Smith Affiliated Capital

SECOND QUARTER 2015 INVESTMENT COMMENTARY

RESTRAINED FED POLICY

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Secular Stagnation, Dormant Inflation, The Strong Dollar and Heightened Global Event Risks Will Restrain Fed Policy and Support Demand for Quality Assets.

With the first quarter in the books there's little question that the slowdown during the closing months of last year has continued into 2015. What was widely expected to be a year in which the economy breaks out of its lackluster 2 – 2 ½ percent pace since the recession ended nearly six years ago, is once again starting off on shaky footing. After downshifting from a 4.8 percent average growth rate in the second and third quarters of last year to 2.2 percent in the fourth (which was revised down from an original estimate of 2.6 percent), economists have been steadily marking down their estimates for the first quarter of 2015. The Atlanta Fed's tracking model of GDP as of March 16 puts the growth rate at 0.2 percent, the ninth downward revision since February 18th when the regional bank's first-quarter growth estimate was 2.3 percent.

Yes, the usual excuses for the two-quarter slowdown are loudly heard with bad weather topping the list. No doubt the economy has been bruised by another harsh winter that crimped spending and put a dent in some weather-related activities, such as construction. This was the case last year as well, and the economy rebounded in the spring and fall. Odds are, activity will pick up again as the weather improves. What's more, with the oil glut continuing to grow, some further declines at the pump may well provide some oomph to the rebound.

The rebound however will not be as vigorous as last year's snapback, much less launch the economy into a sustained higher gear. For one, 2015 will be missing a major tailwind from last year as the Fed is no longer injecting massive new liquidity into the economy having terminated its bond-buying program last September. For another, the surging dollar is becoming a formidable headwind and its growth-dampening deflationary impact will intensify in coming months. Equally important, the fundamental underpinnings do not justify notions of a breakout year as household incomes are just barely keeping pace with inflation and businesses are still reluctant to invest in new capacity or capital equipment. Indeed, the steady increase in payrolls in recent months – the major selling point for the optimists – is more a reflection of declining productivity than increased demand. That's a time-honored recipe for secular stagnation rather than healthy growth, something the Fed is acutely aware of and that will certainly influence its policy decisions.

The Almighty Dollar

The surging dollar has been one of the more astonishing events of the past year. Yet it is only recently that the run-up has attracted much attention in the media and among policy makers. If nothing else, the extreme magnitude of the rise has thrust the dollar into the limelight. Over the past year, the greenback has surged by 20 percent against other major currencies, the second steepest annual increase in more than forty years. Relative to the euro, the climb has been an even more dramatic 25 percent at its peak pushing the euro at one point close to parity with the dollar. At its high last May, 1 euro would cost \$1.39; this month (mid-March) the exchange rate reached a low of \$1.04, although has since recovered a bit. The dollar has also climbed sharply against many emerging market currencies.

There's nothing mysterious about the dollar's strength. Capital tends to flow to currencies that offer safety as well as the highest returns so on both fronts the greenback has been an attractive magnet. As low as interest rates are in the U.S. they are still higher than those available in Europe and elsewhere, including Japan. Meanwhile, the European Central Bank continues to put downward pressure on long-term rates by embarking on a large-scale bond-purchase program aimed at boosting growth in the region.

The Federal Reserve terminated its bond-purchase program last September and is widely expected to raise interest rates sometime later this year. That divergence of actual and

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expected, global central bank policies, is luring capital into the U.S., driving the greenback's upward surge.

Needless to say, the sharp climb in the dollar has drawn the attention of the Federal Reserve as it threatens to be a drag on growth. While the U.S. economy is 87 percent dependent on domestic demand, it is not immune from an adverse shift in trade. A strengthening dollar makes U.S. goods more expensive in the global marketplace, impairing exports while stoking the demand for imports, as it reduces the cost of foreign goods. This combination raises the trade deficit directly impacting the U.S. economy. In 4Q of 2014, the wider trade deficit lopped-off more than 1 percentage point from real GDP, a haircut that loomed large relative to the 2.2 percent overall growth rate.

There are also indirect effects from a strong dollar as almost 50 percent of sales of large corporations are derived from overseas operations and those local revenues are worth less when converted back into the stronger dollar.

To be sure, there are some positive offsets as well; companies that import parts and supplies to generate output find that the stronger dollar lowers production costs this enables them to keep prices lower than otherwise and maintain a competitive edge. However; to a Federal Reserve that is concerned with the stubbornly low inflation rate in the U.S., the disinflationary impact of falling import prices is just another headwind that complicates policy decisions. It is no small wonder that many believe that foreign central banks are striving to export their deflation and stagnation of their economies, to the U.S.

