New Albany
Investment Management

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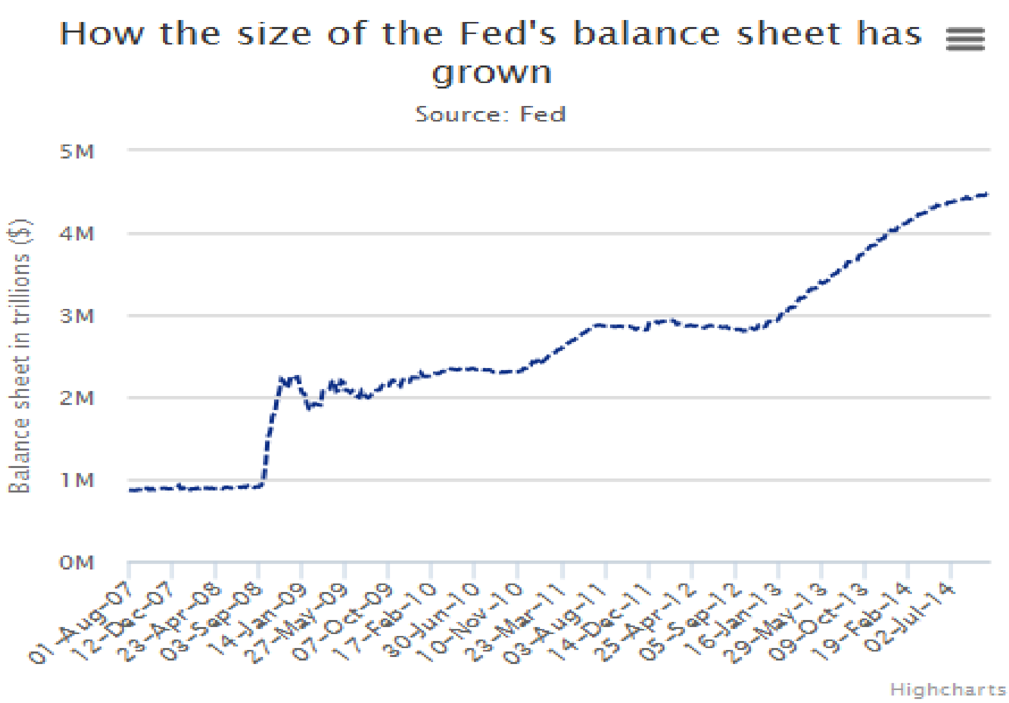
Market Insight: A New Market Environment

Diverging Strategies of Central Banks Catalyst for Market Volatility
It's not just the winter weather that has been hard to navigate and predict, but the financial markets have been slip-sliding around since the start of the year. Market volatility, as measured by the VIX, has risen significantly with daily swings in the US stock market of over 1% not uncommon. It is increasingly apparent that Central Banks have become agents of this volatility, perhaps not deliberately but out of necessity and have in essence caused a global currency war. Indeed, the investment landscape has become much more complex and the financial markets are struggling to find solid footing.

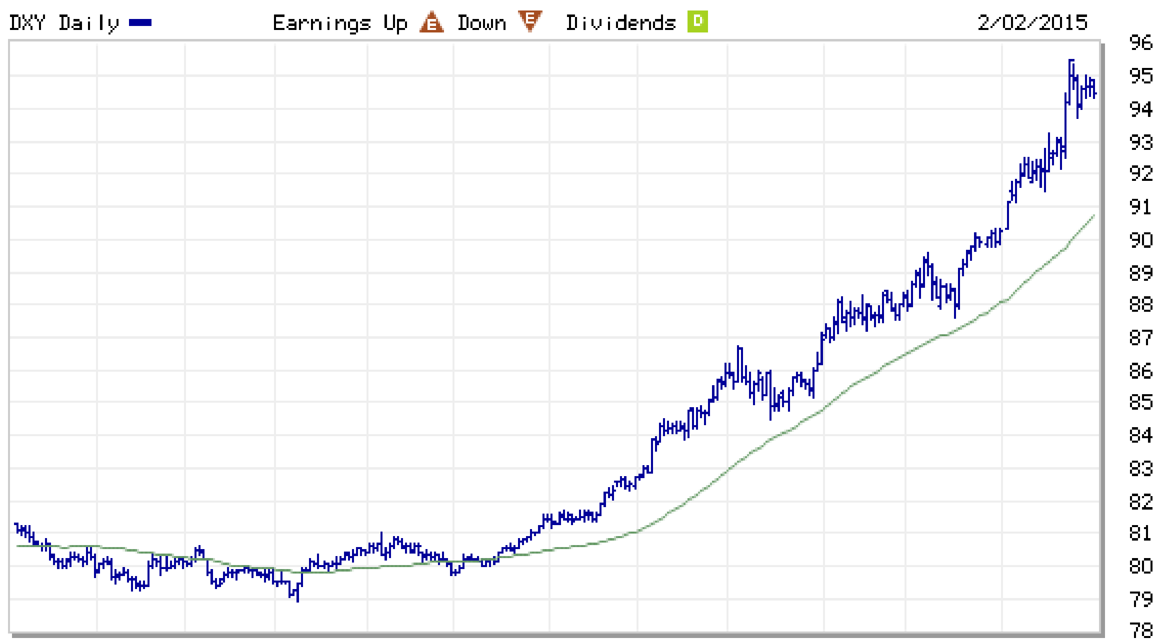
Why the Change? To understand the why, we must look back at how we got here. From 2009 to mid-2014, Central Banks around the globe had been of like mind, with the primary goal of stabilizing the credit markets while huge amounts private debt was written down. There was in essence one global monetary policy with the directive to keep interest rates low until the economies could recover. On top of this global mandate, the US Federal Reserve initiated its own program called Quantitative Easing (QE), injecting over $3.6 trillion dollars into the financial markets. This massive program created cheap US dollars which fueled growth not only in the US growth but many other economies as well.



