VERITY
Asset Management

Commentary

Tactical All Asset Strategy March 31, 2015

The first quarter of 2015 saw a distinct increase in intraday stock market volatility. But when the dust settled at the end, it appeared that very little had transpired. The slight gain in the S&P 500 amounted to little more than a rounding error compared to the 2014 closing value.

From here, one could make a case for stocks moving in either direction over the short term, but we believe that notable developments give 2015 the potential to be an especially significant year, one which could propel important economic and market trends for a number of years to come.

Opposing Central Bank Monetary Policies

As we have alluded to many times, from the perspective of the financial markets, it is becoming more and more a "central bank world". And the predominant central bank activity over the past six years has been quantitative easing (QE). Quantitative easing has ended in the U.S., for now, and the Federal Reserve has in fact been preparing to tighten monetary policy by raising interest rates. However, the implementation of QE is in full force in Japan, and just beginning in Europe.

As a result, the monetary stances of the central banks of the world's major developed economies will be diametrically opposed. As these policy developments have come into focus over the past year, we have witnessed extreme currency moves, with the dollar strengthening dramatically. In today's thoroughly interconnected world, major currency moves can present great challenges for entire nations, not to mention large multinational companies and exporters in general.

Developing nations are caught in the middle. With more historically volatile currencies, their import/export challenges are always of concern. Making matters worse, many developing nations have incurred considerable debt to "build out" their economies, and much of their debt is denominated in dollars. As the truly historic dollar rally of the past year has unfolded, the consequence for some emerging nations is that they may ultimately have to repay these loans in appreciated dollars, increasing their burdens significantly.

At the end of the day, it is debatable whether QE in the U.S. has had any pronounced effect on the real economy, other than to backstop what has evolved into a very languid and historically unimpressive six year expansion. However, there is a distinct correlation between the Federal Reserve's various QE programs and stock market rallies. So, forgetting currency concerns, it is legitimate to wonder whether QE in Europe and Japan might in similar manner supply continued strength to their stock markets. The simple answer from many analysts is "yes". However, QE does not operate in a vacuum, so it may be important to note the extreme differences in underlying conditions between the U.S. and either Europe or Japan.

Both economically and structurally, the U.S. is now and has been for some time considerably stronger than either, regardless of potential central bank stimulation. On a short list of examples, Europe has faced broadly persistent economic weakness; and it is again unclear that Greece will honor its loan repayment obligations, leaving the prospect of an actual sovereign default impossible to ignore. Daunting structural problems remain as headwinds for the entire region. As for Japan, it should be noted that their hyperactive monetary policy is an effort to solve not just the struggle of the past six years, but rather a disinflationary, highly indebted, no-growth malaise which has encumbered the Japanese economy for over two decades.

This is all in stark contrast to conditions in the U.S. both at the beginning of and throughout the Fed's QE programs. Given the differences, it cannot be taken for granted that the sustained effect of QE on U.S. markets will be duplicated in European and Japanese markets.

Low Oil Prices

A second very significant factor coming more clearly into focus this year, with potential implications for the next several years, is the fallout from the incredible collapse in crude oil prices. Plenty of analysts believe prices will rebound strongly, ultimately back into the higher end of the range of the past two years. However, reasonable interpretation of supply and demand projections could lead one to conclude otherwise. To date, plummeting energy prices have produced distinct short term winners and losers, and a widespread realization that this is indicative of a more prolonged new pricing regime could establish those winners and losers for years going forward.

Nations which rely heavily on production of energy will unquestionably be hurt by the reduced prices, among them Canada, our largest trading partner, along with various producing countries in South America. For producing nations also involved in geopolitical conflict, such as Russia and nations in the Middle East, the potential impact could be intensified. Alternatively, a significant net consumer of energy, such as China, gains a clear benefit from lower prices.

