest rates near zero for a **"considerable time"** after bond-buying wraps up at the end of October. As expected, the FOMC tapered monthly bond buying down to $15 billion, the committee's seventh consecutive $10 billion reduction. The Fed continued to see **"significant underutilization of labor resources"** and there was little change in language that would signal an increase in the benchmark fed funds rate is coming sooner than expected. At a press conference after the mid-September meeting, Fed

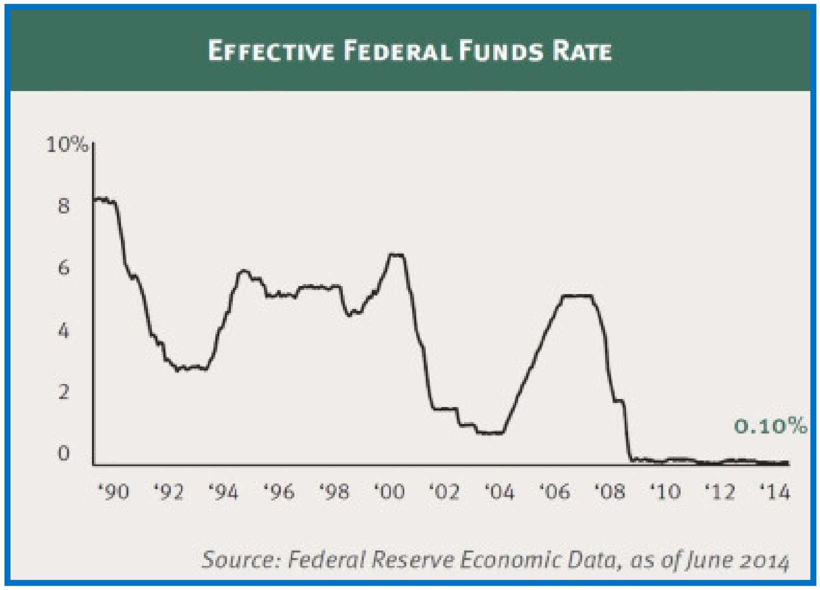
Figure 2



Chairwoman Janet Yellen said, *"the labor market has yet to fully recover"* and *"inflation has been running below the committee's 2 percent objective."* The Fed's preferred price gauge, the personal consumption expenditures index (PCE), rose 1.6 percent in July compared to a year earlier and hasn't surpassed the central bank's stated 2 percent target since March of 2012. Back in early July, Jeffrey Lacker, one of the inflation hawks on the FOMC, was quoted saying, *"The latest numbers suggest that inflation has bottomed out and is moving toward the committee's target. I expect that firming trend to continue this year."* Contrary to his forecast, official inflation measurements have headed lower since then. The Consumer Price Index (CPI) decreased in August, down 0.2 percent from July. Moreover, expectations of future inflation have decreased as well, as the chart in **Figure 2** indicates. This chart displays the yield of five-year Treasury notes minus the yield of inflation-protected securities. The spread or difference between them is called the breakeven yield and represents what the market expects annual inflation to be over the next five years. As of mid-September, the spread is 1.7 percent, which happens to be below the Fed's target inflation level of 2 percent. Some reporters sought to clarify how long **"considerable time"** meant to the Fed and Yellen responded that, *"it is highly conditional, and it is linked to the committee's assessment of the economy. There is no fixed mechanical interpretation of a time period."* Yellen also sought to give the Fed more flexibility in her remarks. She detailed how rates could rise sooner than expected, and further increases could be faster, if gains in the labor market *"continue to be more rapid than anticipated."* Conversely, if progress toward the central bank's goals disappoints, Fed policy would stay accommodative for longer.

