Apr 2016 Investment Newsletter

April Showers

1. Springtime

The coldness has thawed, the bitter barren ground giving way to blossoming sakura. In another time and place, I'll be hanging up my heavy coat for a light dapper pea coat.

The financial markets too, seem to mirror the seasonal change as we emerged from the February freeze into a breezy March.

As we head into April, the inexplicable steep drop, and the doom and gloom of February feels like a distant memory and a passing shower, as the market experienced a sharp rebound (Chart 1).

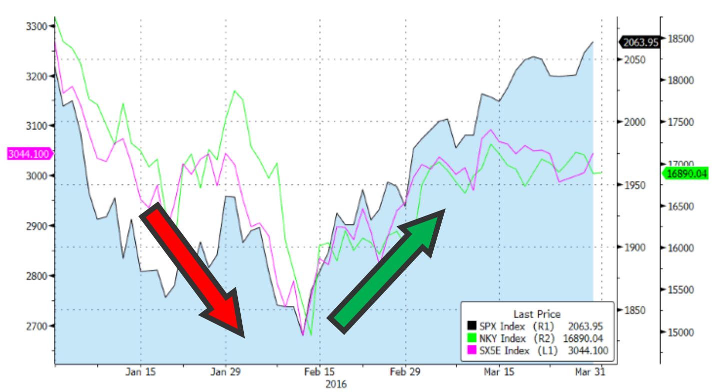

Chart 1: The S&P Index, Nikkei Index and the Eurostoxx 50 Index all rebounded off their February lows and posted strong returns in March. We probably have to get used to these roller coaster rides.

The equity rally coincided with a commodities rebound and VIX, a measure of volatility, has also subsided (Charts 2 and 3). China's currency has stabilized, the oil supply appears to be moderating, and the US economy continues to be growing and creating jobs.

Chart 2: WTI crude oil futures have rebounded off the sub-$30 level and appears to be stabilizing… for now.

Chart 3: The VIX Index, a measure of volatility, is trading at a low level not seen since the August 15 blowup.

What's next? As always there are a number of dark clouds looming over the horizon, and we wonder if they will turn into F-5 hurricanes or mere April showers. A few that stood out for me: effectiveness of monetary policy, China and energy. As we have previously discussed China and energy, I would like to take this opportunity to focus a little bit more on monetary policy.

2. Zombies and Monetary Policy

Recently the European Central Bank (ECB) and Bank Of Japan (BOJ) have continued to expand their monetary policies, buying up huge volumes of bonds and cutting the cash rates below zero. The stimulus seems to have less and less impact in lifting 'animal spirits'; in fact comments from ECB chief Draghi that he is not expecting to cut rates further led to a sell-off in European bonds and equities, and a rally in the Euro. The dominant view of investors now is that lower-for-longer interest rates is losing its effectiveness and that further expansion of monetary policy is akin to pushing on a string.

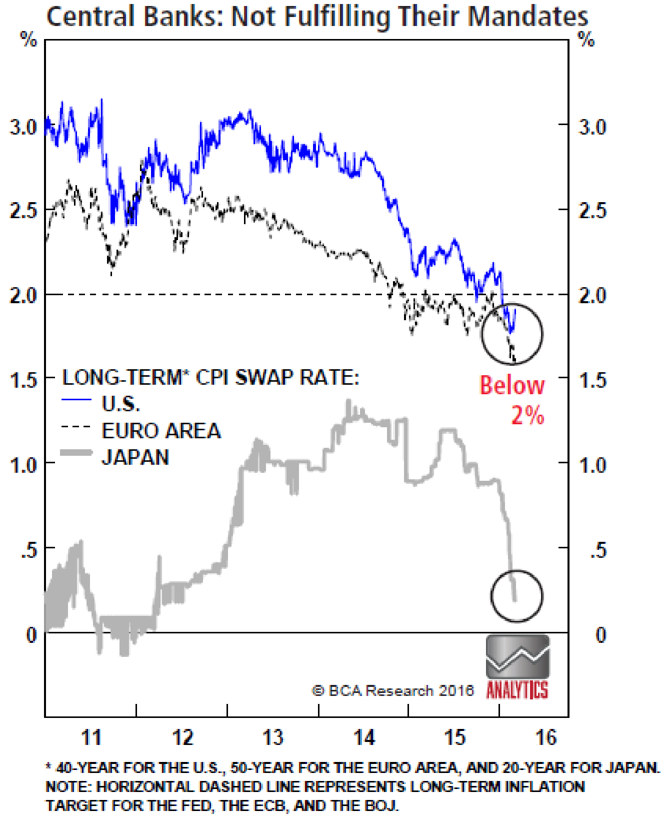

Chart 3: Despite massive efforts, long-term inflation expectations remain below central bank targets.