The Fed's "New" Lower Forecast

At its March policy-setting meeting, the FOMC revealed its latest dot-plot forecast, which details the collective outlook for growth, unemployment and inflation by the 19 members of the committee. The highlight of the meeting and the policy statement that accompanied it was the removal of the word "patient" that has been used since the December meeting to indicate how long the Fed would wait before raising the Federal funds rate from near zero. While the change in verbiage opened the door for a rate increase at any meeting post April, the markets correctly viewed the change as being more window dressing – designed to provide the Fed with flexibility – than actual intent.

On the outside, June lift-off dates is still possible but even a cursory look at how Fed officials see the future argues for a later rather than sooner start date; despite the fact that the unemployment rate is now seen as going lower than what was expected at the December meeting when the previous forecast was made public. But that downward adjustment does not reflect strong hiring demand based on fundamental underpinnings. By just about any measure, payroll growth is outstripping the growth in output which has been slipping since late last year. Simply put, when productivity growth is slowing, as is currently the case, more workers are needed to generate any given level of product; slowing productivity is not just a one or two-quarter phenomenon. In fact, over the past four years, nonfarm productivity has only increased by an average annual rate of just 0.7 percent, down significantly from the 3 percent average over 1995-2005 period and from its longer-term 30-year average of 2 percent. Over the past year productivity has fallen at an annual rate of 0.1 percent.

Several factors have contributed to this dramatic slowdown in productivity but a key one is the lackluster pace of capital spending since the recession. This lack of capital spending deprives workers of more efficient and technologically advanced tools of production that could generate higher output. The reluctance of businesses to step up investment, in turn, reflects the relatively weak recovery itself. This erosion in corporate confidence lowers the absorption rate of the huge excess capacity created by the Great Recession. Some also believe the shortfall in capital spending also reflects a dearth of innovation since the Internet revolution whose transformative effects in boosting productivity, over the past ten years through 2005, may be running out. Whatever the reason, the weak recovery in capital investment and particularly the subpar spending on research and development does not augur for a pick-up in productivity growth anytime soon.

The combination of weak productivity and slower growth in the labor force can only lead to a downshifting in the longer-run growth potential of the U.S., underscoring the secular stagnation prospect put forward by such luminaries as Larry Summers. The Fed may not subscribe to this thesis but its latest forecast is certainly consistent with it. At the March meeting, the FOMC downgraded its GDP growth estimate for 2015 to a range of 2.3 to 2.7 percent from 2.6 – 3.0 percent at its December meeting. Likewise, the outlook for 2016 and 2017 was also lowered by 0.2 percentage points, with the mid-range estimate now put at 2.5 percent and 2.2 percent, respectively. If this forecast is realized, it means we will not see a 3 percent growth rate for any single year from 2005 through 2017 – a stretch of 12 years. To put this in perspective, prior to 2005, the U.S. has not experienced more than four consecutive years without at least one year of 3 percent growth, since the Great Depression in 1930-1933. If that's not secular stagnation, a new definition is needed.

The Conundrum Redux

Not surprisingly, the Fed also lowered its long-run interest rate forecast. A year ago, it thought that the long-term equilibrium federal funds rate, the rate consistent with full employment and stable inflation, was at 4 percent. That rate was reduced to 3.75 percent last June, and taken down another notch at the March meeting. Now the median long-run forecast is for a peak funds rate of 3.66 percent. Needless to say, the lowered interest rate forecast is a product not only of expected slower growth but also of lower inflation. The central tendency of the PCE inflation rate was marked down for 2015 and 2016, and the 2 percent target is not expected to be reached until late 2017.

In such a slow-growth, low-inflation environment, the markets' knee-jerk responses regarding the future "lift-off" date for the first rate increase, is completely irrational. True at some point the Fed will have to start its normalizing policy if only to assuage concerns over asset bubbles and possibly restore some leverage to fight the next recession.

Fears that the tightening cycle, whenever it starts, will lead to a spike in long-term rates and a bloodbath for bond investors reminiscent of 1994 is completely misguided. For one, it is improbable to think that the Fed will push up the federal funds rate as rapidly or as sharply as it has in past tightening cycles, when its main goal was to dampen growth and tame inflationary pressures. That's clearly not the challenge now, as the economy is far from overheating and reaching the 2 percent inflation target still remains a distant hope. We suspect that the Fed will depart from the pattern seen in previous tightening cycles of hiking the funds rate at each and every FOMC meeting until the economy shows signs of stability. What's more, once the Fed starts to lift short-term rates, don't expect bond yields to move in lockstep. Recall the so-called interest rate conundrum that perplexed the then Fed chair Greenspan in February 2005 when, despite hiking the funds rate by 150 basis points, bond yields continued to drift lower.

