CAUBLE & HARRE
WEALTH MANAGEMENT

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July 2016 Market Overview

The markets provided some pre July 4th fireworks prior to quarter end. Before discussing their behavior, I wanted to begin this letter with some discussion on the economy. Over time, markets eventually follow the economy, but they are not always linked perfectly in time because markets can attempt to anticipate what is to come which can be quite different than the current state of affairs.

Since the financial crises, domestic GDP (Gross Domestic Profit) has grown at a slower pace on average than before. This slower rate of positive growth puts our economy in a state that is cruising closer to stall speed and a resulting recession. There is not a lot of cushion for things to slow without experiencing either a recession or the fear of a recession along with its accompanying reductions in stock market valuations.

Compared to an average real GDP Growth rate of 2.8% during the period between 1965 and 2016, real GDP growth has averaged 2.1% since the financial crisis (beginning the second quarter of 2009). It has declined further recently. The nominal growth rate was 2% in the third quarter of 2015, declining to 1.4% during the 4th quarter and 0.8% during the 1st quarter of this year. Subtracting inflation from these recent growth numbers results in skimpy real growth.

A slow growing economy has made it difficult for companies to grow their earnings over the last year or so. Why has GDP growth slowed? Growth in GDP is constrained by the growth in the labor force and whether the workers are being more or less productive with their time. If a company has the same number of workers, and each worker produces half as much as they used to, then productivity and growth will fall. Growth in the labor force is determined by changes in the working age population (impacted by demographics and immigration) and whether these people choose to enter the labor force.

Job creation has also been week with a paltry 25,000 jobs created last month, much below expectations. The unemployment rate seems healthy at 4.7%, but there are two things that make this measure too optimistic. First, the labor-force participation rates are at lows not seen since the 1970’s. Also, other measures that count underemployed workers reflect a less sanguine environment.

Companies’ willingness to invest their capital into new plants/products and markets is key to employment growth and productivity growth, and business investment has been terrible.

Historically, small business has been an important source of employment growth. Unfortunately, since 2009, Bureau of Labor Statistics show that the average pace of new business formation has fallen to its lowest level in at least 32 years. In the past, most net new jobs have come from small businesses. This has changed dramatically reflecting the negative impact of slower small business creation. In the 1980s, firms with fewer than 100 employees generated 58% of net new jobs. In the 1990s, that figure fell to 49% and has fallen further today to 31%.

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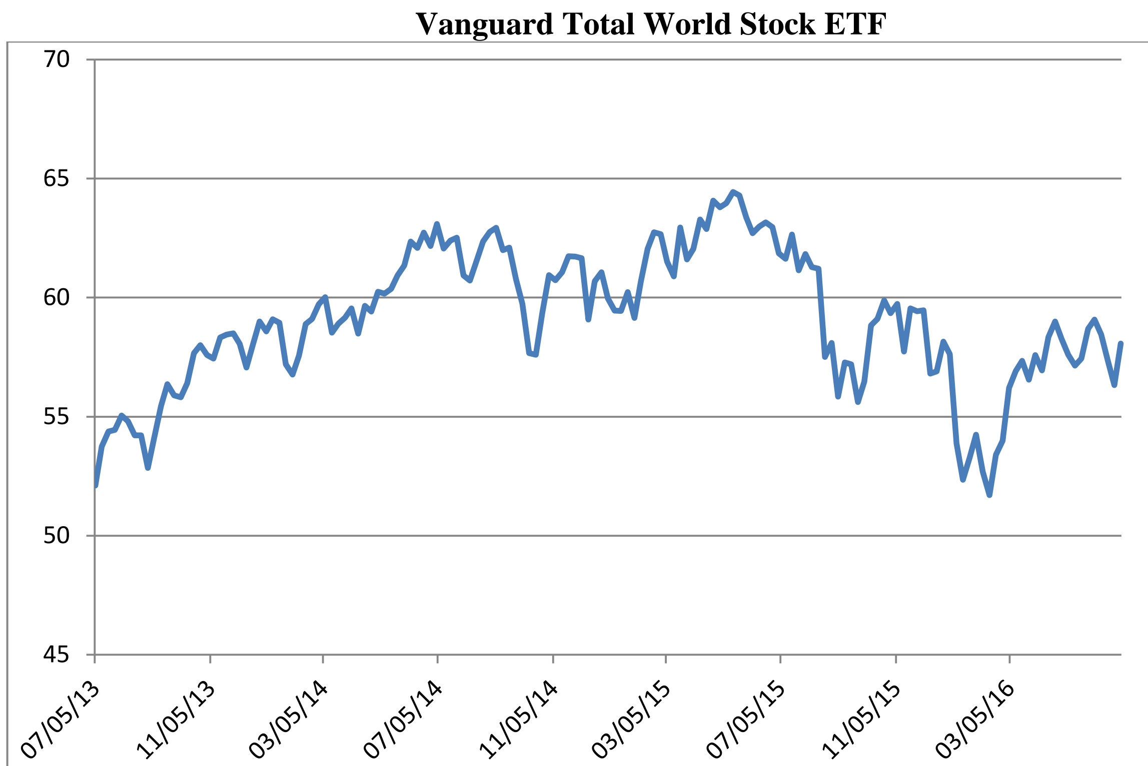
As mentioned before, our economy as measured by GDP growth has been in a weakened state since the financial crisis, and has shown even weaker growth in recent quarters. I would expect GDP growth to remain at a new lower level for some time going forward. The reason for this is an expected slower rate of growth in the labor force due to demographics, and a productivity slowdown that has proved difficult to solve.