Pimco's Scott Mather sums investor sentiment this way: "what was once an appropriate and stimulative policy could become a counterproductive program that creates new and undesired equilibriums… groupthink monetary policy (will) lead to a zombification of the economy."

After the financial crisis, the 'failure' of governments in developed countries to jumpstart growth has put the onus on central banks to do the heavy lifting. Central banks have responded accordingly by cutting rates aggressively. While easy monetary policy (alone) has not delivered a rapid rebound in global economic growth and long-term inflation* expectations remain below central bank targets (see chart 3), Don Stammer (chairman of QV Equities) has put together a chart (chart 4)that illustrates that average unemployment in developed economies has fallen sharply — in part because of the aggressive monetary policies.

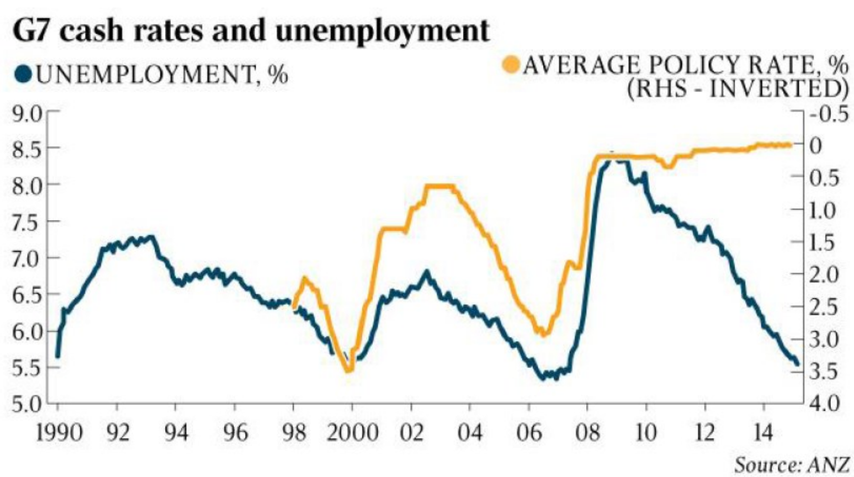

Chart 4: Low interest rates have played a crucial role in driving down the unemployment rate across the G7 economies.

* Moderate inflation simulates the economy, encourages borrowing and reduces layoffs.

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My view is that this apparent ineffectiveness in monetary policy is caused by the divergent paths taken by the US and other countries. It would appear that the action of the Federal Reserve far outweighs the actions of the ECB and BOJ combined. The US is still the engine that drives global economic growth; it has been on a tightening path while Europe and Japan are pursuing their loosening policies. US rate hikes mean a stronger dollar, putting pressure on US companies' profit, making commodities prices dearer (they are priced in dollars), and driving fund flows out of emerging markets.

After the recent turmoil in markets, the Fed appears to be softening its stance, which should prove to be positive for risky assets. At the Economic Club of New York on the 29th March, Yellen reaffirmed the dovish stance of the last FOMC meeting and said that it's appropriate for U.S. central bankers to "proceed cautiously" in raising rates amid deteriorating world growth, and acknowledging the slowdown in China as a risk.

Yellen also said that "Fed has considerable scope for stimulus if needed". This dropped the dollar, lifted commodity prices (priced in dollars), took the steam off a depreciating RMB, and generally acted as a stabilizing factor.

She also cited conditions the committee needs to watch for future rate hikes (source Bloomberg):

- Foreign economies and their financial markets need to stabilize.
- The dollar can't appreciate further. That would depress inflation and exports, and hurt U.S. manufacturing.
- Commodity prices need to stabilize to help foreign producers find a better footing for growth.
- The housing sector needs to make a larger contribution to U.S. output.
- Inflation is a two-sided risk: Yellen is skeptical that the recent rise in core inflation, which strips out food and energy, "will prove durable." She is watching closely.

Market reaction

The immediate reaction was positive, and seems to suggest that the market is not becoming numb to monetary stimulus. (See charts 5, 6 and 7)

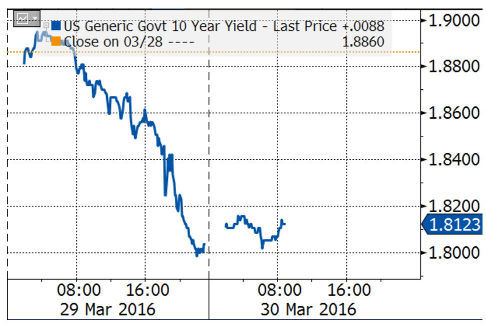

Chart 5: Interest rates (the US 10 year treasury yields) came down.

Chart 6: The dollar index fell sharply, helping emerging market currencies recover.

Chart 7: US equities enjoyed a strong rally.

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