Redstone Advisors

Economic and Market Review

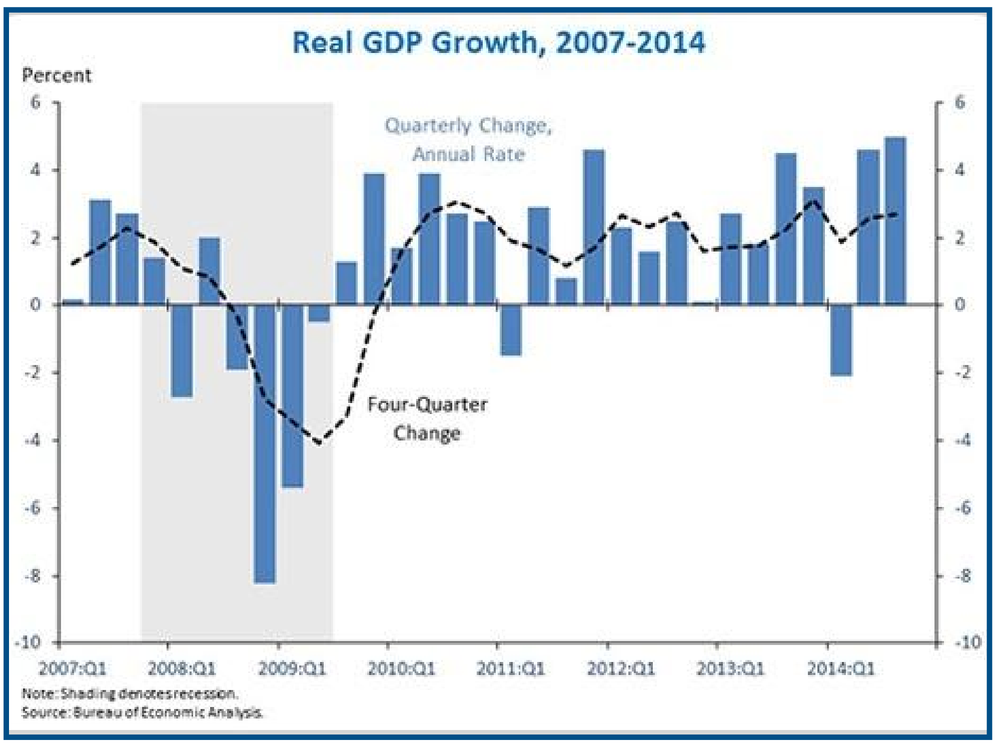
Fourth Quarter 2014

"To be a central banker is an impossible task."
Thomas Mayer, former chief economist at Deutsche Bank

"The United States is the locomotive of growth for the world right now."
David Berson, chief economist at Nationwide Insurance

The fourth quarter of 2014 can be summarized by the **increasing divergence in central bank policy and economic performance** between the steady strength of the United States and the relative weakness of other major world economies, namely Europe and Japan. This theme will continue to have important implications for financial markets, notably a **stronger dollar** which was discussed in last quarter's market review and caution regarding short-term U.S. bonds. Strong economic data coming out of the U.S. recently, including a robust November nonfarm payrolls report and a booming **5.0% Gross Domestic Product (GDP) growth in the 3rd quarter**, support the consensus view that the **U.S. economy will continue to outperform most other countries** in the developed world. Quarterly change in U.S. GDP growth going back to 2007 is shown in **Figure 1.** The strong dollar has been the clear winner among global currencies in 2014. The **greenback rose an impressive 12 percent** against a