Turning now to the markets, we note a domestic market that seems to be close to its high. Does this make sense in light of weak economic growth? Looking at results closer, we see a market that has experienced volatility but has not gained much over the last year. While we are close to highs, we cannot seem to make much progress moving beyond this point.

Looking at global markets, we see an even worse trend. It would seem that the U.S. market has been one of the only ones that has at least maintained its level from a year ago. Other markets are decidedly lower. Below is a graph of the Vanguard Total World Stock ETF, which includes the U.S. market.

Vanguard Total World Stock ETF



I suppose a key question would be is the U.S. leading the way to a flat market, or is it the last man standing before it too falls to lower levels? The S&P500 appreciated 3.89% in price terms during the first six months of this year, and 3.99% over the last 12 months in total return. This is more than 13% better than international markets (iShares EFA ETF which represents the EAFE index). Three sectors produced most of this gain this year: Utilities, Telecommunications and Consumer Staples (up 23.7%, 18.6% and 10.5% respectively as measured by the Vanguard ETF's VPU, VOX and VDC).

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These are typically sectors that investors run to when they become concerned about the markets. This might explain some of the dynamic, but I also think that it reflects a rush for dividend yield and I think that prices are being pushed to unsustainable levels.

I believe that we need to study the unprecedented actions of the world's central banks to begin to understand what has happened and anticipate where we might be headed. In my opinion, central banks have played a role over the last 8 years far beyond what they were intended to play, and we might be reaching a point where their effectiveness begins to be perceived differently, and a point where we begin to learn of and experience more of the unintended consequences from their actions.

Why have central banks stretched well beyond their traditional tool box and taken such significant actions and actions without historical precedent? While their role for significant action should have been temporary in nature, they did have a mandate to follow, and the failure of global fiscal authorities to take the baton from them and act with sufficient force caused the central banks to continue doing what they could. In the U.S., the ongoing failure of our Executive and Legislative branch to pursue pro-growth economic policies has left the Federal Reserve alone in its efforts to encourage economic growth.

Specifically what have they done? By acting as a significant purchaser of bonds, central banks have driven prices higher on many bonds, even to the point where the resulting yields become negative. This means that the central banks pay more for bonds then they know they will receive back in principal and interest payments. Because they have created trillions of dollars to buy so many securities, their buying drives prices up for everyone else that needs to buy bonds.

