44 North financial partners

Forging Your Path

GLOBAL UPDATE

April 2016 - Quantitative Easing

"Stocks higher because the Fed is less confident it can normalize rates and sees weaker global growth environment".

This is an actual headline from a news agency on March 29th, 2016. Please let this sink in for a second and I'll attempt to explain why it makes sense below.

You've undoubtedly heard the term Quantitative Easing (Q.E.) if you listen to the financial media or read financial papers. We've decided to tackle this concept in our April newsletter as it is **extremely important for you to understand** and has direct ramifications on your investments, savings account rates, real estate values and currency value/inflation. This policy, executed by non-elected officials, impacts you every day.

Although you might not understand Q.E., you've likely heard that the U.S. Central Bank (a.k.a. the "Fed") is "printing money". What they (the Central Bank) are actually doing is purchasing bonds (other countries central banks, such as Japan, actually also purchase stocks) to increase the value of the asset in turn, lowering the yield. These purchases also increase the money supply which theoretically should mean that banks have more money to lend out to companies and individuals in the real economy. A side effect of increasing the money supply, or printing money, is that it should also lower the value of your currency versus your trading partners, thus creating inflation. More on that later.

If you look at the chart to the right, produced by the St. Louis Federal Reserve Bank, it shows that the S&P 500 has very closely tracked the trajectory of the increase in the money supply since 2009. In the past, when the Fed has paused the program, or promised not to expand it further, as they did in 2010 and 2012, you can see that the market volatility increased and there was a sell-off that resulted. When, on the other hand, the Fed discussed implementing the program again (Q.E. 2, Q.E. 3) the market regained its composure and the upward trajectory resumed.

In 2015, the Fed ended its Q.E. program (interestingly, stocks peaked in May of 2015), and in December of 2015, they raised interest rates from zero to 0.25% for the first time since initiating emergency monetary policy in 2009. While the stock market threw a tantrum in August of 2015, it did regain its composure when promises of more easing came from the European Central Bank (ECB) as well as the Bank of Japan at a level that more than offset the U.S. Fed's purchases. Between January 1 and February 11th of this year, however, the S&P 500 had sold off by 10.5% (source, Bloomberg). This was enough to send the Central Banks into a tizzy and led to the following:

- Jan 28th: The Bank of Japan announces that it lowered its interest rate from zero to negative 0.25% in order to stimulate lending.
- Feb 15th: The ECB announced changes to its Q.E. program that allowed it to expand bond purchases (money printing).
- Feb 29th: The Bank of China reduced bank reserve requirements (the amount banks need to maintain in reserves to protect against loan losses) by 0.5% to increase the amount of available capital to lend.
- March 10th: The ECB reduced its interest rate further, to negative 0.4%

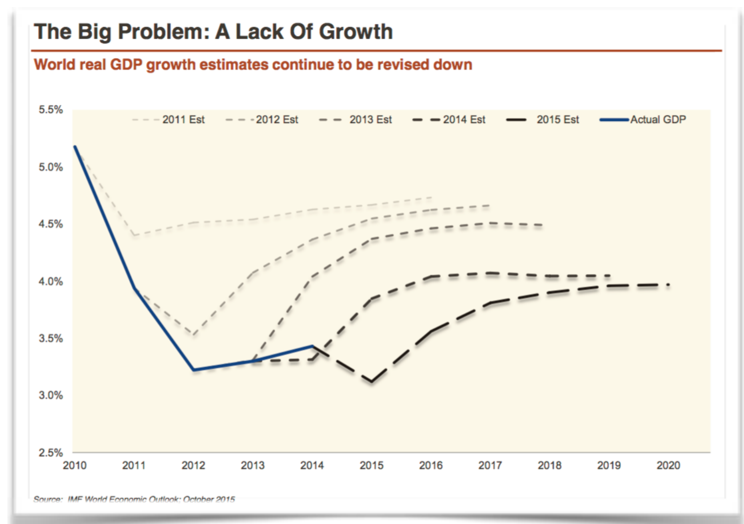
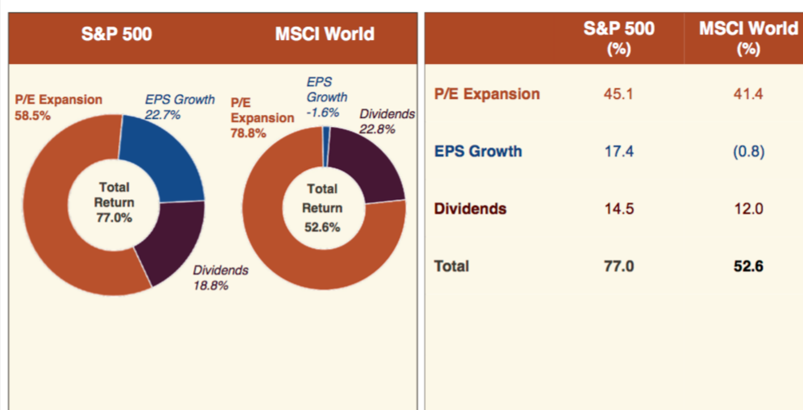


Chart Source: IMF World Economic Outlook - Oct 2015

As you can see, the central banks of the major economies of the world are continuing to try their absolute hardest to keep asset prices up. The markets responded to these actions by rallying significantly off the February 11th bottom to finish the quarter close to even, depending on which equity index you look at.

