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Update on Current Market Conditions

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Well what a difference three months can make. Never before, at least in the modern era, have I ever seen a central bank reverse their stated policy course so quickly and in doing create so much confusion in such a short period of time. For most of last year, investors had to listen to countless speeches from numerous Federal Reserve officials that the era of artificially low rates was coming to a close. They said that they were preparing the markets for a series of multi-year interest rate hikes that would eventually push short term rates from zero to the 2.0% to 2.5% range. Even though many respected economists and investors thought that raising rates in such a weak economic environment would have very negative consequences, the Fed remained adamant in pursuing that course of action. Despite those concerns, last December the Federal Reserve decided to initiate the first interest rate hike in nine years. What could go wrong?

Now, I'm not so naïve as to believe that the world's most powerful central bank would ever admit to making a mistake but their actions certainly can. In their December news conference following their initial increase, Chairwoman Yellen revealed that the Fed expected to raise rates at least four times throughout 2016 with additional rate hikes to follow in 2017. In her March press conference investors heard a completely different tune. No expected rate hike in March or April. No four rate hikes for the year and an acknowledgement that the global economy was in fact as fragile as investors had thought. What had changed?

After that first rate increase everything that we had predicted came true, the US dollar soared in value, commodity prices crashed, global stock markets fell, and foreign currencies plunged creating large losses in the world's debt markets. The idea that our central bank would start raising rates into a slowing economic environment while every other central bank is either lowering rates or trying to devalue their currencies never made any sense. As I have written in detail previously, the Federal Reserve had numerous opportunities to raise rates and create a more normalized yield curve. Three years ago, when US corporations were posting some of the biggest profits on record and the global economy was gaining strength, would have been an ideal time to begin the process. Yet the Fed chose not to act, and now with the wisdom that only hindsight can provide they now realize that their window of opportunity had been missed due to their own timidity.

Believe it or not, there was a time not that many years ago when the Federal Reserve didn't tell anyone what they were doing. It was the market's responsibility to figure it out for themselves and then ascertain what the repercussions would be. Historically, the Fed wouldn't even announce if they raised or lowered interest rates. Bond traders following the intraday activity of the Federal Reserve Bank of New York's trading desk would have to figure out what had transpired and let the rest of us know. The Fed chairman never gave press conferences, and you certainly never saw what you see today a never ending stream of Fed members giving their own commentary and monetary perspective on what seems like a weekly basis.

This current feel good fixation on transparency and openess is creating nothing more than institutional confusion which can easily morph into the market confusion that we have now. While we all enjoy the benefits that consensus brings that doesn't mean that we have to watch the process that creates it. Like the old saying goes, "if you like sausage you don't need to see how it's made". In their quest to be more open as an institution they have actually damaged their own prestige in the process. They have forgotten that the markets, whether rightly or wrongly will always associate clarity with resolve, and resolve with strength. The Federal Reserve has now been revealed to be just like every other governmental organization. Rife with widely differing viewpoints and a desperate desire to show unity that ultimately projects the unnerving impression that they really don't know what they are doing. What I find most disconcerting is that it seems that the most pervasive force that inhabits the Fed is a sense of fear and the paralysis that it inevitably creates.

So, how does this sudden change in monetary policy impact us, and how do these events determine how I will manage our portfolios for the remainder of the year? The good news is that we won't have to be as defensively positioned as we were heading into the first quarter. The first and most important point is that the once very real risk of a US recession has now been dramatically reduced by the Fed's policy reversal. Problems do remain and because the US and global economies are growing so slowly any surprise setback would have immediate negative consequences. While corporate earnings for the next few quarters will continue to be negatively impacted by the currency and commodity volatility that we have just witnessed, stocks are already beginning to reflect a more stable and positive outlook 12 months into the future. Other than the possibility of one more additional rate hike coming probably around December, I expect that the Fed will stand pat and on the sidelines in the coming months. There are two reasons for that belief. The first is that the leading economic indicators are still forecasting significant economic weakness in the months immediately ahead. The estimates for 1st quarter GDP have also been revised much lower in just the last few months from originally 2.3% to now an expected growth rate of only 0.7%. The second is that historically it is very rare for the Federal Reserve to make any changes to its monetary policy stance during the period of a presidential campaign as it would not want to be perceived as being viewed as partisan.

Ultimately, I believe that risks to the global economy have been dramatically reduced at least for the time being. Growth will continue to be weak as many nations will still teeter on the fine line between expansion versus recession. While growth would be wonderful, what the markets and investors want more than anything else is stabilization. The sooner global currencies and commodities can reflect their true underlying economic fundamentals the greater the visibility will be for all investors. This brings us to my third point China, which is still the world's fastest growing economy. While it is well known that China is slowing economically, the rate of that decline is probably significantly more than what her government is willing to admit. The key here is that a more stable global environment will allow the Chinese government the time they need to better manage their slowdown as they gradually evolve from an export dependent economy to a consumer driven one. But until then, they will remain the world's biggest importer of natural resources and exporter of finished goods. What continues to be a concern, is that globally debt continues to increase at a much faster rate than actual economic growth. For investors, significant risks still remain and they must be quantified as we review each portfolio's boundaries for risk tolerance.

Since the beginning of the global financial crisis in 2008, the world's central banks continue to intervene on a massive scale. Whether it is by devaluing their currencies, or printing money to artificially suppress interest rates, they have shown a willingness to use extreme measures to pursue previously untested policies. It's remarkable that these government economists won't let reality get in the way of theory as their efforts have done little to increase growth while adding trillions in national debt. Long term interest rates are by their very nature, reflective of what investors are expecting in terms of economic growth and inflation many years into the future. Over the past 100 years, US Treasury 10 year yields have averaged in a range of 4.0% to 4.5%. Currently yields in the US are right at 1.75%, in Germany 0.13% and in Japan a negative 0.11%.