Consider the plight of insurance companies. These companies have made promises to pay certain amounts to policyholders over time. If they cannot earn a return on the assets that they are investing, they may fail to meet their obligations, and may fail as a firm. In Germany, where interest rates on 10-year government bonds are negative, regulators are concerned about the impact on life insurance companies. Reflecting this concern, the regulators recently stated that they can "only be sure the sector is safe through 2018." *WSJ April 15, 2016*.

A question I ask myself is how bad can things be presently, that a central bank will pursue a strategy that puts life insurance companies in jeopardy?

It is not just the European Central Bank. In Japan, where the central bank has orchestrated negative rates for some time, their biggest bank in June (Bank of Tokyo-Mitsubishi UFJ told the central bank that it might stop acting as a primary dealer of Japanese government bonds. Primary dealers in Japan are forced to bid on at least 4% of Government Bond auctions, so their stepping away from this function would represent a material vote of no confidence on the viability of Japanese bonds as an investment.

Not to be left out of the unique behavior club, consider the Swiss National Bank. Switzerland previously began creating money to purchase Euros in an effort to stall the appreciation of its currency. Because Switzerland was more fiscally sound, investors began putting their savings in Swiss francs, in order to maintain their purchasing power. The problem for Switzerland was that this action caused the franc to appreciate in value, making their exports much more expensive.

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If people were going to buy Swiss francs aggressively, then the Swiss National Bank was going to sell them aggressively. So they created a bunch of francs and then traded them for Euros. What is interesting is that it isn't just Euros' they have been buying. According to its latest 13-F form (a publically available form that you file with the U.S. SEC when you own a certain amount of stocks) the Swiss National Bank has purchased over $54 billion of U.S. stocks with the money that it created out of nothing.

Besides reducing the yield that other investors can earn on bonds, significant central bank buying also makes it possible for borrowers to continue to increase their borrowings with a low interest rate. Governments, including our own, have only been too happy to continue spending significantly more than they collect in revenue because the short term cost for doing so has not been significant yet.

All of this activity has not seemed to have caused a major problem yet. What is different now? Recent developments in Japan and Germany persuade me that we are closer to the end of the current central bank cycle, and that the 'end' is likely to include a period of greater uncertainty and volatility.

To date, for the most part, central bank action has given market participants a belief that things would be okay in the end; a belief that the central banks always had more tools that they could use to 'fix' things. But perhaps now that so many countries are experiencing negative rates on their government bonds, investors are beginning to question whether the central banks have run out of options and will subsequently lose the confidence of investors. With all the debt that has been created throughout the world, investors losing confidence in central bank planning would not be a good thing.

Negative rates do not seem to be a positive in major markets that are experiencing them. Japan's stock market fell 4.4% YTD, Germany fell 5.9%, Switzerland is down 2%% YTD and France is down 3.1% (as measured by the iShares EWJ, EWG, EWL and EWQ).

As corporate earnings have declined over the last four quarters, the U.S. market has seemed to maintain its valuation, albeit with greater levels of volatility. In fact, since the market is close to the same level as it was last year, but earnings have declined, the valuation (as measured by J.P. Morgan's calculated P/E ratio) is higher than it has been since 2003, when it was still working off its excessive valuation from the 2000 dot-com bust.

Either the market expects earnings to increase strongly or the U.S. market has become a destination for world investors looking to buy without regard to sustainable valuation. Earnings are expected to rise, but I fear that some of the recent gains can be explained by the latter.

What are we doing about all of this? We remain slightly underweight equities in general. We are underweight Telecom, Utilities and Consumer Staples, sectors that we think are overpriced.

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Because so much cash has been created, there is a risk for all currencies to lose value relative to real assets. Having some exposure to some combination of income producing real estate, oil, gold related assets or perhaps other commodities can help protect against this risk.

Interest rates, while low today, may experience increased levels of volatility if the world's central banks cannot maintain the same level of currency creation and bond buying that they have over the last few years. For this reason, we have been shifting more of the fixed income exposure to staggered maturities of individual bonds. By doing this, we can ignore some of the chaos that may come to the bond markets.

Finally, as market volatility picks up, opportunities can be created to purchase good long term assets at more attractive prices. We are always looking to do this. Please feel free to call us with any questions or concerns.

Regards,

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