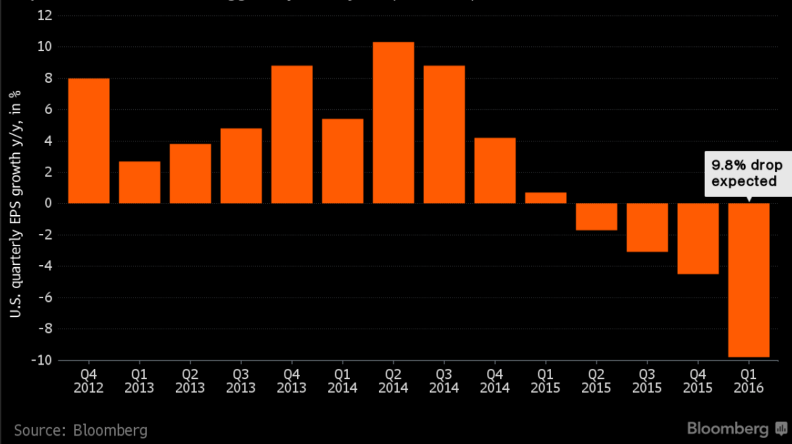
By keeping interest rates down, the plan is to force investors to move money out of cash, where you get virtually no return (negative after inflation), and into more risky investments (stocks, corporate bonds, real estate, businesses, etc.) in order to artificially inflate their value beyond what the real underlying economy supports. They hope that with asset prices increasing, people will feel more comfortable, spurring them to spend more freely, thus supporting the economy. As evidenced by the chart on the prior page, the growth simply hasn't occurred. The chart shows revised estimates beginning in 2010, and showing that expectations were for over 5% global GDP growth in 2010. As expectations continued to be ratcheted down and pushed out, our central planners have been waiting for the accelerating growth ever since.It simply hasn't occurred as central bankers had expected.



	S&P 500 (%)	MSCI World (%)
P/E Expansion	45.1	41.4
EPS Growth	17.4	(0.8)
Dividends	14.5	12.0
Total	77.0	52.6

Source: Standard & Poors, MSCI, Epoch Investment Partners, Dec 2015

What has occurred however, is that their policies have inflated assets. In fact, since 2012 almost 60% of the returns in the S&P 500, and almost 80% of the gains in the MSCI World stock indices have come simply from increased valuation of the market (P/E ratio), not through either earnings growth or dividends (see chart above). This value expansion has occurred with the expectation that growth and earnings would accelerate into the future. With market returns having been propped up by expectations for accelerating and increasing future earnings, it may leave them particularly vulnerable now that **earnings are decelerating, and have actually turned negative year over year** (chart to right).



> **“Switzerland in deflation for 17th consecutive month”**
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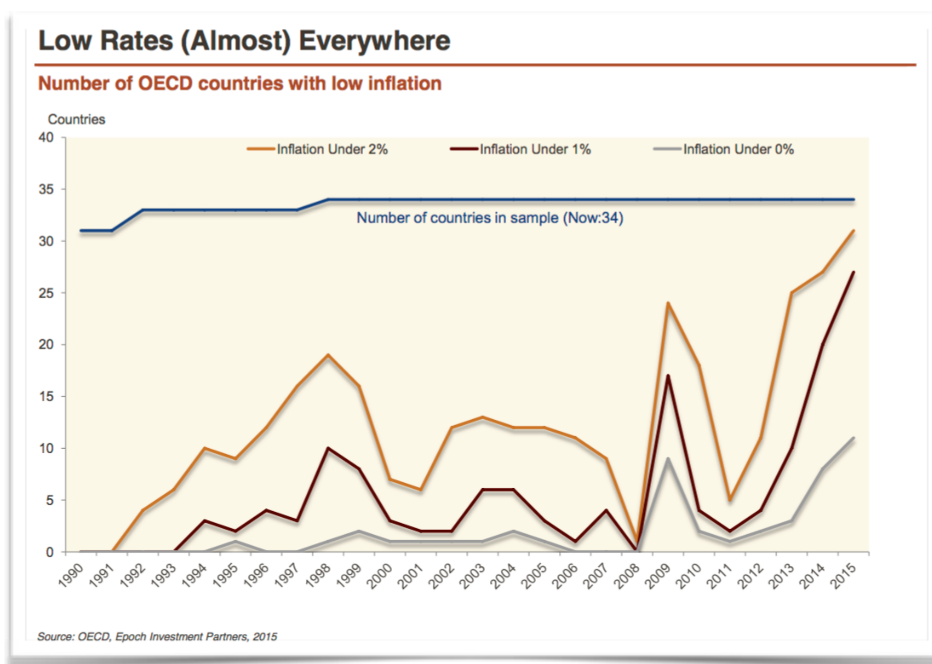
> *FINANCIAL TIMES, APRIL 8, 2016*

