

Market Insight: Wild ride to first quarter. What lies ahead?

The first quarter ends almost back where it started, but not without some major shifts. Despite many market indices reaching their best levels this year, it has been a wild ride in the global markets. Currencies, commodities, stocks, and bonds have seen enormous volatility as investors have tried to navigate the implications of changing Central Bank policies against the reality of slowing global growth and declining earnings. It is indeed a tale of two forces where weak fundamentals are challenging the ineffectiveness of monetary stimulus. Interest rates, currency valuation, and the potential for earnings growth are key elements to sustaining asset prices. A change in any of these factors quickly changes the direction of the market and the Central Banks have been right in the middle of it. Though the market might ‘feel good’ right now, the underpinnings supporting the market are tenuous. Below is a briefing of the key factors that explain the current investment climate:

- **Negative Interest Rates:** In January, the Bank of Japan joined the list of Central Banks (including the European Central Bank) that employ negative interest rates as a tool to incentivize banks to lend and businesses to spend. Now, **nearly 25% of the world’s GDP is under the umbrella of negative rates and \$7 trillion of government bonds yield below zero.** So far, in every country that has employed negative interest rates, economic growth has either remained subdued or weakened further. Negative interest rates can only be read as sign of desperation on the part of Central banks or at best very weak growth ahead.
- **First Quarter Earnings revised down again, to -8.7%; Valuations elevated.** Downward revisions are normal and happen every single quarter, but this time the revisions are the largest since 2009. Downward revisions are seen across all 10 main industry sectors, but energy, unsurprisingly, accounts for a large portion—a 50% reduction in earnings growth. And even excluding the energy sector, earnings are expected to decline in the first quarter. Much of this decline is due to the 20% appreciation of the US dollar. At the same time the quality of earnings has deteriorated as revenue growth has flat lined. Falling earnings have kept price-to-earnings ratios elevated. On a forward 12-month basis, the P/E ratio for the S&P 500 is at 16.5, above the 10-year average of 14.4, according to FactSet.
- **The Dollar, Interest Rates & Fed Policy:** The direction of US Dollar is a significant factor for future earnings growth as almost 45% of US earnings are generated abroad. As the dollar appreciates, earnings decline, and vice versa. The value of the Dollar is directly connected to the level of interest rates. Until earlier this month, the Fed was on track to raise rates four times this year. This action combined with other Central Banks lowering rates (into negative territory) had pressured the dollar higher and the stock market lower. So a **key to future earnings is the direction of the US Dollar and Fed Policy.**

- **Fed Policy has become erratic, unpredictable, and destabilizing to the markets.** After nearly 18mos of telegraphing to the markets that rates will be rising, the Fed finally acted in December. Chairman Yellen reiterated her policy stance in mid-February. And since that time, there has been a rash of opinions expressed by various Fed members to continue to raise rates. But by mid-March, the Fed announced they will be slowing the pace of tightening. And just this week, Chairman Yellen gave the most dovish talk yet, saying “global and financial uncertainties posed risks to the domestic economy” and indicated the Fed will not likely raise rates at all this year. This about face jolted the market higher. Never in my 35 years have I seen the Central Bank change course so abruptly without some major shock to the economy. What does the Fed know, that we don’t? **It is difficult to have confidence in the future when the biggest influence to the free markets is so uncertain.**
- **First Quarter GDP forecast revised down to 0.6% from 2.3%** according to the Atlanta Fed who has a relatively good record of forecasting GDP. The decline in GDP is due to a drop in personal income and spending. However, at the same time, the employment numbers are looking strong with the rate of unemployed falling to 4.9%. How can spending and income be down if employment is up? One explanation is that companies are continuing to boost earnings thru staffing positions with lower pay.
- **Housing and Auto sales continue to be the bright spot in the US economy.** Both of these areas of the economy are well supported by extremely cheap financing.
- **Global Growth revised lower:** According to the Conference Board’s Global Economic Outlook for 2016, GDP is now projected at 2.5 percent, which is 0.3 percentage point lower than their November outlook. China’s growth is now pegged at 6.5 percent this year and 6.2 percent in 2017. The largest downward adjustments are seen in emerging markets, of which Brazil and Russia are the most pronounced. Emerging markets are dependent upon exports and therefore are particularly vulnerable to sharp exchange-rate movements and the effects of high domestic debt.

Investment Strategy: With a fragile economic environment the risk of disappointment is elevated. At the same time, we are in an election year, and therefore it is unlikely any further significant changes will come from monetary policy. Washington (fiscal policy) is dead in the water. Thus the markets are likely to remain very volatile and held captive in a wide trading range. And given we are near the upper end of the trading range, it is prudent to reorder the investment objectives of capital preservation first, then income and growth. Risk has been reduced to the lower end of the range through rotating out of growth and into value and income generating assets.

As always, please contact me with any questions or concerns. I hope you enjoy the beauty of Spring!

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