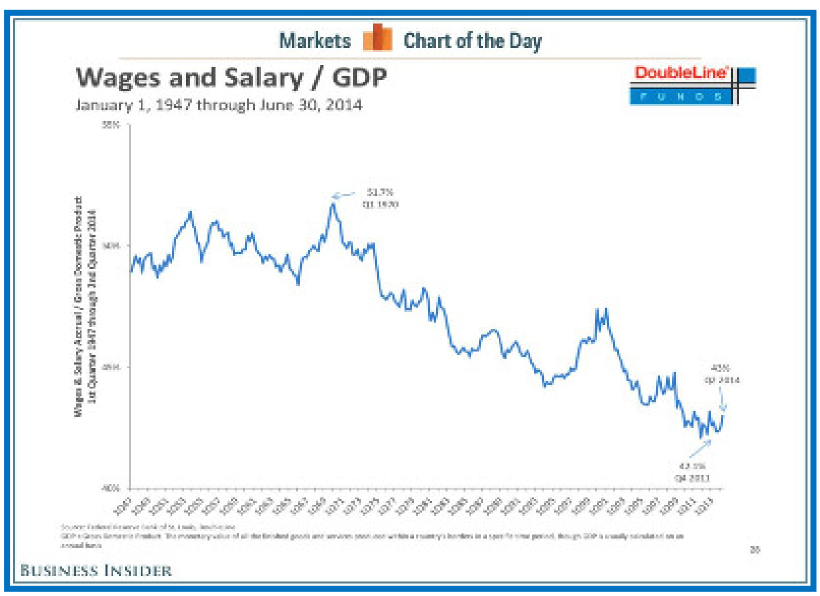
Six years of **zero interest rate policy** or **ZIRP** have passed and alas it appears the Fed could finally start raising rates in the summer of 2015, based on Fed forward guidance and current fed futures contracts. **Figure 3** shows the benchmark federal funds rate going back to 1990. Recent upward moves in short-term Treasury yields and the strengthening U.S. dollar show investors are increasing their bets that ZIRP will soon be a thing of the past. However, many

Figure 3



analysts point to **U.S. wage stagnation** as a main factor why the Fed and Yellen have no desire to raise interest rates anytime soon. As you can see in the chart in Figure 4, wages as a percent of GDP remain near multi-decade lows. Furthermore, real wages for the bottom seven-tenths of workers have dropped between 2007 and 2014. It does not seem logical that with so many wage earners seeing their purchasing power eroded on a year-over-year basis, the Fed would choose to raise short-term interest rates. According to the Bureau of Labor Statistics (BLS), wage inflation so far this year has been a **meager 2.2%**. That is below the historical benchmark, as **average wage inflation from 1948 to 2014 has been 5.1%**. Data gathered by Bloomberg LP depicts that growth in hourly earnings in the past five years has been the *weakest* over the duration of any expansion dating back to the 1960s. Also recall that September 2012 was when the Fed initiated QE3, its eighty-five billion dollars of bond-buying/month stimulus program.

Figure 4



GDP growth today is little different than it was in 2012. GDP expanded at a 4.6% annual rate in the second quarter, **sharply rebounding** from a -2.1% contraction in the first quarter. Most economists expect growth to average around 2.0% for the year as a whole. The argument made by skeptics is that if the U.S. economy was too sluggish in 2012 to raise rates and needed stimulus support, how could similar or lower GDP growth today necessitate higher interest rates? In fact, bond-market indicators for long-term inflation, growth and funding costs are all currently lower than they were at the conclusion of the Fed's first two rounds of quantitative easing. That being said, the current consensus market view is that in the coming months the Fed will be pressured to raise rates in response to a growing economy and improving labor market.