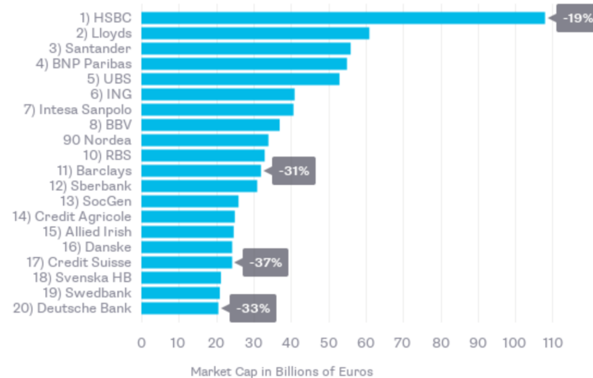
Another goal of the central banks is to fend off deflation. They well know that when deflation sets in, and people stop spending because they feel they can buy products more cheaply in the future, their policies become virtually useless.

At the end of December, the Fed felt the economy was strong enough to withstand four rate hikes this year. By the end of the first quarter, after the market trauma through February and the coordinated reaction by the other central banks, the Fed has been stymied in their plan to begin “normalizing” interest rates. This chart shows that of the 34 OECD countries, over 30 have inflation rates under 2%, approximately 27 have rates under 1%, and 10 have inflation rates under 0% (deflation). The trend is headed in the wrong direction and has been since 2011. This is one of the main reasons the central banks have kept interest rates so low for so long. They are engaged in an epic battle to fight deflation and create inflation to ensure the stability of the current financial system and preserve the health of the banks. If deflation were to take hold, the downward economic spiral created by the velocity of money coming to a standstill drives up loan default rates, unemployment, and ultimately may lead to another financial crisis.



To put this all together, and referring back to the quote at the beginning of this newsletter, the markets are still responding in a perverse way by cheering weakness in the real economy because it will lead to further stimulus and financial engineering from central banks to support asset prices at currently inflated levels. In reality, through these actions, prices are allowed to separate further from their intrinsic values, which we strongly feel will ultimately lead to a collapse among many asset classes. The problem is that nobody knows what the catalyst will be in causing that break to occur. We’ve already begun to see how a misallocation of capital through low rates has allowed over investment in the energy industry. This is very similar to the real estate boom that occurred in the U.S. in the 2004-2007 timeframe. Banks are currently in the process of boosting their reserves to protect against bankruptcies in the energy space.

"European banks have lost their mojo. A toxic combination of negative interest rates, comatose economies and a regulatory backdrop that might euphemistically be described as challenging is wreaking havoc with bank business models. Their collective market value has dropped by a quarter so far this year."



BLOOMBERG VIEW, APRIL 7, 2016

The policies pursued by the central banks are robbing you of safe returns in your bank accounts, retirement accounts and pension funds. They are forcing the world to take more risk, even though they see that their policies have failed to produce the growth they've anticipated for the past six years.

We believe that they won't stop pursuing their goals until they achieve their desired goal of creating inflation. This will likely ultimately reduce the value of your currency, as money printing typically has that effect.

Janet Yellen regarding negative interest rates. "We had previously considered them and decided that they would not work well to foster accommodation back in 2010," Yellen told the Senate Banking Committee Thursday. "In light of the experience of European countries and others that have gone to negative rates, we're taking a look at them again because we would want to be prepared in the event that we needed to add accommodation."

BLOOMBERG: FEB 11, 2016

Because of low and uneven growth rates around the world, we also believe that the volatility that has returned to the market over the past year will continue going forward. We've seen two bouts of significant selling, quickly producing market declines of roughly 10% since August of 2015, leading to more stimulus and financial "accommodation" by global central banks. We see that the market trend has changed to lower highs and lower lows since that point. We see a deceleration in corporate earnings. We see valuations pushing multi-year highs. Finally, we see central bankers themselves seeking ever more creative ways to continue to push assets higher, including the introduction of negative interest rates.

Our feeling is that our caution in portfolio positioning will pay off, and our use of “alternative” and flexible investment strategies is well warranted. We appreciate your continued trust. We are confident in our approach even though we see a difficult environment ahead. As always, we welcome your thoughts and questions.

Your team at 44 North Financial Partners

Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. Investing in alternative investments may not be suitable for all investors and involves special risks, such as risk associated with leveraging the investment, adverse market forces, regulatory changes, and illiquidity. There is no assurance that the investment objective will be attained. Investments are subject to risk, including the loss of principal. Because investment return and principal value fluctuate, shares may be worth more or less than their original value. Some investments are not suitable for all investors, and there is no guarantee that any investing goal will be met. Talk to your financial advisor before making any investing decisions.

Investing in commodities may have greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs, and international economic, political, and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss.

Asset allocation programs do not assure a profit or protect against loss in declining markets. No program can guarantee that any objective or goal will be achieved.

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