Figure 1



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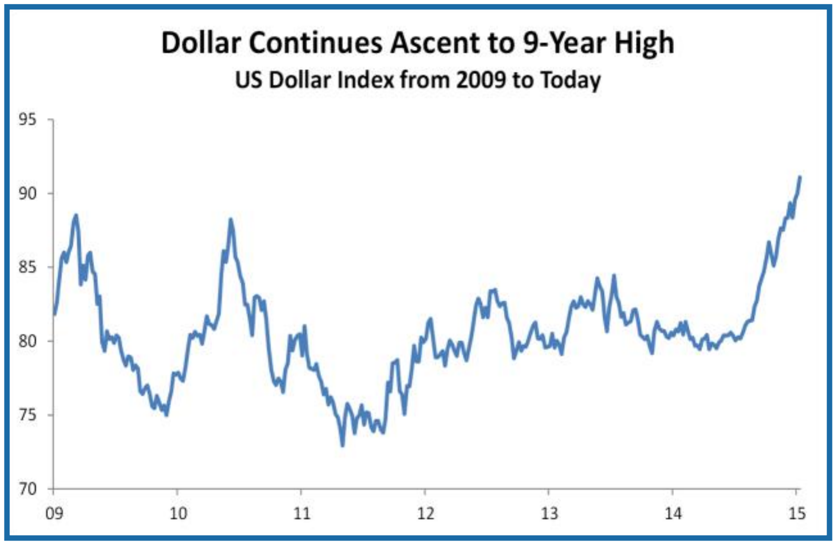
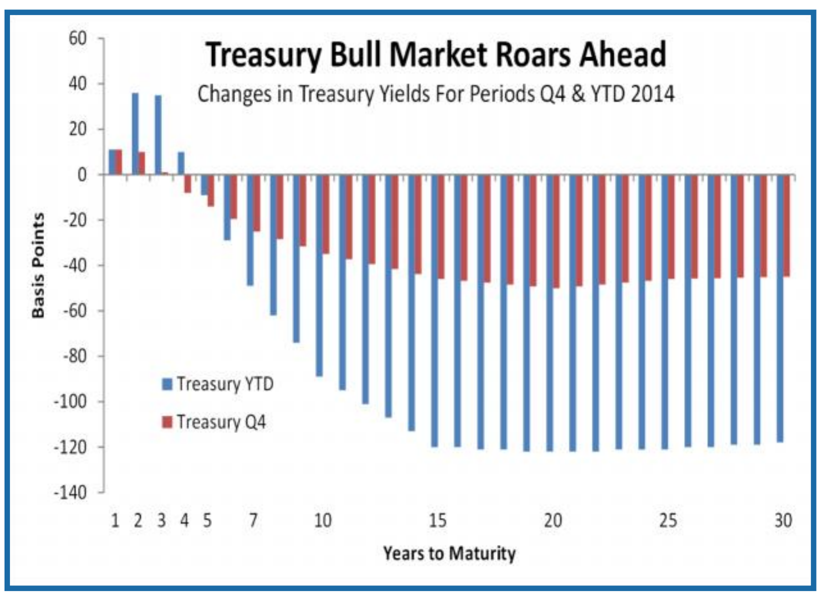
broad index of other currencies last year, finishing 2014 at a **9-year high**. Powering the dollar rally is a broad-based anticipation of the first interest-rate hike in almost a decade by the Federal Reserve. Analysts see the strong dollar trend continuing in 2015 based on the relative strength of the American economy, emerging market weakness and differing monetary policy among the Fed and other major central banks. The dollar's surge can be seen in **Figure 2**.

Figure 2



The Treasury yield curve has flattened this past quarter, as short-term bonds sold off in anticipation of a **possible mid-to-late 2015 Fed funds rate hike**. Changes in the Treasury yield curve for the quarter and year are shown in **Figure 3.** In late December, the yield on the two-year U.S. Treasury rose to 0.78%, the highest level since the spring of 2011. The spread between the U.S. five-year note and thirty-year bond narrowed to 127 basis points by mid-December, the smallest margin in almost six years as below-target inflation made longer-term bonds relatively more attractive. By late December, the spread between the two-year and ten-year Treasury note decreased to 153 basis points, a drop of exactly 100 basis points from the recent peak spread of 253 basis points in November 2013. American banks have noticeably ramped up their purchase of Treasuries, as U.S. government debt holdings by these banks has increased to a **record $2 trillion**. This comes in the wake of global regulators enacting post-2008 financial crisis rules requiring financial institutions own high quality liquid assets

Figure 3



(HQLA) while reducing risk-taking activity. Fed data shows that banks have been net buyers of Treasuries and other agency debt for fourteen straight months, the longest such streak of gains since June 2003. Moreover, the Treasury Department reported last year that **foreign holdings of U.S. Treasuries reached a record high** of $6.07 trillion in the month of August. Buyers that month included Japan, which added $11 billion, and China which added $12 billion. According to a report by JPMorgan Chase, global demand for debt securities has surpassed issuance five times in the past seven years. For 2015, the company predicts global demand will outpace supply by roughly $400 billion as central banks in Europe and Japan increase their bond buying. The strong demand for bonds reflects disappointing global growth and that has been a consistent theme for a while now.