Contrary to this view is the belief that the U.S. recovery is lackluster and not enough to force the Fed to increase the fed funds rate. Dr. Robert Gordon of Northwestern University, in a paper released this September by the National Bureau of Economic Research, argues that, "*The American economy has evolved from a fast-moving rabbit to a slow-moving turtle, and the community of business economic forecasters and policymakers inside the government have been slow to recognize this profound transformation.*" He writes that "*Forecasters universally predict that actual real GDP growth will increase from the 2.1 percent average of the past five years to between 3.0 and 3.5 percent per year over the next two to three years. For output to grow at that rate would require some combination of a much slower rate of decline in the labor-force participation rate as well as a revival of labor productivity growth well above the 1.2 percent average growth of the past decade.*" The result is a subdued outlook for the future of the American economy. Notably, the Federal Reserve **downgraded** their expectations for economic growth in 2014, 2015 and 2016 in forecasts published after their two-day meeting in mid-September. The Fed now expects the economy to grow between 2.6 percent and 3.0 percent next year, down from its June forecast of growth between 3.0 percent and 3.2 percent. In their first-ever forecast for 2017, the Fed sees GDP growth of just 2.3 percent to 2.5 percent. Keep in mind that historically the Fed, along with most economic prognosticators, have been proven to be overly optimistic in their GDP forecasts. We have previously discussed Dr. Gordon's work that details his opinion of how **formidable headwinds** are acting to reduce future US economic growth. These headwinds, as you may recall, include **demographics**, **globalization, debt and income inequality**. Certainly, with America's outstanding public debt at a record $17.7 trillion, Yellen faces the difficult task of ending ZIRP without igniting a jump in borrowing costs in a still fragile U.S. economy. Significantly, the ongoing slowdown in Europe, whose collective economies are roughly 40 percent larger than China's, could drag down U.S. growth and postpone the Federal Reserve from raising its benchmark rate. The central bank's more hawkish members are clearly outnumbered, but they will continue their dissent and warn against the risks of too easy monetary policy that persists for too long.

A final noteworthy theme in the U.S. bond market this year has been the collapse of volatility. The Merrill Lynch MOVE Index shows the average implied volatility of options on Treasury futures contracts across the yield curve. Currently, as seen in **Figure 5**, the MOVE Index is resting close to historic lows. Explanations for the low volatility vary. Many point to the Fed's shift in monetary policy communication. The commitment from the Fed to keep rates low for an extended period of time regardless of data has removed much of the uncertainty surrounding the future path of interest rates. It is also true that the low inflation expectations provide space for policy rates to stay low and for long term expectations of rates to remain muted. Moreover, as we have discussed previously, the normal **supply and demand dynamic of the bond market has been heavily distorted** by central bank bond buying and balance sheet expansion over the past few years. Just last year the Fed purchased roughly **71% of net Treasury issuance**, a remarkable number. It is apparent that with QE purchases winding down in October, and the absence of a consistent sizable Fed bid for bonds, that prices seem unlikely to remain as quiet as they have been recently. We have seen defensive positioning by investors in the U.S. Treasury market this past quarter as short-term Treasuries in the two to seven year range have largely sold off. In September, the two-year note rose in yield to 0.57 percent, its highest level since May 2011. Overall, the Treasury yield curve certainly underwent a bullish flattening this past quarter. Yields on Treasury bills and notes at the shorter end of the curve are more sensitive to shifts in the Federal Reserve's interest rate policy, while yields on longer-dated bonds are more dependent on the inflation outlook. Longer-dated Treasury bonds rallied modestly this quarter, and the softness of long-term yields underscores the concern about the pace of growth and strength in the U.S. economic recovery. Keep in mind that the re-investment of the annual maturities, calls and prepayments from the Fed's enormous $4 trillion portfolio will continue to provide up to $400 billion in tacit support annually. After its September meeting, the Fed put out new guidelines for its exit strategy from QE, stating that the phasing out of reinvestment, *"will depend on economic and financial conditions and how the economic outlook evolves."* Investors should not get too complacent regarding the Fed's ability to smoothly extricate itself from the most-aggressive stimulus in its 100-year history without any complications. We would not rule out the possibility of seeing further extraordinary Federal Reserve measures in the near future. Janet Yellen can surely sympathize with Michael Corleone, ***"Just when I thought I was out...they pull me back in."***

Figure 5