## Global Economic Thoughts and Reflections

Our discussion in January revolved around a softer US economy than that perceived by the more hawkish Federal Reserve. The Fed has since changed its tune regarding interest rate hikes, though comments on April 8th were that everything is fine. If so, then the economy should be able to take another rate hike, correct? The Fed forecast is much higher than market expectations: the Overnight Index Swap (OIS) rate is around 1.25% two years out, while the FOMC discussion is around 3%. The Fed backed off after markets sold off so dramatically in the first 6 weeks, so don't expect another hike until June. I really question Janet Yellen's leadership. Does the Fed know what its mission is? Is it inflation, global economic issues, full employment or trying to keep markets from going down?

In other news oil recovered, but we wouldn't be overly optimistic about supply being absorbed. The US has added over 40 million barrels of crude stock over the last 12 months. We'll be watching.

The US still faces a number of headwinds – an aging population, a low savings rate, lower productivity, full employment (hard to grow from here) and a lack of pent-up demand. This has been evident in the total business sales year-over-year change being down 1.10% and total business profits being down 15% from a year earlier as reported by the Commerce Department. S&P profits are down about 14% from a year earlier (4th quarter profits are not completely in as of this writing). The consumer is beginning to make some headway, however. Compensation is up from 52.8% of GDP to 53.6%; plus a tight labor market gives employees a bit more bargaining power. I did mention that profit contraction is a catalyst for layoffs, and there was very slight evidence recently with the unemployment rate ticking up to 5%.

The European Central Bank (ECB) and the Bank of Japan (BoJ) have embarked on negative interest rate paths. This is a big change in 1st quarter for ECB. The ECB anticipates purchasing $1.0 trillion of corporate debt from banks in 2016. They are fighting strong deflationary forces overseas that will keep rates here from rising too much. A substantial rise in rates would bring an unwelcomed rise in the dollar. We discussed that dollar strength could shave off as much as 1.5% of GDP growth. The strong dollar is due to global weakness, not a robust US economy. The dollar has weakened recently, but it will take lower rates to keep it from regaining any steam. We expect the dollar will not retreat too much in 2016, but it is in its last leg of this multi-year bull market. This could put the Fed in a tough spot over the next year as inflation ticks up here in the US.

Core CPI was up 2.3% year-over-year for 12 months ending February 2016. Before we ring the inflation bell, we will need more evidence. Total CPI has been down for 3 straight months which includes food and energy. If you don't eat or buy gas, prices have increased. Ultimately, inflation will take a foothold. This could be years away, but weak productivity growth rates over the last decade will have an impact. Productivity has been declining for 15 years from 3% to below 2%. The last 7 years have been consistently below 2%. What are the short- and long-run implications? Over the short run, it is deflationary as lower productivity reduces consumption and investment. In the long run, underinvestment leads to lower capacity, which ultimately closes the output gap between actual and potential GDP. As potential and actual GDP get closer, capacity is more fully utilized and price pressures evolve.

My point is this: Just as in the 70s and early 80s when people thought interest rates would never go lower, we should also realize inflation or the business cycle hasn't been repealed. It just may be a much different timeframe than we had originally imagined.