A major topic of discussion in the financial markets this past year has been the Federal Reserve and speculation regarding when it might finally start to raise the benchmark Federal funds rate it controls. The Fed wound down the third and perhaps final iteration of its massive quantitative easing program (QE3) this past October. The Federal Open Market Committee (FOMC) statement released last December stated that, *"the committee judges it can be patient in beginning to normalize the stance of monetary policy",* replacing a pledge to keep borrowing costs near zero for a **"considerable time"**. The Fed said the **new forward guidance is "consistent" with its previous "considerable time" wording**. Fed watchers saw the inclusion of **"patience"** as a ploy by Fed members to give themselves more flexibility. Fed Chairwoman Janet Yellen clarified in a press conference afterwards that "patient" should be interpreted as that the Fed is **unlikely to begin the normalization process for at least the next couple of meetings**, which occur in January and March. The Fed reiterated in their statement that rates could rise sooner than anticipated if the Fed makes faster progress toward its goals of full employment and stable prices. *"Conversely, if progress proves slower than expected, then increases in the target range are likely to occur later than currently anticipated."* Also in the statement the Fed noted the labor market *"improved further"* and that *"underutilization of labor resources continues to diminish."*

One of the major economic stories in 2015 will be the beginning of the Fed's push to normalize historically low rates. Many on Wall Street fear the transition to higher borrowing costs could lead to turbulence in the bond market and slower growth. For certain, the Fed is preparing for a crucial phase in its seven-year battle with a financial crisis, recession, and frustratingly slow recovery. Fed Chairwoman Janet Yellen said in November that the central bank, *"will strive to clearly and transparently communicate its monetary policy strategy in order to minimize the likelihood of surprises that could disrupt financial markets, both at home and around the world."* She added that the decision to start raising rates would, *"be an important sign that economic conditions more generally are finally emerging from the shadow of the Great Recession."* Ms. Yellen also noted that *"in advanced economies, the current macroeconomic policy mix generally remains one of extraordinary monetary policy stimulus and somewhat contractionary fiscal policy. Considering the headwinds that continue to weigh on growth, employment and prices, this situation is hardly ideal."* Central bankers know that global growth is shaky and that they're receiving little help from government fiscal policies. Thus, economic progress in 2015, along with stock prices, bond yields, and commodities demand, looks to be heavily dependent on global central bank policy.