In the U.S., the effect may be mixed. After years of significant dependence on foreign energy, we have over recent years emerged as a major global producer, bringing new jobs and corporate profits which are now threatened by falling prices. On the other hand, in an economy so heavily driven by domestic consumption, the benefit of lower energy prices to consumers should be a real boon. Regionally, and on a company by company basis, there will be obvious winners and losers, but ultimately, the numbers will need to be closely monitored to determine the net effect to the overall economy. Will job losses in energy producing states be offset by gains in profits for consumer discretionary businesses, or is a potentially long term downturn in the energy patch a bigger hit to the U.S. than most are considering? In the short term, despite all those energy savings in consumers' pockets, we've seen only meager growth in consumer spending, and the most recent monthly employment statistics were less than encouraging. The rest of this year should provide a better sense for how some of these trends are likely to play out.

Fed Rate Increase

The Federal Reserve has held interest rates at an artificially low level since the financial crisis more than six years ago. So perhaps the most important factor for U.S. markets at this point is whether the Fed will tighten monetary policy for the first time in 9 years by raising rates in an effort to begin the "normalization" process. Based on a year-long stream of nuanced statements from the Fed, edging ever closer to action, many commentators are assuming this will occur. However, it should be noted that we've had this conversation for a very long time. A Wall Street Journal story in November 2009 reported a polling of economists that revealed the expectation of an interest rate hike in September 2010. To have had almost unabated speculation ever since, with no Fed action despite a gradually improving economy, seems little short of astounding.

Although many financial talking heads conclude that a mere quarter percent interest rate increase would have no impact, merely confirming the health of the economy, we remain a bit skeptical. It's not clear that markets have priced in any rate increase just yet--why would they given the previous nine years of accommodative Fed policy. Of greater concern, even the smallest increase could cause markets to anticipate more hikes to come and react negatively in response. An added complication is the potential for a rate hike to further spike the dollar, a concern discussed by Fed governors in their last meeting.

Whether a rate hike, whenever it comes, will properly reflect a healthy, expanding domestic economy, or alternatively create enough economic drag to end this expansion, is far from certain. After all, many segments of the economy have become very comfortable with the notion that borrowing is essentially free. And nine year trends do not end suddenly without unforeseen consequences.

Portfolio Impact

Given the complexity of this picture and the scope of the potential outcomes, it would be dangerous to draw definitive conclusions, but we have incorporated these insights into our analysis of the investment landscape. Considering their exposure to the currency issues, we elected to reduce exposure to multinational corporations, instead placing an increased emphasis on U.S. companies doing business primarily within the U.S. The result was an incremental shift from an index position in the Dow Jones Industrials into a position indexed to the small cap Russell 2000, and we maintained significant positions in Home Builders and Biotechnology. All were up very strongly during 1st quarter.

Though we are reluctant to rely on the sustained effectiveness of QE in Europe and Japan, we profitably added a couple of small, targeted positions in regions where further central bank easing was anticipated. European small caps provided potential opportunity to profit from local economic progress without the international currency effects. And with Chinese markets showing the potential to emerge from a multi-year trading range, anticipated government stimulus provided the potential for a significant advance in Chinese equities.

To gain increased exposure to the potential consumer benefit from declining energy costs, we sold Consumer Staples early in the quarter and built a significant position in Consumer Discretionary, while maintaining a previously established position in Retail. This adjustment has proven very effective in the short term, with both positions performing favorably, but we will be closely monitoring consumer spending moving forward.

Given the uncertainty regarding the timing and ultimate effect of any Fed rate hike, we continue to maintain diverse exposure to other sectors and asset classes. As expected, while results in these remaining portfolio positions were mixed during first quarter, they helped buffer overall portfolio volatility.

Conclusion

Without a functioning crystal ball, we cannot speak with certainty, but there is an excellent chance that developments unfolding in 2015 may represent a real departure from the six year period just preceding. We're pleased with the progress of the portfolio as markets have begun to focus on these developments over the past six to nine months and will remain attentive to the manner in which they impact the investment process moving forward.