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IN A CHINESE HANDCUFF?
INVESTMENT STRATEGY
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The US stock market may be in a Chinese handcuff? Remember the tubular woven piece that fit over your finger and fit over another person's finger at the same time. When the other person pulled away the tubular material tightened its grip on both your fingers so that the other person couldn't get away. But if the other individual stayed close to you the tubular material fit comfortably around both fingers – but you had to stay close together to be comfortable.

The US stock market is in a similar position: if economic growth remains soft, interest rates will remain low, corporate earnings will grow modestly, everything will be comfortable, but unemployment and consumer demand won't improve much, investment will be soft, and everyone – except the unemployed – will be comfortable. But high unemployment is anathema for politicians in the US. The stock market will remain where it is until year end when it will anticipate earnings growth for the following year.

But if growth accelerates as we expect above 3% in the second quarter and for the rest of the year, interest rates will rise, driven not by the Federal Reserve, but rather by investors, and at least initially stock markets around the world will fall and global growth may soften for a quarter or more. Thus, the US economic growth rate may fall right back to where it was in 2013 – thus the Chinese handcuff! Unless growth continues to be much softer than we expect, our basic view remains that we are likely to witness a significant decline in global stock markets as financial markets anticipate the normalization of interest rates by the Federal Reserve in 2015 or sooner depending on the strength of growth. We know that historically the US stock market has risen as interest rates normalized. However, we are very concerned about the debt levels both here and of various countries' abroad. In the last ten years US government public debt (excluding intra governmental debt) has more than doubled from 35% to 72% of GDP. At the same time, total US government debt has risen from 60% to 101% of GDP. Rising rates worldwide present a problem in the face of its modest growth rate.

Global Events – Russia & Crimea:

The Russian annexation of Crimea is actually quite understandable, and does not pose a real threat to the current world order in the short term. Populated largely by Russians, and the home of a very critical naval base in Sevastopol, Crimea in geo-political terms was far more important to Russia than to Ukraine. The sanctions imposed on Russia so far are mere slaps on the wrist, and it is no accident that Europeans are against serious economic sanctions, as the price will be paid by Europe in the form of higher gas prices. Europe imports about 30% its natural gas supply from Russia of which half enters via the Ukraine. Instead, the real punch was delivered by investors as capital outflows from Russia have been larger in this quarter alone than the entire last year. As a result, the country's economic growth outlook for 2014 has been lowered to less than 1% from about 2.5%. Europe too is at risk as rising energy prices would reduce its already meager expected growth of 1% this year.

Yes, it is a land grab by Russia that put's Ukraine in s**omething of a vise militarily,** and the annexation of Crimea clearly shows the nature of Putin and his government: authoritarian, militaristic (where the opponent is smaller), and corrupt. His attack on Crimea and the values that Putin represents are why we have never been investors in the Russian stock market. The recent sharp decline of its stock market and currency reinforces our view.

Eurozone:

With inflation at a four year low of only 0.5% in the Eurozone, pressure is now building on the ECB to implement unconventional monetary policies to avoid a deflationary spiral. ECB chief, Mario Draghi, has called inflation rates below 1% as being “in the danger zone.” Interestingly, after having spent the last six months in the danger zone, even the hawkish Bundesbank President and ECB Governing Council member, Jens Weidmann, has indicated the possibility of further action in the form of quantitative easing or negative interest rates, if needed.

Since US Government bonds represent more than 50% of the global government bond market, any rise in interest rates here usually translates into rate rises across the globe. As the US approaches the day when the Federal Reserve will begin to normalize (raise) interest rates, it is no accident that the Europeans should try to prevent the transfer of interest rate increases by preparing their own “quantitative easing” to prevent another Eurozone crisis in those countries such as Portugal, Greece, Spain and Italy who have so recently barely avoided disaster.

China:

In the meantime, the Chinese continue to put their house in order. Investors there have known of the debt problems (both large amounts and often poor quality) and the excess capacity being written about in local newspapers recently. Visitors there have seen entire cities which have no occupants that have been built but in order to keep people employed. This is not new.

What is new, is the serious attempt by the government to rationalize banking practices and reporting, to even permit bankruptcies so that the Chinese understand that there are consequences to irresponsible behavior and risk taking. A floating interest rate is being introduced and with that the daily trading band of the renminbi-dollar exchange rate has been expanded to 2% from 1%. This is a step towards a freely convertible currency that might some-day supplant the dollar as the world’s reserve currency.

While maintaining political control, the government seems to be moving in the direction of a (more) market driven economy. We suspect that Singapore may be their model: an authoritarian government sitting atop a market economy?

In the process of this transition, the government is keeping a wary eye on inflation (especially home prices) and interest rates – both of which seem under control while growth remains at the 7%-8% level, a range that is the equivalent of 1%-2% for the US. There are signs the government is tackling various forms of pollution, consolidation of inefficient industries such as the steel and aluminum industries, and shifting the economy gradually away from its dependence on exports to personal and business consumption.

While there are some still predicting a “hard landing” i.e. recession for China, we rather think they will “muddle through” during the course of their transition at a growth rate of 6%-8% annually depending on how strong growth is elsewhere.

Japan:

April 1st begins the new fiscal year and with it a steep rise in the sales tax from 5% to 8%. The Japanese market has declined almost 10% year to date, in anticipation of slower growth particularly in its first fiscal quarter. This may represent a buying opportunity since we expect both the Abe administration and Bank of Japan to continue to implement policies to inflate the economy and thereby also equity prices until they reach their 2% inflation target. Core CPI, their preferred inflation measure which excludes fresh foods and the impact of tomorrows sales tax hike, is currently at 1.3%, a significant improvement from the -0.3% reading this time last year. To enhance the second round effects of inflation (a price wage spiral) and to spur economic growth the government is now trying to convince the country’s 1,800 leading companies to raise their wages.

Brazil:

Attractive Brazilian valuations! Over the last three years the Brazilian Real has depreciated significantly against the dollar and Brazilian equity market has dramatically underperformed the US. It is now in recession with inflation rising (a nasty combination) and with short term policy rates and the 10-year bond at 10.75% and 13%, respectively. The inflation is driven by unit labor costs due to a tight labor market and stagnant productivity rather than commodity prices. We expect the October elections to bring a more business friendly government focused on increasing productivity by improving the country's infrastructure and by encouraging investment in new technologies, even if Dilma Rousseff remains in power.

What to Do:

We continue to maintain cash balances (money market funds) in accounts consistent with risk tolerances. Both stocks and bonds are vulnerable particularly US Treasuries.

Our basic strategy of buying cyclical late cycle industries is now beginning to pay off and we haven't changed our portfolios significantly. We continue to like raw materials, energy, industrials, technology and banking.

Given the sharp declines and relative underperformance of various foreign, often secondary markets, we are adding positions in some of the larger and smaller markets that have potential for significant rebounds. We like both China and Brazil. We recognize that if our scenario for rising rates is correct that these markets may experience difficulty just as they did in January. We will use our cash to add to such positions.

We do not intend to commit funds to fixed income until we have seen the bulk if not all of the normalization of interest rates. If we do, it will be through floating rate instruments.

We would be happy to answer any questions, and look forward to talking with you soon.

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