As the markets prepare for probable Fed tightening in 2015, recall what happened when former Fed Chairman Alan Greenspan raised the benchmark federal funds rate by 425 basis points between 2004 and 2006. Greenspan was attempting to tighten credit and curb excesses in the financial system, but to his dismay, long-term borrowing costs failed to increase to the degree intended. Thirty year mortgage rates rose only 100 basis points, and running counter to Fed intentions, more credit became available to too many, sometimes less credit-worthy, borrowers. The housing bubble and subprime mortgage loans continued, ultimately contributing to the worst financial crisis since the Great Depression. *"We wanted to control the federal funds rate, but ran into trouble because long-term rates did not, as they always had previously, respond to the rise in short-term rates,"* Greenspan said in an interview back in November. The current Fed under Yellen has created a panel, led by Vice Chairman Stanley Fischer, to monitor financial markets and detect early signs of asset bubbles. The bond market is indicating that **history may be repeating itself** as the Fed prepares to raise rates in 2015. The yield on the 10-year U.S. Treasury note fell over 90 basis points in 2014 even as the Fed finished tapering and ended QE3. The stakes are higher this time compared to 2004 because rates are lower and the yield curve is flatter. Increasing short-term rates in the face of stable or decreasing long-term rates could bring about a scenario where the Fed quickly inverts the yield curve and dangerously disrupts credit creation. An inverted yield curve happens when short-term Treasury bills yield more than longer-term bonds. This discourages banks from extending credit because they finance long-term loans with short-term debt. Historically, inverted yield curves have typically preceded recessions. One thing to remember is that Yellen's Fed has one tool that Greenspan didn't: a **$4.5 trillion portfolio accumulated after three rounds of bond buying**. Selling some of those assets could provide a way to raise long-term rates if necessary. Also, as we have discussed, economic stagnation has sent yields plunging in Europe and Japan, meaning that these foreign investors will buy up relatively attractive U.S. bonds and help suppress Treasury yields from rising. Foreign investors have certainly replaced the Fed's purchases as a major source of demand for U.S. government debt. Moreover, unlike the 2004-2006 period, when the dollar was depreciating, a rising dollar in an upcoming monetary tightening cycle will boost foreigners' incentive to hold American assets. Some analysts see Europe and Japanese officials willfully weakening the euro and yen to help them fight deflation. While there is no explicit agreement by representatives of the major world economies to drive the dollar higher, most of the world now views a U.S. dollar appreciation as beneficial.

There are plenty of economists and analysts who are again predicting the bond bubble to burst and the remarkable **30-year long bond bull market** to finally end in 2015. The bond bubble story started about four to five years ago and has consistently not materialized as the doomsayers have predicted. A fundamental reason why bubbles burst is that there is too much supply relative to demand. However, today in the bond market there is a dynamic where there exists too much demand relative to supply. Simply put, that is the inverse of what a bubble is. Other analysts say the likelihood that inflation will remain tame worldwide is a big factor for why they forecast interest rates to stay low in 2015. It is important to put the Fed's upcoming policy shift into perspective and realize that the future rate-hike cycle is starting from a very low base. The Fed funds rate is currently at 0%, and a 0% rate implies emergency conditions. The point is the United States is far from emergency conditions. U.S. Gross Domestic Product (GDP) growth for the second and third quarters registered a robust 4.6% and 5.0% gain respectively. A move in the Fed funds rate from 0% to 1% would upset doves opposed to premature monetary tightening. Perspective is important though, and a **1% Fed funds rate is an incredibly low and accommodative policy on a historic basis**. Also it is likely that the Fed will keep the Fed funds rate at a lower level for a longer period of time than it has historically. Fed Bank of Atlanta President Dennis Lockhart said in his view the central bank should be "patient" regarding the timing of the initial rate increase and have a "cautious bias" on further moves. Lockhart emphasized that the Fed should wait to start raising rates from almost zero because a reversal would damage Fed credibility. An important reason for the Fed to go slow on future rate hikes is that the world is awash in debt. According to a report by the International Center for Monetary and Banking Studies in Geneva, the level of debt in the global economy, excluding financial companies, has increased by more than a third since 2008. The report found that the potential global growth rate has fallen to less than 3 percent from about 4.5 percent prior to 2008. Simply put, the more debt there is, the greater the cost to governments, businesses and consumers of higher rates. After the last FOMC meeting in December, Yellen stated that central bankers will react to economic data as it unfolds and that the timing of the initial rise in the fed funds rate as well as the path for the target thereafter are contingent on economic conditions. She added that, ***"monetary policy will still be very accommodative for a long time"* after rates increase**.

