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GREECE, THE PIIGS, & PUTIN
INVESTMENT STRATEGY
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The US economy has normalized. Economic growth for the last five quarters has averaged 3.1% - roughly the average rate of growth for more than a century – and four of the last five quarters growth has been 3.5% or higher. New unemployment insurance claims, i.e. the number of job losses due to termination, is now at an annualized level (under 300,000) consistent with a very strong economy. Corporate investment is finally rising, and the number of new jobs is averaging almost 250,000 a month or close to three million new jobs annually (which is the most since 1999). Housing starts, currently around one million annually, have doubled from their recession lows and should rise to 1.5 million over the next couple of years. It is a goldilocks economy – not too hot, and not too cold.

Truly, the best news for the US economy has been the almost 50% decline in the price of oil from $101/barrel in late June to $53/barrel on December 31st for West Texas Intermediate crude. This is good news for approximately 85% of the economy as transportation and product input costs decline. While oil and gas capital spending is declining already, the net benefit to GDP is 0.2% annually for each $10 of price decline. Thus, if prices stay at the current level the price decline translates to almost a 1% boost to GDP. At the pump, national average regular gasoline prices have declined from around $3.65 to around $2.25 over the same timeframe - equivalent to a $140 billion tax break for consumers. Although only about 25% of the oil and gasoline price decline took place in the third quarter, we saw an impressive 70 basis point uptick in consumer spending from the second quarter – indicating that more is to come.

Triggering the sharp decline in the oil price was OPEC's (read Saudi Arabia's) decision to continue production in order to maintain market share. Despite continuously falling prices, Saudi oil minister, Ali al-Naimi, recently explained that he convinced OPEC not to cut production **whatever the price** is. With a very low cost of production, the Saudi's can drive the price down until production worldwide begins to shut down as the decline makes it unprofitable to continue producing. All in all, oil importers such as US, Europe, and China stand to benefit while exporters such as Russia and Brazil are struggling.

Which brings us to our central thesis: geopolitical issues will be very important next year. The Russian response to the declining oil price will move financial markets. Putin is very popular in Russia because he is seen as a "strong man." His annexation of Crimea and infiltration of Ukraine give Russia a direct route through safe territory to the warm water port of Sevastopol where the major Russian fleet is based. Whether he will make advances against the Baltic Republics, of Latvia, Estonia and Lithuania in order to distract the Russian populace from recessionary economic conditions remains to be seen. If he does, we should see sharp declines in financial markets. If, on the other hand, Putin were to retreat from Ukraine, that would stimulate a rise in financial markets.

Greece and the PIIGS (Portugal, Italy, Ireland, Greece, and Spain) may be in trouble again in 2015. Greece has now scheduled a snap election in late January as the left wing party, Syriza, which wants to abrogate the agreements with the European institutions that have been funding its recovery, seeks control of the government. If this party succeeds, fears will arise again that the European currency union will break apart (as was feared in 2012) with Greece being the first to leave. This will again put pressure on the bond markets not only of Greece, but also of Italy, France, Portugal, and to a lesser degree Spain. Ireland would appear to be in relatively good shape.

As articulated in a prior strategy piece, we remain concerned about the lack of, or slow progress being made in the implementation of necessary labor and budgetary reforms in several of the PIIGS, particularly Italy, as well as in France. As a result, we anticipate the slow growth and low inflation to continue and thereby forcing the ECB to ease further by implementing a public QE program in the first half of next year. Considering the already rather tight labor market and steady rise of asset prices in Germany, Europe may face a "one size does not fit all" monetary problem sooner than currently expected

Our judgment would be that even if the left wing party in Greece gets into power, they may well decide to continue working with the "Troika" (the IMF, the European Central Bank, and the European Commission) as it is truly economically better to do so in the long run, than to break away and default on their debt. Just as Nixon, the Republican President, opened the doors to China, Syriza, if in control, may agree to help from Europe despite their campaign against doing so. Instead, judging from the close polls between New Democracy and Syriza, we suspect the largest risk to the country is a stalemate or successive general elections (similar to 2012) that could delay further assistance from the Troika.

