Smith Affiliated Capital

FIRST QUARTER 2015 INVESTMENT COMMENTARY

THE RISK OFF TRADE WILL DOMINATE 2015 AS FOREIGN ENTITIES GRAPPLE WITH UNTENABLE DEBT BURDENS AND DEFLATIONARY FORCES INTENSIFIED BY OIL SHOCK

In this Issue:

The revised third-quarter GDP report showing robust back-to-back quarterly growth rates was clearly good news for an economy that is still only increasing by a subpar 2.7 percent on a year-over-year basis. Before jumping on the "off-to-the-races" bandwagon, however, be prepared for a marked slowdown in the current quarter. Fully 1.5 percentage points of the 5 percent growth rate was due to an aberrational 16 percent annual rate of increase in defense spending and a sizeable gain in net exports. With military operations winding down in Afghanistan, Iraq and other trouble spots, the spike in defense spending – the largest quarterly jump in five years – was clearly an outlier that will likely not recur. Meanwhile, given the weakening economies among most of our key trading partners and the run up in the dollar, it's hard to justify continued strength in exports. We expect these components to at best make a neutral contribution to growth over the near term and more likely pose a drag on GDP in the current quarter.

Following the better than expected reports on GDP and an array of other indicators economists are marking up their forecasts for 2015. It's easy to be blinded by headline-grabbing data in the rear-view mirror and lose sight of ominous potholes that justify a more jaundiced view of the future. The plunge in oil and gasoline prices provide a big lift for millions of budget-constrained households and probably gave the holiday shopping season a solid boost. In short order, however, the effects will begin to wear off as household behavior adjusts to lower gasoline prices. As the New Year gets underway, consumption will once again align itself with income growth, so the latter will need to take a leap forward to sustain the near-term impetus provided by lower oil prices. But the growth in paychecks continues to hover around 2 percent with little sign that labor's bargaining power is strengthening.

Of course, oil could still go lower, and generate more extra cash for consumers to spend. According to Saudi Arabia's oil minister, OPEC will not cut production even if the price falls to $20 a barrel. We suspect, however, that market forces will establish an equilibrium price well above that level, as lower oil prices stimulate demand and cut supply by pushing inefficient oil producers out of the market. Those forces appear to be unfolding already; sales of less fuel-efficient motor vehicles are increasing and rig counts are falling, reflecting the announced plans of several Texas oil companies to curtail drilling operations. Indeed, should the plunge in oil prices persist, the losers would greatly outnumber the winners. Not only would the domestic energy sector – the economy's biggest growth driver – be stifled, the risks of another global financial crisis would intensify as fiscal and monetary authorities have few bullets left in their arsenal to right the ship.

The Dark Side of the Oil Plunge

The astonishing plunge in oil prices garnered the biggest headline in the final months of 2014. Like any sudden and dramatic event on the global stage, this one has understandably stirred up conflicting emotions, as well as a good deal of stress in financial markets. Clearly, oil's tumble has both positive and negative connotations. The biggest negative is that it has been facilitated in no small part by weakening global demand, which is symptomatic of mounting economic hardship among a broad swath of developed and emerging market nations. An ancillary concern is that the squeeze on revenues of oil-exporting nations is undermining their ability to service external debt obligations, invoking fears of default that could become contagious and lead to another financial crisis.

Indeed, oil exporters are suffering a three-pronged attack on their economies – from lower oil prices, reduced oil exports and declining currencies, which increases the cost of imports. The poster child for this triple-whammy is Russia, where the ruble has plummeted by 40 percent over the second half of last year and inflation is soaring. Of course, Russia has been buffeted by non-oil-related issues as well, particularly the economic sanctions associated with its incursions into Ukraine and the annexation of Crimea. But the adverse balance of supply and demand for most other commodities – copper, iron ore, sugar, soy beans and the like – is dragging down growth and destroying the revenue base of Brazil, Venezuela, Peru and a host of other developing countries in Latin America and Asia.

Nor is the U.S. emerging unscathed from the nosedive in oil prices. Thanks to major technological advances in extracting shale oil from rock formations through hydraulic fracking methods, the energy industry has become one of the most dynamic growth sectors in the country, generating billions of dollars in investment spending and plentiful job opportunities in North Dakota, Texas and a handful of other states. The energy boom, of course, was facilitated by the enormous profit opportunities available when oil prices topped $100 a barrel back in the summer. At less than $50 now, many of the newcomers to the industry have seen those profits vanish and will be forced to close shop. Some of the oil behemoths have already announced cuts in their capital budgets and hiring plans. Capital spending by energy companies' accounts for the largest share of GDP since the early 1980s, so these cutbacks will make a noticeable dent on growth in 2015. Simply put, the plunge in oil prices is sapping the vigor from a key source of the economy's strength in recent years.