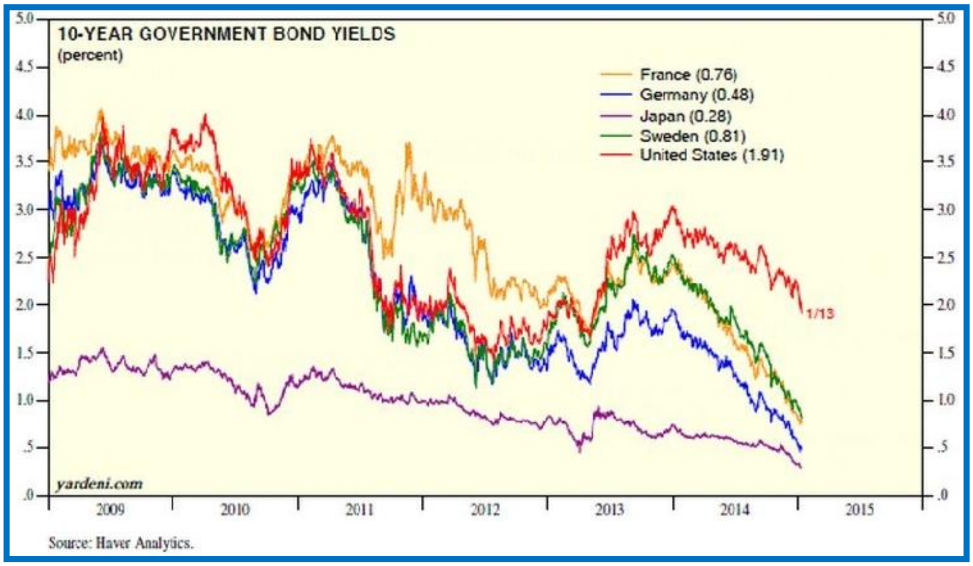
Regarding longer-term rates, demographics, specifically an aging population, will be a large force behind a robust demand for fixed-income investments. Insurance companies and pension funds of course have a strong appetite for safe, conservative investments and the consistent stream of income generated from bonds. Combine a globally aging population with actions by the European Central Bank and the Bank of Japan who are undertaking their own Fed-style quantitative easing involving massive bond-buying and you have forces acting to keep a lid on interest rates moving significantly higher. Of course, there is the risk that monetary policy alone will not work exactly as intended, with inflation and growth in the Eurozone and Japan continuing to stagnate. The extraordinarily accommodative monetary policy is seen as buying time until the **proper fiscal policies** can be implemented that hopefully lead to real growth. That being said, politicians can be reluctant to enact tough fiscal initiatives that are unpopular with a majority of their citizens. Central bankers, including former Fed Chairman Ben Bernanke, have alluded to the **limitations of using monetary policy to address economic problems**. In Japan's case, the country is weighed down by a highly inefficient domestic economy. Europe is burdened by a fragile and fragmented banking system. The core problems of these economies will not be solved by injecting massive amounts of cheap credit into them. Critics contend that Europe and Japan are just copying the U.S. Federal Reserve when they in fact have different problems.

It is interesting to note that the world's largest central banks have not been this divided on policy since 1989. History shows that 1989 was the time when the Bundesbank had been increasing interest rates for a year, in response to their sense that the West German economy was running too hot. For three years after the fall of the Berlin Wall, they continued to raise rates, wary that huge money transfers from west to east could ignite spiraling out of control inflation. Meanwhile Japan had begun tightening monetary policy in an effort to tamp down an asset price bubble. In contrast, the Federal Reserve was initiating the process of monetary easing. After more than a year of inflation-fighting rate hikes and a sluggish economy due partly to the savings & loan crisis, the Fed began lowering the Fed funds rate in 1989. The Fed quickened the pace of the cuts as the U.S. economy slowed during the first Gulf war in 1990.

Now in the year 2015, global monetary policy interestingly appears to be a **mirror image of its 1989 self**. The Bank of Japan made news back in October when it significantly widened the size of its asset purchases. BOJ Governor Haruhiko Kuroda stated his central bank would boost asset purchases to an annual pace of about 80 trillion yen or $675 billion. President Mario Draghi and the European Central Bank are expected to announce a package of broad-based asset purchases sometime in January. Mr. Draghi gave a speech in early December where he said policy makers **"won't tolerate" a prolonged period of low inflation**, and that officials discussed "all assets but gold" as potential targets for buying. Draghi emphasized that the **ECB must return inflation to target levels "without delay."** The ECB downgraded its economic outlook in early December, forecasting inflation at a tepid 0.7 percent in 2015 and growth to register a paltry 1 percent. With deflation and recession mounting as worries for Europe and Japan, this desperate central bank policy comes as no surprise. The inflation rate for the 18-nation euro area matched a five-year-low in November and Japan's economy officially entered a recession, contracting in the 2nd and 3rd quarter. Wall Street consensus is for the **European and Japanese central banks to buy just over $1 trillion of bonds in 2015**. Policy makers of these major economies are clearly becoming more worried as they confront deteriorating domestic conditions, combined with soft global demand that is weighing down prices and keeping inflation at levels many central bankers consider alarmingly low. In addition to Europe and Japan, China's central bank embarked on looser monetary policy in the fourth quarter. In November, the People's Bank of China announced a surprise cut in benchmark lending and deposit rates, the first reductions since 2012.