We think Europe really becomes a problem once the US and much of the world enters a recession again. But that will take a while. In summary, we expect the geopolitical events, rather than economic events to create the volatility in financial markets this year.

Having said that, if the US experiences 3%-4% growth in the first half of 2015 we would expect inflation to increase modestly and the Federal Reserve to begin normalizing interest rates by mid-year, i.e. in June or July. Further, Chair Yellen indicated in her most recent press conference that even after the liftoff, monetary policy will remain very accommodative. It is therefore really the expectations for inflation, rather than a sharp normalization of interest rates by the Central Bank, that will determine the response of the financial markets, and we expect the markets current disinflation worries to subside and inflation to pick up without overshooting the Fed's target anytime soon.

Global Markets:

The key underlying theme around the world is the flooding of economies with liquidity (money) by Central Banks in order to stimulate growth. Looking at the balance sheets of the four major Central Banks, we find that their combined assets have increased from around $4 trillion in early 2008 to more than $10 trillion today. This means that these Central Banks have been printing currency and buying up securities in the open market and putting them on their balance sheet as an asset. Even though the Fed and the Bank of England now are keeping their balance sheets constant, the total expansion will continue since the Bank of Japan is buying the equivalent of $670 billion of assets annually and the ECB is set to expand its balance sheet by €1 trillion over the next two years. Generally this is good for financial markets as much of the liquidity goes into financial assets rather than the real economy. The prime example is China, where the People's Bank of China cut rates in November and loosened lending standards in the face of slowing economic growth and expectations of further deceleration next year, contributing to a 53% gain in the Shanghai Composite for the year. The calculation by central bankers is that even if this happens the wealth effects will improve their economies and the low borrowing rate will stimulate investment leading to growth.

We expect those economies still undergoing reforms to experience very low growth rates - .e.g. China (where 6% growth is recessionary) and Europe. Brazil remains in recession, and therefore both its market valuation, currency and economy look attractive going forward. Japan has bitten the bullet on the fiscal side by raising the sales tax from 5% to 8% and looks rather attractive. It is now set to reduce its effective corporate tax rate in fiscal 2015 from 34.62% to 32.11% and to 31.33% in fiscal 2016 and ultimately to below 30%. Furthermore, following Abe's strong election results on December 14, 2014, we expect the government along with the Central Bank to continue to push hard to meet their 2% inflation target. Core inflation, their favorite measure, is currently running somewhat below 1%. In this new inflationary environment the cash flooded Japanese corporations are no longer earning positive real return on their cash as they did during the deflationary years and may therefore be less prone to hoard cash. Instead, buybacks and crossholdings are likely to rise driving the equity market higher. (According to Merrill Lynch, during the deflationary years from 2000 to 2012 the cash to market cap ratio of Japanese companies almost doubled to close to 30% and around 50% of Japanese companies have a positive net cash balance, cash minus total debt, versus only 22% of US corporations.)

With the US leading the way, we don't expect a global recession yet, but rather think the US will provide support for growth elsewhere. As more investors have confidence in the US, attention will shift to peripheral markets, and we suspect that later during the year, there will be a shift in the risk preferences of investors – that is, we will see "risk on" – as long as geo-political events don't scare financial markets.

What to Do?

First, given the risks, we will continue to hold cash to the extent of 10%-25% of the portfolio depending on individual risk tolerances and other issues.

Secondly, we will add to our Brazilian, Swedish, and Japanese positions.

Third, we will continue to maintain our cyclical holdings in the face of expected relatively strong growth in the US, and an improvement in growth worldwide. At this point we see steel, aluminum, and technology as undervalued.

Finally, although we cannot pick the bottom in the oil price, we believe the oil industry – both production and oil service have become attractive and will from time to time pick up or add to holdings we already have.

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