Disinflationary Forces Intensify

At the start of 2014, the consensus among economists and the financial community was that interest rates were poised to head higher underpinned by a less accommodative monetary policy and strengthening economic conditions. Once again, the best-laid plans went astray as the Fed kept the federal funds target at near zero, and bond yields slid by almost a full percentage point over the course of 2014. This miscalculation occurred despite the impressive performance of such headline measures as GDP, the unemployment rate and payrolls, but the headline data did not resonate on Main Street, where median household incomes continued to languish, millions of workers were stuck in part-time jobs and the share of the adult population in the labor force remained at a 38-year low.

The Fed correctly perceived that the underlying fundamentals were not as strong as the macro statistics suggested, a perception corroborated by the fact that the majority of Americans still believe the economy is in recession. What's more, the oil-price slide that began in July intensified disinflationary forces already underway even as it brought the deflation threat closer to reality in Europe and elsewhere. Since January 2012 the Fed has officially adopted a 2 percent inflation target but, unlike progress on the employment front, it has consistently failed to come close to meeting that objective. The price index for personal consumption expenditures, the Fed's preferred inflation measure, has increased by an annual rate of just 1.5 percent from January 2012 through November 2014, and the trend is moving further away from the 2 percent target. In November, the deflator stood just 1.2 percent above its year-earlier level, down from a nearby peak of 1.7 percent in May.

Most economists, including the Fed, like to strip out the effects of energy prices, which like food prices, tend to be volatile and unresponsive to policy actions. But removing those items does not change the pattern much. The so-called core personal consumption deflator has also increased by an annual rate of 1.5 percent since January 2012, and currently stands just 1.4 percent above a year ago. While oil does not have a direct impact on the core PCE deflator, it does have knock-on effects, as producers of energy-intensive goods and services can pass on their lowered costs to consumers. Some die-hard inflation hawks still assert that the Fed is falling behind the curve, but it is the deflation not the inflation curve that it is in danger of falling behind.

The Risk-On Trade Sows Seeds of a Financial Crisis

That said, by sticking with its massive bond-buying program until the fall and keeping rates at rock-bottom levels, the Fed has set the stage for another ominous prospect that could haunt it in 2015. Simply put, investors have been encouraged to chase after riskier, higher-yielding assets that, in turn, coaxed companies with junk ratings to issue debt with abandon. Not surprisingly, highly leveraged North American oil and gas producers led the pack, and their issues now account for more than 15 percent of outstanding high-yielding debt. Nor were these companies the only borrowers with shaky financials to reach the bond market. While lenders shunned offering subprime mortgages, which precipitated 2008 financial crisis, they were more than willing to extend auto loans to risky borrowers. These loans have become the latest time bomb in the asset-backed securities market, soaring by an annual rate of $77 billion over the first three quarters of 2014 to nearly $1 trillion.

Meanwhile, investor appetite for risky assets encouraged companies in emerging markets to issue a record $276 billion in dollar-denominated bonds in 2014, augmenting huge government offerings. The combined total of outstanding private company and sovereign bonds from emerging market countries has soared fourfold since 2008 to over $6 trillion in late 2014. Needless to say, the default risk on this debt has risen exponentially with the plunge in revenues from declining oil and commodity prices and the run-up in the dollar. No country is more at risk than Russia, whose external debt obligations totaled $731 billion in June, $130 billion of which comes due this year. Russia not only has to deal with the deeply devalued ruble but with Western sanctions as well, which shuts out a wide swath of highly-indebted Russian companies from the capital markets. Companies under western sanctions owe about 60 percent of the debts due this year, which means that they do not have access to hard currencies to repay or refinance the loans.

In short, the risk of a wave of defaults that could lead to a financial crisis is clearly a nontrivial prospect. At the very least, Russia's woes, combined with its unpredictable leader, heighten the prospect of more geopolitical turmoil that is always a recipe for financial market disruption. Indeed, geopolitical issues are already looming large in the foreseeable future with Greece once again in the forefront. Should the leftist Syriza party win the election on January 25th, there's a very good chance that the new government would repudiate both the austerity measures imposed on the country as well as its outstanding debt, resulting in expulsion from the Eurozone. So far, the markets are either in denial of that prospect or unfazed by it, but investors who ignore the looming contagion effects do so at their own peril. The risk-on trade that drove worldwide bond yields down to historic lows last year is about to lose its underpinnings amidst heightened geopolitical and credit risks that are increasingly overhanging the global landscape.