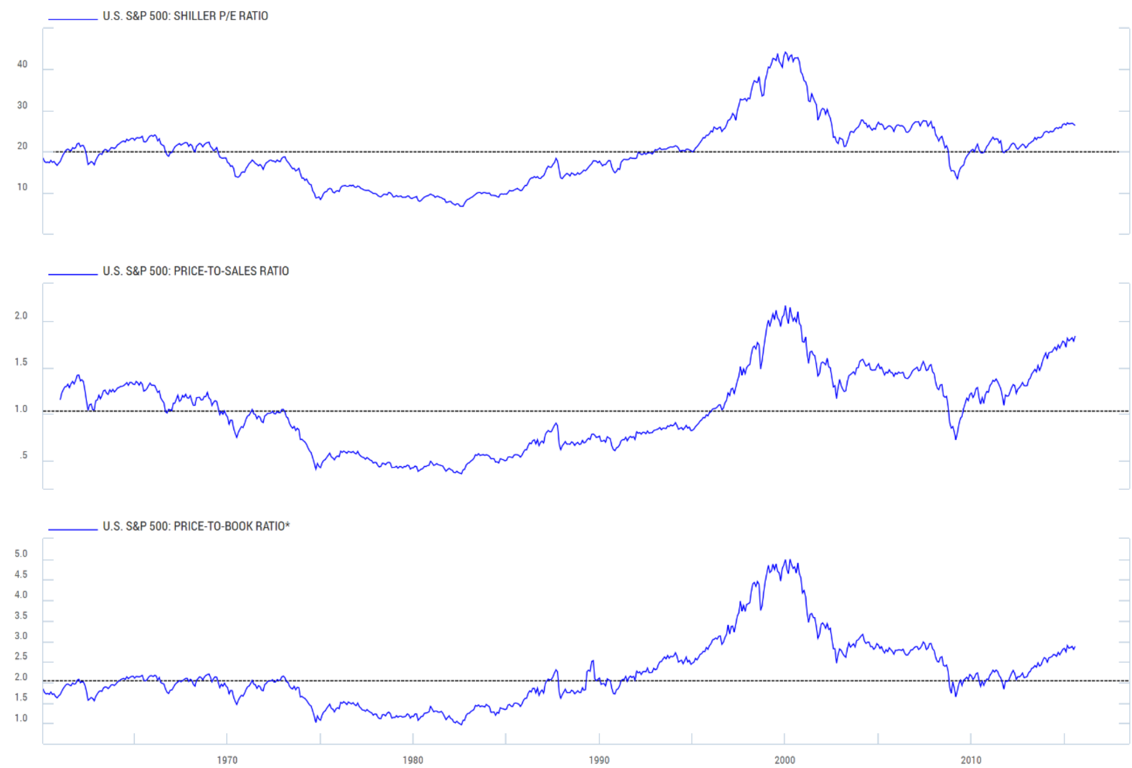
## Stocks

Here is the rundown. The S&P over the last 12 months has been the best performing with about 1.67% total return and over the last 9 months about 1.47% return. Over the last 9 months, foreign stocks are down about 9.63% and emerging markets are off close to 13%. Needless to say, this is one of those difficult periods when you prefer to just be on the sideline. Below are charts from last quarter's review. Not much has changed as stocks have mostly gone sideways the last 3 months, though it may feel much different with early sell-off and strong recovery over the last 6 weeks. Our quantitative model still forecasts lower compounded returns over the next 5 years of around 4% for US equities and close to 9% for foreign stocks. Our model is a 3-factor model using valuation and economic factors. Expected returns have a fair amount of variance and are never the actual returns realized. Within that 5-year forecast, a lot is going to happen!

Our opinion is that stocks will remain underweight until valuations and earnings improve. It is hard for us to get excited about the recent recovery in equities as profits and top-line sales continue to struggle. The US is the most overvalued space in our equity basket and continues to be a focus for underweighting.

BCA RESEARCH INC.

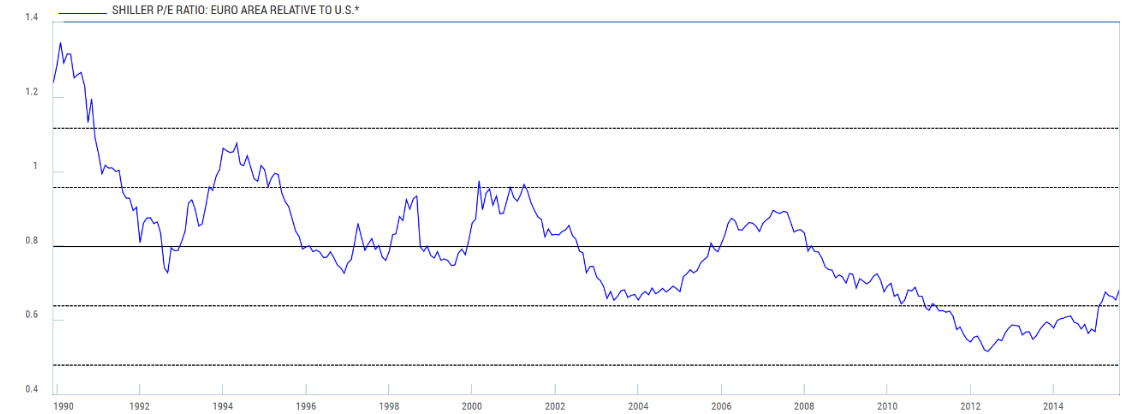
**U.S. Stock Market Valuation**




* EXCLUDING FINANCIALS, UTILITIES AND TRANSPORTS PRIOR TO 1977.