That's right negative real returns, where investors are willing to give a government their money with the promise that they will get less back in return 10 years later and actually be happy about it. Imagine the sales job a bond broker has trying to sell that investment. If you thought pension funds were already having a hard time meeting their requirements with low yields now the future looks even worse. Typically a domestic pension fund needs to generate a yearly return of around 7% to 8% to remain fully funded. With interest rates so low on "safe" government bonds they find themselves in the same predicament that many income seeking investors do. They are forced to take on substantially greater risk in order to generate the income that their pensioners require to live on. This is just another example of the real risks that the Federal Reserve's artificially low interest rate policy is having on all investors, savers are punished as debtors are rewarded. As I had discussed at length in my last letter, the unintended consequences that these central banks are having are in many ways creating the mispricing of all asset classes and by doing so actually suppressing the very growth they are trying to create.

There are times when your profession can't seem to make any sense of a problem but you realize that if you change your perspective you can often see what others might be overlooking. In this case one academic field of study can be used to explain the underlying dynamics of another. If we do that with the global economy and its seeming inability to grow more dynamically what would we find? Is there a force at work that even all the central banks and governments are powerless to stop? Yes there is, and it's called demographics. These long term population trends could explain why after more than $11 trillion of fiscal and monetary stimulus that governments and central bankers have spent, the global economy remains mired in a slow or zero growth environment. Not only are the populations of every industrialized nation growing older more quickly, we now have several advanced countries experiencing actual negative population growth.

The list may surprise you as it includes Russia, Japan, Germany, the Czech Republic, Italy, Greece, Poland and the Ukraine. With populations aging, their citizens are no longer buying houses, cars and other consumer goods that would stimulate a country's economic growth. Instead they are living off savings or becoming more dependent upon tax payer funded government programs. As the younger generations that follow them are smaller in size, their economic opportunities become less and their tax burden becomes greater. Again, this is not the recipe for producing strong and sustainable growth. The most extreme example is China and that is because this outcome was completely self-inflicted not a natural occurrence. The Communist government imposed a strict "one child" policy per family starting in 1979 and lasting 36 years till 2015. The repercussions of that decision will prove to be very consequential for China's economy and societal makeup. Their population is ageing so rapidly that the government hasn't even begun to put in place the social safety nets that other advanced countries have already established. As I had read several years ago, China will be the first major economy that will grow old before it becomes rich. The important take away regarding the dynamics that demographic change forces upon governments is I believe one of the seldom discussed but underlying factors that is preventing a return to the vibrant economic growth trends of the past.

I want to briefly touch on one sector that was front and center in the headlines for most of the first quarter. The collapse in oil prices and the corresponding impact on energy company's earnings will be significant and last for several quarters. This sector is a major component of the S&P 500 index and therefore this downturn in crude oil and other commodities will negatively impact the market's year over year performance as well as the indices' widely followed price to earnings ratio. As of today, the world's crude oil oversupply is only 1.45 million barrels over current daily demand which averages just over 93 million barrels. Any reduction in domestic production coupled with even a marginal increase in demand will quickly bring the market back into equilibrium and improve price stability. During the quarter for risk appropriate accounts we were able to add several energy stocks, closed-end funds, and ETFs that were all trading near multi year lows, with all of them providing very compelling dividend yields.

The collapse in oil prices also triggered a simultaneous selloff in the banking sector as fears of imminent oil company bankruptcies and debt defaults caused widespread selling. The selling was so intense that several of my favorite names were actually trading well below their asset liquidation value or what we call "book value". As with the energy sector, a couple of large very well capitalized financials and a two regional bank stocks met these requirements and were purchased at what I feel were fear induced valuations. Another sector that gave us a very opportunistic entry point was the much maligned pharmaceutical industry. This group has been an easy target for candidates from both parties this political season and therefore has been under sustained selling pressure for some time. But with the selloff in our markets and especially the European markets, three of my longtime favorite names all paying substantial dividends, were purchased or added to last month. One note of caution though, not all sectors share the same compelling value during a market selloff. During the recent downturn, many investors flocked to "defensive stocks" such as the large consumer staples and non-discretionary names as a safe haven. That may prove to be an error even as the market recovers, since most of these companies are already very richly valued and offer little to no real future organic growth. It is also important to differentiate how a company actually produces their stated growth. Many names within this group appear to show year over year earnings growth when in reality that growth is nothing more than financial engineering driven by massive share buybacks.

Overall, what had begun as a very tumultuous first quarter of the year, ended up becoming a quite constructive one as we were able to put a significant portion of our substantial cash reserves back to work in the market. Our caution and prudence have served us well and has allowed us to also be rather opportunistic and acquire a number of long term investments at what I believe to be very compelling prices. Ultimately the recovery we saw in the stock market had nothing to do with any real economic improvement. In fact, a number of economic data points for the quarter got much worse. Rather, the market's strength in March was based solely on the surprising reversal of the Federal Reserve's stated policy and the belief that further economic damage resulting from that policy would be avoided. Sometimes the sense that a situation won't get any worse carries the same weight as actually getting good news. For the rest of the year I'm relatively sanguine that the market and economy will get back on a much more solid footing with each gaining strength into the year end. As always, I will remain vigilant as there remains a number of risks that our portfolios must be prepared to navigate. When opportunities do present themselves, I will continue to act decisively so long as the potential reward substantially outweighs the downside risks. Unfortunately, this has become a market of extremes, one vacillating between the complacency we saw last summer and the extreme negativity this past winter. We will continue to use this volatility to our advantage as these swings in sentiment provide us with excellent opportunities to purchase great companies on sale and sell those that I feel have become overvalued.