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Update on Current Market Conditions

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Over the last three months, global stock and bond markets have been forced to deal with three major issues that always seem to be in a constant state of change and uncertainty. Issues appearing to have been resolved are once again unresolved. Economic data that had given investors clarity and reassurance are only to be called into question again on an almost weekly basis. The question here at home of when will the Federal Reserve raise rates, has now become one of why would they if our economic growth is so weak. Any rate increase would only make our dollar in a world of currency devaluation only stronger and put our multinational companies at a further disadvantage.

The second major concern is whether the Chinese economy slowing to the point that it will affect the global economy as its once voracious demand for foreign goods and resources slows. The rapid decline in Chinese stocks only further heightens the fears that many analysts have that many Chinese asset classes are fundamentally overvalued or have even reached speculative levels. Many economists believe that the recent collapse in their market is symptomatic of underlying economic weakness that will spread to the rest of their economy. The Chinese stock market has fallen more than 30% in the last two months, wiping almost $4 trillion in market value. We are now seeing unprecedented intervention by their communist government as it tries to inspire confidence amid growing investor panic. The heavy hand of the Chinese regulators was shown last week when they banned major shareholders from selling their shares for six months and then encouraged more than half of the companies listed on the exchange to indefinitely suspend trading in their shares. The government had allowed investors in China can now use their apartments as collateral to buy stocks on margin and investors as young as 9 years old are known to be trading stocks. What could possibly go wrong? After a yearlong rally which was fueled by record borrowing, millions of first time investors and surging valuations it came as no surprise that it would end in a market crash. Stock market excesses and speculative bubbles know no boundaries as human nature is the one great constant throughout history. We are just as fearful and as greedy now as our ancestors were a thousand years ago.

Since the 1920's, the health of the US economy has been the major determinant of the state of the global economy. Over the past 50 years, all the previous world's recessions have coincided with significant contractions in the U.S. economy. Unfortunately that is about to change as many economists now expect that the next global slowdown will be triggered by China. While China's growth is still growing, that rate of growth may decline faster than many predict and despite the stimulative efforts of the Chinese government. The country's influence on the global landscape has increased dramatically since becoming the world's second biggest economic power. A Chinese led slowdown will have many negative consequences for the economic outlook of other nations as China accounted for 38 percent of all global growth in 2014, a very significant increase from 23% just four years ago.

The third question which has been tormenting the European markets for the last five years is whether Greece will ever get their economic house in order? Many now believe that even if a deal with the Eurozone is reached, does the Greek government even have the ability to actually enact any reforms that are going to be required. Historically the Greek people have never demanded nor expected that level of discipline from their leaders or government. The country has a much different history than the rest of Europe in that while the rest of Europe was profoundly impacted by the institutional changes brought on by the Reformation and the "Age of Enlightenment", the Greeks remained under the repressive control of the Ottoman Turks for nearly four hundred years. Social institutions and a government that is accountable to the public good were evolutionary steps that the Greek culture has missed. All the more tragic since Greece was the birthplace of democracy that modern nations seek to emulate. I often think of the ancient Chinese curse of "May you live in interesting times" is becoming much more apropos.

In many ways the Greek financial crisis is a precursor of what lies ahead for many western democracies. Greece has a population that is aging quickly with a negative population growth. Of a total Greek population of about 12 million, only around 3 million are employed and of those working nearly a third are government based jobs. A Greek exit from the Eurozone would actually be quite bullish for US multinationals. It is the weaker European countries and their large amounts of debt that help keep the Euro weak with Germany's export dependent economy the primary beneficiary. If Greece were to exit the Euro, the currency would rise in value and the value of our dollar would fall, with US multinationals and our exporters reaping the benefits. It is my opinion that the Federal Reserve has completely missed their opportunity to raise short term interest rates and thereby minimize the negative impact on corporate and consumer spending. The last three years corporate earnings were growing and balance sheets were as strong as ever, providing the Fed with a perfect opportunity to move off there zero interest rate policy. Now for the second quarter, corporate earnings for the S&P 500 are expected to decline by 4.5% year over year and retail sales are beginning to show real weakness. Exactly not the type of economic landscape in which you want to start tightening monetary policy.

Why does this matter? Well whenever we head into the next economic slowdown, the Fed will be walking into that gunfight carrying an empty gun with no bullets. Historically at this point in the economic cycle short term interest rates would be at least 2.0% or more not the artificially suppressed rate of 0.0%. Likewise long term rates given the current rate of GDP and inflation should be around 4.5% to 5.0% not the 2.3% rate we see the 10 year bond currently yielding. This is important because with interest rates already at zero, the Federal Reserve has no ability to use its most powerful tool of cutting rates to offset a domestic economic slowdown or even a future global recession. Even the badly outnumbered Gary Cooper in "High Noon" at least had a loaded gun.