## BCA RESEARCH INC.

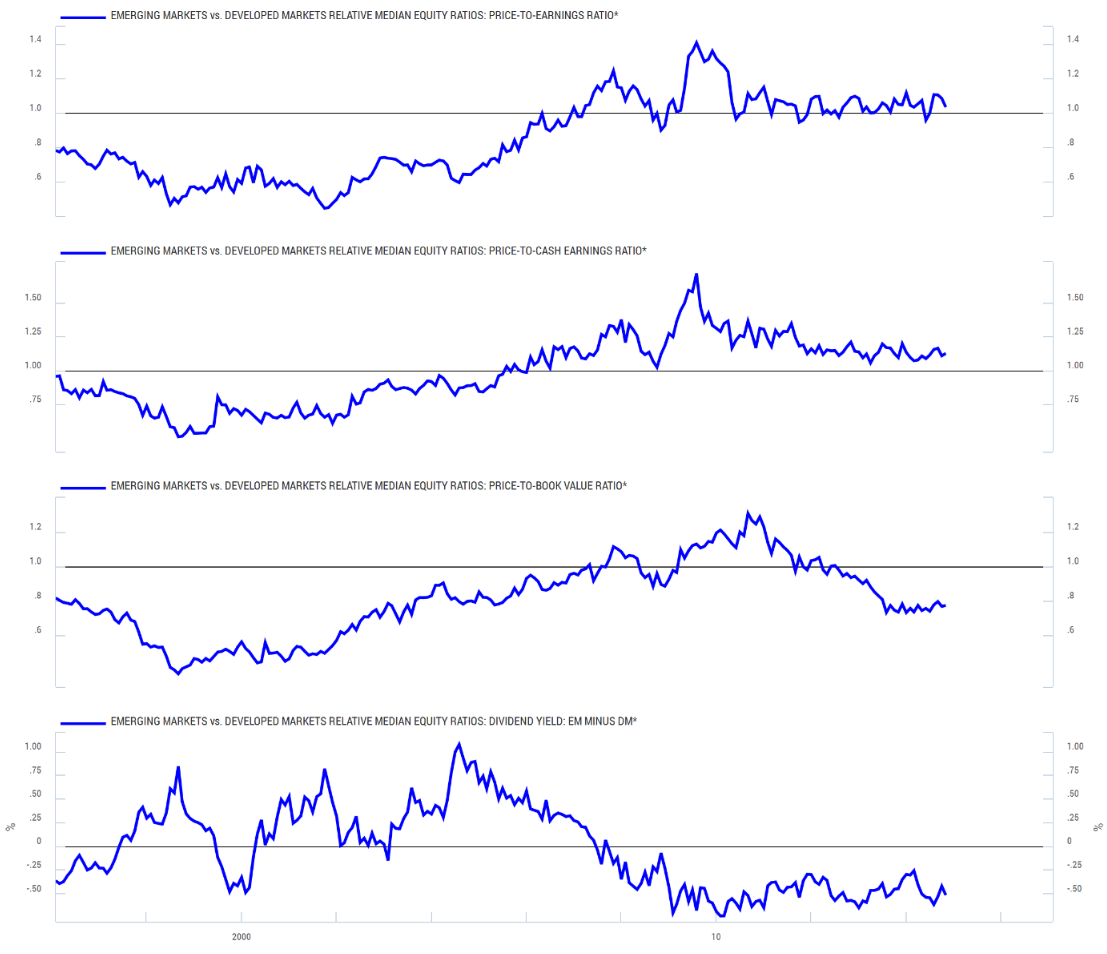
### Relative Equity Valuations: Euro Area Versus U.S.




* SOURCE: THOMSON REUTERS.