The Rush to Safety Will Check Rate Rise

Domestically, the remarkable decline in Treasury bond yields last year reflected a confluence of forces, including deflation fears and the Fed's bond-buying program, combined with pinning short-term rates at near zero and the historically low competitive yields overseas. We suspect that the demand for high-quality Treasuries this year will be just as heavy if not more so, even without the Fed's incremental bond purchases. This time, however, it will be paced by the increased investor appetite for safety. Indeed, the risk-off trade is already well underway, as shareholders pulled billions of dollars out of high-yield mutual funds in November and December. What's more, the cessation of the Fed's bond buying will be offset by purchases from the ECB and other central banks aiming to drive their currencies lower to stimulate growth.

True, the Fed is counting on inflationary expectations remaining "well anchored" among households, as has been the case in recent years despite the fall in actual inflation. But lowered inflation expectations are decidedly embedded in financial market prices which have garnered some attention at the December FOMC meeting. If, in fact, deflationary readings hit the headlines over the first few months of the year, as seem likely, household expectations could easily become unhinged, leading to a growth-retarding change in spending behavior. Also keep in mind that with interest rates sitting at the near-zero floor, declining inflation translates into a rise in real interest rates, which amounts to a de facto tightening of policy.

As the calendar page turns to 2015, the forecasting community is once again betting that interest rates will rise throughout the year, spurred by a tightening Fed and gathering strength in the U.S. economy. We concur that the Fed is planning to lift the funds rate around mid-year, hoping to finally start normalizing monetary policy. However, be aware of some obstacles that could defer, if not derail, these plans again, as was the case last year. For one, the Fed could well be facing negative year-over-year price changes in coming months, reflecting the drag from gasoline prices. If headline deflation persists through the spring, it will be difficult to justify lifting the funds rate.

It remains to be seen how well the economy can withstand the combination of a rise in real rates, a global economic slowdown and the potential financial turmoil stemming from the escalating geopolitical and credit risks that are set to unfold in the coming months. Things could get particularly dicey if the long stock market rally comes to an abrupt halt, depriving the economy of the wealth and confidence-boost it enjoyed over the past five years. It should be noted that more than half the earnings of big-cap companies comes from overseas operations. Not only are foreign earnings in local currencies likely to suffer because of slowing activity, these funds will be repatriated into fewer dollars, thanks to the surging greenback. Any crisis of confidence in the stock market would be another force driving investors to the safety of Treasuries. In short, while the fundamentals underpinning the domestic economy appear to be strengthening, the U.S. is navigating a sea of global turbulence, highlighted by deflationary forces and heightened event risk that constitutes a powerful check to any rise in interest rates.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISONS

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.09	0.04	0.09	0.02	0.12
2-Yr. Note	0.39	0.59	0.68	0.17	0.66
5-Yr. Note	1.74	1.78	1.66	1.14	2.89
10-Yr. Note	3.01	2.51	2.17	3.57	10.74
30-Yr. Note	3.94	3.21	2.75	10.06	29.38

Municipal Bonds	Yields (%)			Total Return (%)	
	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	4.92	3.14	3.11	2.47	2.11
ML G.O. 22+ Index	4.74	2.94	2.74	2.23	15.31

Equities	Levels			US $ Terms (%)	
	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
S&P 500	1,848.36	1,972.29	2,058.90	4.92	13.65
DJIA	16,576.70	17,042.90	17,823.07	5.19	10.03
NIKKEI (Tokyo)	16,291.31	16,173.52	17,450.77	8.01	8.91

Commodities	US $			Percent Change (%)	
	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,202.30	1,210.50	1,184.86	-2.12	-1.45
CRB Future Com. Pr. Index*	280.17	278.55	229.95	-17.44	-17.92
West Texas Intermediate Crude ($ per bbl)	98.42	91.16	53.27	-41.56	-45.87

Currencies	Levels			Percent Change (%)	
	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
Yen	105.31	109.65	119.78	-9.24	-13.74
Sterling	1.65	1.62	1.55	4.01	5.92
Euro	1.37	1.26	1.21	4.22	11.69

Foreign Bond Markets	Levels			US $ Total Return (%)	
	12/31/2013	9/30/2014	12/31/2014	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	0.27	0.06	Discontinued	N/A	N/A
ML German 10-Yr.+ Bond Index	2.59	1.61	1.12	8.07	26.78
3-Mo. LIBOR Yen Fixing (3)	0.15	0.12	0.11	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	1.29	1.10	0.82	5.30	10.14

Source: Bloomberg Financial Data

Notes: 1) 9/30/2014 thru 12/31/2014 2) 12/31/2013 thru 12/31/2014

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

Smith Affiliated Capital • 800 Third Avenue • New York, NY 10022 • (212) 644-9440 • www.smithcapital.com