Chairwoman Yellen's conference call after the last Fed meeting, while intended to reassure our markets, actually revealed the fear and uncertainty that now paralyzes the Fed's Open Market Committee. They say they want to normalize the interest rate environment, they won't. If they did the interest rate borrowing costs of the US government would soar as over a third of its outstanding debt is in maturities of three years or less. They say that they want to raise rates, they can't as corporate earnings and economic growth are now either slowing or actually declining. They are now coming to the realization that they are caught in a trap of their own making. One based on the arrogance of the academic rather than the wisdom learned by a student of the markets. A true economist understands that while an economy is inherently self-correcting, they are also self-healing. This Federal Reserve put the economic patient in the hospital but has made him so dependent upon the zero interest rate drug that he can never summon the strength to leave. Even academic credentials are not immune to the laws of unintended consequences. The unspoken but implicit understanding is that the world's central bankers are more than willing to impose a future tax on their respective citizens by actively pursuing inflationary policies through currency devaluation in order to insure the promises of an entitlement state that none of these countries can truly afford.

Updating one of the major stories from last year is the current outlook for oil production. The global price of crude oil is remains depressed and unable to rise as OPEC continues to increase supply in order to maintain their market share. Global demand is still soft and has not grown to keep up with large increases in production especially here at home. Ten years ago, Chinese oil demand was growing at a 10% year over year rate. Now that rate of increase is just around 2%. With Saudi Arabia unwilling to cut production, and the belief that Iranian sanctions will soon be lifted allowing them to sell their crude in the global markets, the world remains awash in oil. With energy and oil stocks making up a major component of the S&P 500 index, this sector's earnings shortfall will account for almost half of this indices' quarterly earnings decline. We are definitely seeing some signs of speculative froth in our markets as well. As I have noted in past letters, I feel that our markets are at the very least fairly valued and some sectors are from my perspective overvalued. A good example would be the fast food industry which has a number of glaring discrepancies in valuations. The largest player in the group is obviously

McDonalds (MCD). Now I don't own this name or even recommend it for purchase because of their persistent declining sales, but what I find interesting is how the market values the company. An easy way to determine this is to figure out the value the market places on each restaurant the chain has. McDonalds has a market value of just over $94 billion and they currently have 36,258 locations. Simple math gives us an average market value of just under $2.6 million per store. Compare that to a newly listed burger competitor, Shake Shack (SHAK) went public this February and rose to a market valuation of over $3.6 billion. Even with a compelling growth story, with only 63 stores, the market valued every store at just over $56 million apiece. Although the shares have fallen by over 47% in the last two months you still have to flip a lot of burgers to justify even the current valuation.

Adding a little humor to further the point we can look at the recently listed Grilled Cheese Truck Company (GRLD) which enticed our former NATO commander Gen. Wesley Clark with $570,000 a year to be on its board of directors. It went public earlier this year at $6 per share giving the company an initial market value of $120 million. That's great because they have a total of 12 trucks with each one being valued at $9.9 million apiece. Now I'm not bragging but I can make a pretty good grilled cheese sandwich and I bet I can buy a pretty nice food truck for around $50 grand. Maybe everyone else thought the same thing as the stock is down 88% over the last five months….. The bottom line is that as investors, we have to be forever vigilant in identifying speculative excesses that can permeate any company, sector or for that matter any country. Therefore our ability in determining what a company's true value is, will always be a constant and ongoing process.

It's easy to let all of the recent financial turmoil and geo-political brinksmanship put our view of the future in a negative light but we need to realize that our outlook must be much more nuanced. Yes, the risks are real and therefore their impact on the markets are as well, but remember so are the opportunities. For every sector or company that is overvalued there is one that is equally undervalued and trading at a discount to its true value. This constant reexamination of our holdings and the justification of our investment premise is the foundation of active portfolio management. We find ourselves with a market that is willing to put a lofty premium on growth stocks or as we say "growth at any price". This same market in my opinion in now discounting value stocks which in many cases offer very safe dividends that yield much more than US bonds with equally strong balance sheets. Companies with a strong domestic revenue focus will be much less impacted by the dramatic swings in the global currency markets in much the same way that large foreign based multinationals will actually benefit from the dollar's strength. As for now, I am willing to forgo paying a premium for strong top line revenue growth and all of the valuation risks that it entails as I would rather seek the safe harbor that only larger, dividend paying value stocks can provide. Healthy dividends and long term capital gains will remain our favorite way to build wealth and provide our clients with reliable income.