Meanwhile as we have discussed, the U.S. is expected to start tightening monetary policy in mid-to-late 2015. Continuing a theme from last quarter, the spread between the 10-year U.S. Treasury bond and the 10-year German Bund rose to **158 basis points**, the **most since 1999**. The spread between the U.S. and Japan is even larger at 188 basis points. For certain, one of the main reasons the Treasury yield curve flattened over the past quarter is the **underlying bid that's in the European market, as yield-hungry investors flock to the relative value of U.S. Treasuries**. **Figure 4** shows 10-year government bond yields going back to 2009. The threat of inflation in the U.S. has continued to recede, echoing another theme from last quarter. Minutes from the Fed's meeting released in November said that, *"participants observed the committee should remain attentive to evidence of a possible downward shift in longer-term inflation expectations."* The spread between yields on 10-year Treasury notes and similar maturity Treasury Inflation Protected Securities (TIPS), which act as a gauge of market expectation for consumer prices over the life of the debt, narrowed to 172 basis points in December, the lowest level since 2011.

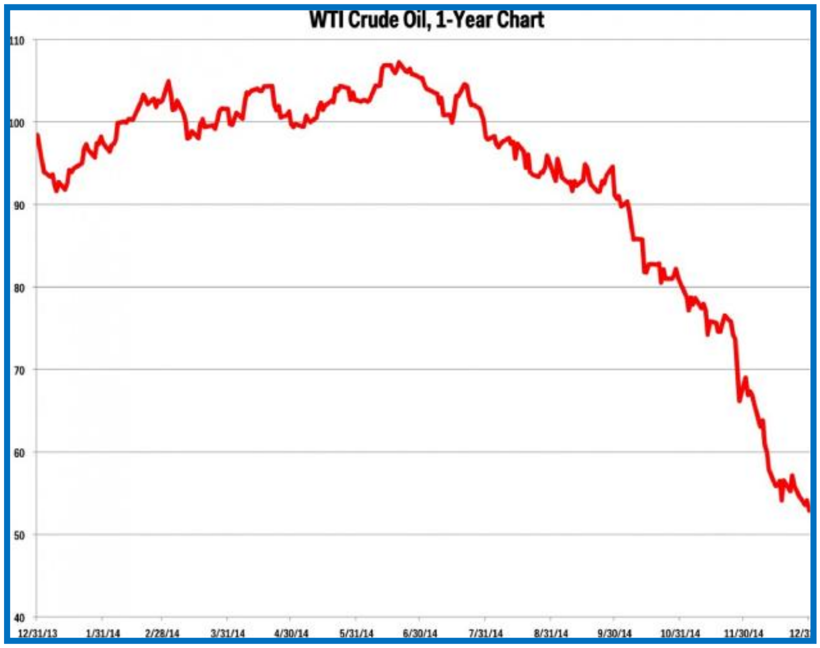
Figure 4



The U.S. consumer price index (CPI) rose 1.4 percent in October from the same period a year ago. CPI has failed to reach the Fed's 2 percent inflation target for 30 straight months going back to March 2012. In fact, CPI has risen an average of 1.6 percent over the past five years, the least since the five-year period ending in 1965. However, at the household level, rising prices for some things are crowding out spending on others, leaving many families with the impression of inflation. For example, the Wall Street Journal recently reported that out-of-pocket health-care spending by middle-income Americans rose 24 percent from 2007 to 2013. Combine that with increasing prices on other items seen as necessities, like cell phones, internet service, college tuition, and insurance, and the result is less money for other consumer essentials like food, clothes and household goods.