While the reasons may differ, we suspect that U.S. bond yields will resist the upward pull from a normalization of Fed policy. Ten years ago many believed it was a global savings glut that kept a lid on bond yields. This time the resistance will come from a multitude of forces. For certain, the pull of the strong dollar will continue to lure foreign capital into the U.S. markets, where returns will continue to outperform other currencies. The 2 percent yield on 10-year Treasuries still dwarfs that available on comparable maturities throughout the developed world, including Germany (0.2 percent), Japan (0.4 percent) and even the weak European sisters, Italy and Spain (each at 1.3 percent).

Another Debt Crisis Looming

Although the dollar has slipped from its peak relative to the euro, closing at 1.08 on March 30, most currency traders expect the greenback to resume its climb toward parity. Some even expect it to approach the 85 cents last seen in early 2002. To foreign investors, any appreciation in the dollar amplifies the return derived from the yield differential, thus boosting the total return obtained from a dollar-denominated debt holding. But the dollar also offers a safe haven at a time when the event and default risks around the world are proliferating. The threat of a euro upheaval still looms large, as a Grexit appears more than a nontrivial prospect in the months ahead. European leaders are downplaying the significance of such an event, but they are whistling in the wind, in our view. Once Greece exits, the ironclad bond of other currencies becomes unglued, raising the prospect of similar actions down the road when weak peripheral members like Italy, Spain and Portugal fail to meet budget and other austerity imperatives mandated by the German-led coalition of European leaders.

Keep in mind that the dollar appreciation comes in the wake of a huge buildup of dollar-denominated debt issued by foreign companies and governments in recent years, which now becomes more difficult to repay. According to the Bank for International Settlements, there is more than $9 trillion of dollar loans outside of the U.S. What's more, a big chunk of those loans are owed by emerging market nations and are backed by oil revenues, with a heavy concentration in the private sector. These borrowers are being hit with a double whammy – depreciating collateral and having to repay in more expensive dollars. Through our lens, this is a recipe for widespread defaults, layoffs and other cost-cutting measures that will only intensify slowing growth in Brazil and other developing nations. The Fed faces many headwinds in the months ahead, including the strong dollar, deteriorating global conditions and the threat of a debt crisis, not to mention the uncertain fate of the domestic economy. In this environment, investors, foreign and domestic, will continue to seek out quality assets, which are far more abundant in the U.S. than elsewhere.

Rates and Total Returns Quarterly And Annual Comparisons

U.S. Treasury Market	Yields (%)			Total Return (%)	
(Barclays TSY Bellwethers)	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
6-Mo. Bill	0.06	0.09	0.11	0.05	0.12
2-Yr. Note	0.42	0.68	0.56	0.50	0.97
5-Yr. Note	1.72	1.66	1.38	1.74	3.92
10-Yr. Note	2.72	2.17	1.93	2.60	9.91
30-Yr. Note	3.56	2.75	2.54	5.05	25.73

Municipal Bonds	Yields (%)			Total Return (%)	
	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
ML Rev 22+ Index	4.11	3.11	2.81	1.67	10.63
ML G.O. 22+ Index	3.73	2.74	2.60	1.69	11.03

Equities	Levels			US $ Terms (%)	
	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
S&P 500	1,872.34	2,058.90	2,067.89	0.95	12.69
DJIA	16,457.70	17,823.07	17,776.12	0.32	10.55
NIKKEI (Tokyo)	14,827.83	17,450.77	19,206.99	10.69	31.44

Commodities	US $			Percent Change (%)	
	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
COMEX Gold Active Monthly	1,283.40	1,184.86	1,183.68	-0.10	-7.77
CRB Future Com. Pr. Index*	304.67	229.96	211.86	-7.87	-30.46
West Texas Intermediate Crude ($ per bbl)	101.58	53.27	47.60	-10.64	-53.14

Currencies	Levels			Percent Change (%)	
	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
Yen	103.23	119.78	120.13	-0.29	-16.37
Sterling	1.66	1.56	1.48	-4.87	-10.84
Euro	1.38	1.21	1.07	-11.30	-22.24

Foreign Bond Markets	Levels			US $ Total Return (%)	
	3/31/2014	12/31/2014	3/31/2015	Last Quarter (1)	Last Year (2)
3-Mo. LIBOR DEM Fixing (3)	0.02	0.03	0.01	N/A	N/A
ML German 10-Yr.+ Bond Index	2.26	1.12	0.47	11.24	33.18
3-Mo. LIBOR Yen Fixing (3)	0.14	0.11	0.10	N/A	N/A
ML Japanese 10-Yr.+ Bond Index	1.22	0.82	0.89	-0.88	7.53

Source: Bloomberg Financial Data

Notes: 1) 12/31/2014 thru 3/31/2015 2)3/31/2014 thru 3/31/2015

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index