Last October the Fed announced an end to QE, weaning the global markets off one of the most radical monetary experiments in history. Now with US growth on reasonably solid footing, the Fed is committed to begin to raise rates sometime this year, leaving the rest of the global economies to fend for themselves.

Stronger Dollar Causes Dilemma for Central banks: The net effect of the Fed's policy change has been a stronger US dollar which has forced other Central Banks into the dilemma of either supporting their economy or currency. The shift in policy is already being felt around the globe. For Europe, whose economy never really recovered, this has put further pressure on the European Central bank to take radical action to stimulate the economy. In fact, it just recently announced its own version of QE. At the same time, many emerging economies are feeling the pinch of a rising dollar because most of their debt is financed in US dollars. So as the dollar rises, the cost of debt rises, in effect creating tighter monetary policy in the face of weaker growth.

Below is a 1yr chart of the US dollar index. About mid-year the dollar began to rise in anticipation of the end to Quantitative Easing and is now up +18% from its lows.

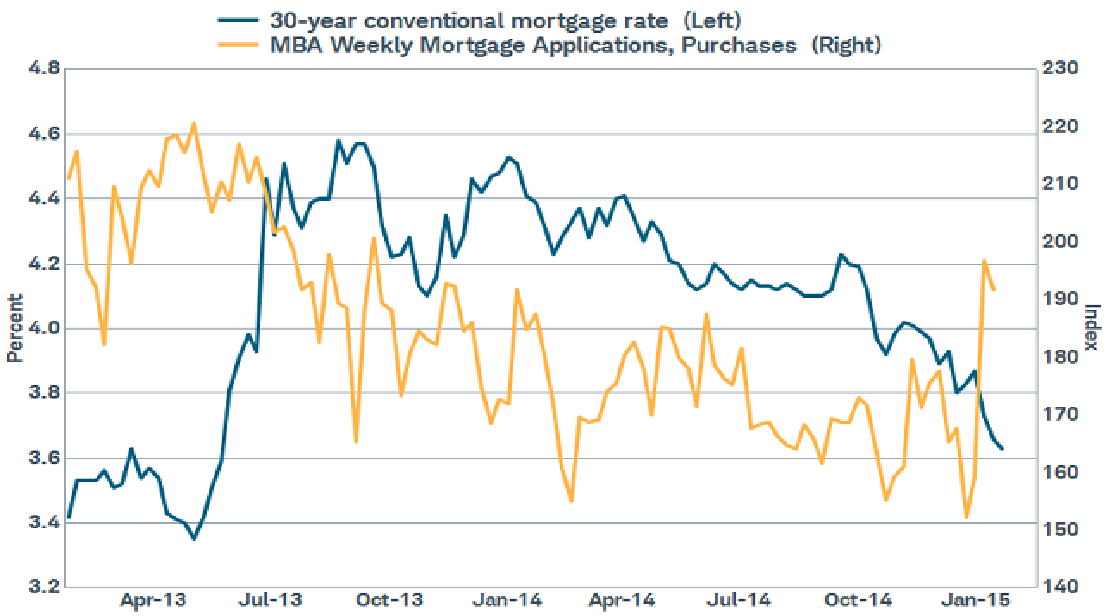


Stronger Dollar Causes Challenge for US Companies: Any US business that has operations located overseas has foreign exchange exposure. When they deal with foreign suppliers and buyers in the local currency the resulting profits also occur in the foreign currency and must be converted back to dollars. When the conversion occurs, converting the weaker currency to the stronger currency, results in lower reported earnings. Of course many companies try to hedge future profits, but given the recent radical volatility, this has become more difficult. Thus even though the US economy is a source of strength, any company with business overseas is vulnerable on two fronts: weakening growth and currency fluctuation.

Not All Gloom: Despite the negative factors elsewhere, the US economy is on solid footing as the stronger dollar and falling oil prices provide a significant tailwind for the consumer. Employment continues to strengthen, with the jobless rate now at 5.6%, down from 6.7% a year ago. Also, the Small Business Optimism Survey rose to its highest level since October 2006, showing both earnings trends and employment plans increasing.

Another significant tailwind for the consumer is the recent dramatic drop in US long term interest rates which have been pulled lower due to declining global rates. Falling mortgage rates continue to be a support to the housing market.

Below is a chart showing the drop in 30yr mortgage rates (Blue) and rise in Mortgage Applications (Tan).



Market Outlook & Investment Strategy: Many Moving Parts Leave the Market Vulnerable
With currencies, commodities, economies, and global monetary policies no longer in synch, the markets are likely to continue to experience higher volatility and larger price swings. Gains in the stock market will be more a function of actual earnings growth rather than P/E expansion and annual returns are likely to be lower than in years past.

Investment strategy has been adjusted over the last three months to a slightly more defensive posture through the following changes: broader diversification across asset classes; increasing exposure to health care and US Bonds; reducing exposure to High Yield bonds; increasing exposure to dollar denominated foreign bonds. The result has been solid performance in the face of a down market.

As always, please contact me with any questions or concerns.

Kind Regards,

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