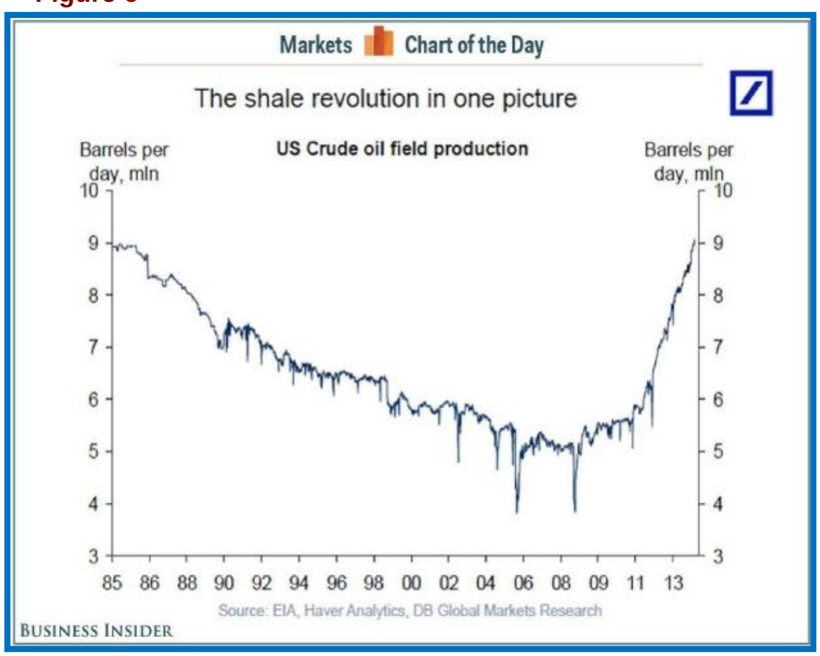
A major theme in the global economy for the second half of 2014 was the **collapse of oil prices**. The price of a barrel of oil has **plunged about 50 percent** since its peak in mid-June of last year, as the chart in **Figure 5** illustrates. Last November the Organization of Petroleum Exporting Countries (OPEC) decided against reducing production levels amid the global glut of supply and plunging prices. That continued a downward price trend driven by a weak global economy and expanding U.S. domestic energy supplies. U.S. crude oil production has been surging, reaching in excess of 9 million barrels per day, the **most in 31 years**, as the chart in **Figure 6** demonstrates. Amidst the shale boom, **U.S. oil production has jumped 65 percent in just the past five years**. America has moved closer and closer to **energy independence**, supplying 89 percent of its own energy in 2014. The OPEC move was seen by many analysts as a strategy by Persian Gulf states, particularly Saudi Arabia, to test the willingness of American shale-oil producers to keep drilling wells. Saudi Arabia has grown concerned that oil production will continue to increase outside OPEC, diminishing the cartel to a reduced share of the global market. Thus the Arab kingdom has opted to fight for market share by letting prices decline. Falling oil prices are draining hundreds of billions of dollars from the coffers of oil companies and oil-rich exporters like Iran and Russia and providing much-needed relief for American consumers. The end result could be one of the largest transfers of wealth in history, potentially reshaping everything from negotiations on Russian sanctions to the Federal Reserve's policies for the U.S. economy. Average national gasoline prices have plummeted from $3.30/gallon a year ago to about $2.20/gallon at the end of 2014, the lowest since May 2009. Drivers in the U.S. spent $370 billion on gasoline last year. The drop in gas prices over the past six months has amounted to a **$75 billion tax break for American consumers** according to analysis by Goldman Sachs. Goldman estimated that the total boost from lower gas prices could add 0.4 percent to GDP in 2015.