## BCA RESEARCH INC.

### EM Valuation Relative To Developed Markets

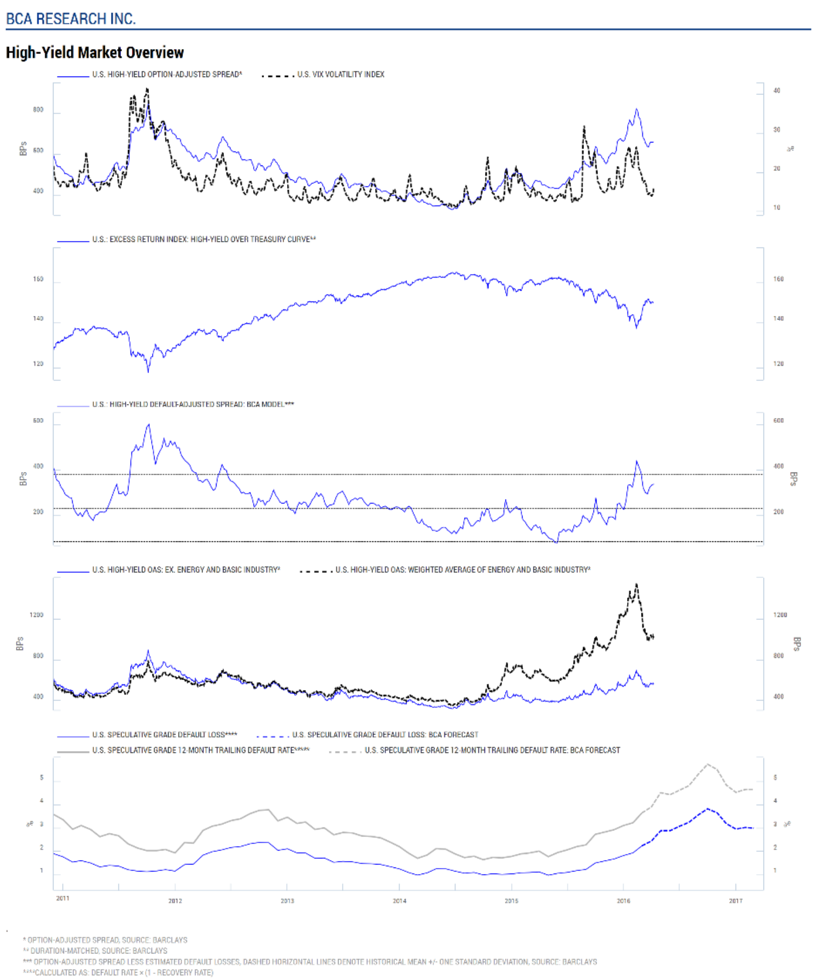



*INCLUDES 50 INDUSTRY GROUPS; SOURCE: MSCI Inc. (SEE COPYRIGHT DECLARATION)

## Bonds

The fact that this has been one of the best performing asset classes over the last 9 months is probably a bit of a shock to most. The Barclay's Bond Aggregate is up about 3.8%. The US 10-year treasury yield almost reached 1.5% in mid-February. As stocks have recovered, yields pushed up close to 2%. However, an odd thing took place during March. Yields have since come down to 1.7% on the 10-year Treasury note. Why is that? We think two reasons – global economic softness and the willingness of the ECB and BoJ to embark on a negative interest rate strategy. An amazing $7.0 trillion dollars of debt is now yielding less than zero! That means lenders are paying borrowers, a ridiculous and unsustainable arrangement! I have said before that we are living an experiment in monetary policy. There are ways out that don't have to end badly.

The high-yield market is down about 6.8% over the preceding 9 months. Energy companies are not out of the woods by any stretch with recent oil recovery. Investment banks are beginning to shut down new high-yield deals. The last year saw $1.4 trillion dollars' worth of new high-yield debt. The high-yield option adjusted spread has risen from a low of about 3.5% in 2014 to 7.11% and is now above its long-term average of 5.8%. Valuations have improved.



## Portfolio Concepts

There is good news and bad news on the portfolio front. Whenever has everything been working right in any portfolio! The bad news is that our relative overweight to foreign developed (FX) markets versus the US has not panned out well. We hold about 10% to 20% underweight in US versus FX. While not materially significant, so far not a great tactical decision.

Now for the good news. Our decision to be collectively underweight in stocks and overweight in fixed income has been particularly productive since initiating in the latter part of 2nd Q 2015. Additionally, we have been underweight in commodities and high yield, which have been off approximately 30% and 7% respectively. Our performance relative to our strategic allocation is positive, but still portfolio nominal returns are off.

We added a gold exchange traded fund to portfolios in the 1st quarter as part of our commodities allocation. We are in the early stages of a deleveraging process in emerging markets along with high valuations in US equities and fixed income globally. This coupled with an apparent shift in momentum for precious metals from a 5-year contraction makes this a positive addition.

I hear some grumbling about advisors and how happy people are (or aren't) with the recent period. There are periods of low and negative returns. They can even last for an extended period of time. To be a good investor, it takes patience and an understanding of risk-adjusted returns.

The recent rally in stocks has not caused us to vary in our portfolio structure. Valuations have actually deteriorated in that time span. We are looking at 2016 or early 2017 as period of transition for financial markets but making predictions of that kind are best left to entertainment shows like CNBC. Here is our current thinking on portfolios:

- Underweight to equities with a focus on looking for an opportunity to raise our FX exposure. Our preferred asset class is FX developed markets.
- Underweight high yield and corporate spread product. Valuations are becoming more interesting.
- Overweight fixed income, but look to reduce in 2016 should opportunities present themselves.
- Underweight commodities, but look to go neutral here as well.
- Neutral on real estate.

We made some major shifts in 2015 and until conditions meet our parameters, we will stay with our conviction. Conditions can change that cause us to change as well. It is important to keep in mind that being a long-term investor is not buy and hold. It is making a series of planned strategic short-term decisions to be successful. It is not short-term trading but continuously reviewing and rebalancing your portfolio. We are always concerned about our value-at-risk and become more sensitive to this issue when valuations are high.

We would welcome any input as to what you'd like to see or if you have some particular subject you'd like us to explore. Please feel free to contact me at my email below and I will get back to you.

harold@chasefield.co April 13, 2016

**Disclosure**

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