Figure 5



The roughly 50 percent drop in the price of the international benchmark Brent crude oil over the past six months will reduce annual revenue to global oil producers by a **staggering $1.5 trillion**. Big losers include Russia, where plunging oil prices have done more to hurt the economy than Western sanctions, and as a result, the value of the ruble has been collapsing. In response to the ruble's freefall, Russia's central bank increased its benchmark interest rate by a remarkable 650 basis points, from 10.5

Figure 6



percent to 17 percent in mid-December. That was the sixth time in 2014 that the Russian central bank has raised rates, all in an effort to halt a 49 percent plunge of the ruble, the world's worst-performing currency of 2014. Regarding Iran, the Iranian economy and government rely heavily on oil sales. Continued low prices could bolster the effect of economic sanctions aimed at pressuring the regime into reaching a diplomatic accord on its nuclear program. Another effect of the sharp decline in oil prices has been increased scrutiny and rising borrowing costs for many energy companies. Energy producers have issued $550 billion of new bonds and loans since early 2010, and now with oil prices dropping, investors are questioning the ability of some issuers to meet their debt obligations. Junk-rated energy bond yields shot up to a five-year high of 9.5 percent in mid-December, an increase from 5.7 percent in June. Prices fall when bond yields rise. The sharp decline in price of energy debt is the latest example of a boom and bust in the U.S. financial markets as an unprecedented Fed stimulus and six years of record low interest rates fueled a hunt for yield. Energy industry analysts predict the default rate for energy junk bonds could double to eight percent in 2015.

The United States economy added a better than expected 252,000 jobs to nonfarm payrolls in December. This followed an impressive **353,000 jobs gain in November** and a solid addition of 261,000 jobs in October. December marked the **eleventh straight month that nonfarm payrolls have increased by at least 200,000, the longest stretch since March 1995**. Over the course of 2014 the United States added an average of 246,000 jobs per month. The unemployment rate in December dipped to **5.6 percent, a six-year low**. However, a discouraging part of the report was that average hourly wages declined 0.2%, from $24.62 to $24.57. Last report we discussed how U.S. wage stagnation was a main factor for why the Fed has no desire to raise interest rates anytime soon. According to the Bureau of Labor Statistics (BLS), wage inflation for 2014 registered a meager 2.2%. Wages were rising between 3 and 4 percent on average before the financial crisis back in 2008. Amid the boost in hiring and dropping unemployment rate, rising wages have remained frustratingly elusive. Some analysts cite the large pool of 18 million people who want a full-time job but still can't find one as a factor holding back wage growth. Employee wages have been on a distinctly downward trend since 1970, as the chart in **Figure 7** illustrates. The graph shows employee compensation (wages and salaries) divided by Gross National Product (GNP) as well as corporate profits divided by GNP. The **divergence in wages and corporate profits is quite stark** in the aftermath of the Great Recession.

For 2014, the U.S. generated **2.95 million new jobs**, the largest such increase since a 3.2 million gain in 1999. The U.S. continues to outpace other major world economies, in fact over the past four years America has added more new jobs than Europe and Japan combined. Suddenly the BRIC economies (Brazil, Russia, India & China) aren't looking so hot. Brazil is struggling to grow and China is attempting to manage a slowdown. Russia recently forecast a recession for 2015. Meanwhile, the Commerce Department reported in late December that U.S. Gross Domestic Product expanded at a **stunning 5.0 percent annual rate in the third quarter**, revised upward from a previously estimated 3.9 percent. This gain, powered by consumer and business spending, was the **biggest expansion in GDP since 2003**. Combined with the 4.6 percent increase in GDP in the second quarter, the U.S. has impressively recorded **strong back-to-back quarterly performances**. Most of the increase was attributed to consumer spending on health care and business spending on structures and software. The second and third quarters have been encouraging because since the Great Recession ended in June 2009, GDP growth in the U.S. has averaged at frustratingly subpar rates of just around 2 percent. Additionally, the Federal Reserve's Beige Book, a gathering of anecdotal information on current economic conditions, found that business activity continued to expand in October and November as lower gasoline prices stimulated consumer spending. Consumer spending accounts for about 70 percent of economic activity. A labor market that continues to improve could influence the timing of the Federal Reserve's first rate hike since 2006, which is currently expected to occur in mid-to-late 2015. Also, whether growth can be sustained at high levels at normal type interest rates conducive to financial stability has not yet been fully established.

Figure 7