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Global Financial Markets Outlook

For Interest Rates, Currencies, Commodities and Stocks

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As you know, markets are driven by investment flows. Interest rates are the most important factor because bonds are the largest global asset class. Currency prices are the second most important factor for capital flows. A rising currency will attract international bond buyers, particularly to those interest rates that are higher on an inflation-adjusted basis. While commodities are driven by supply and demand over the long term, they can be affected by currency prices over the short term. Stocks generally follow business cycles, as expanding economies lead to rising earnings and stock prices. In periods of uncertainty, however, stocks can also be used as stores of value, as investors seek refuge from declining currency prices or sovereign government bond defaults. In the past decade, the normal investment cycle has been interrupted by central banks' quantitative easing (QE) programs. Their purchases have contributed to the misallocation of capital into bonds and interest-rate-sensitive assets. The analysis below examines these markets within the context of the current global economic environment.

Interest Rates

History has proven that all markets are cyclical. Interest rates rose for 35 years, from 1946 to 1981. Following the rise, they then declined for the next 35 years, reaching a low in mid-2016. But how can we be sure this truly was the low? History has revealed a natural progression of types of investors in every market cycle, and the involvement of these types of investors indicates where in the cycle a market is:

- At the beginning of the cycle, the investors are individuals who buy because the market offers great value. For example, in 1981, at the start of a new cycle, individual investors bought 10-year CDs offered at 20% and long-term Treasury bonds at more than 15%.
- Next in the cycle are endowments and foundations, which are required to distribute about 5% of their portfolio assets annually.
- Third in the progression are private pensions.
- Public pension plans are the final investors. Normally, there are no other buyers after public pension plans, so their appearance also marks the top of a market cycle.

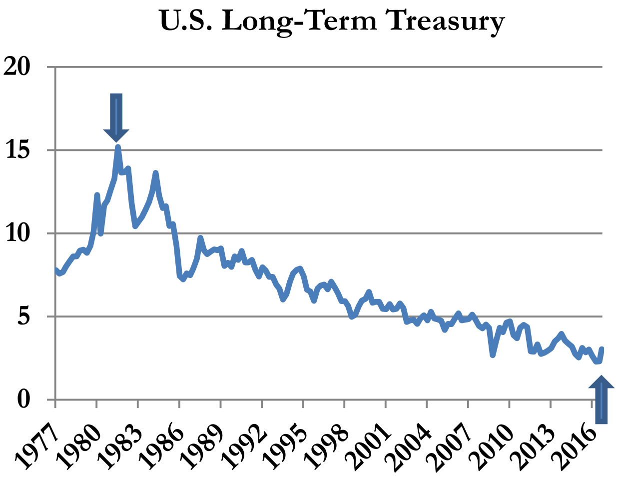
In the recent bond market rally, however, the central banks threw the historically predictable market cycle for a loop. They followed the public pension funds and bought bonds in the wake of the 2008 financial crisis in an effort to lower interest rates and stimulate economic growth. Interest rates, which were about 4.5% in 2008, plunged to 2.1% on 30-year Treasury bonds by mid-2016. Although the U.S. stopped its QE program in 2013, European and Japanese central banks continued their QE programs, which require them to buy $200 billion in government and corporate bonds monthly, or $2.5 trillion annually. At the end of June 2016, their continual buying led to more than $12 trillion in government bonds trading at negative interest rates, which is about 20% of the total outstanding. As a result, traditional investors moved to physical cash and other markets that offer positive returns, or to assets such as real estate that produce positive cash flows.

QE programs are inherently unstable for a number of reasons. First, governments continue to run deficits, which need to be financed. The accumulated interest on the deficits also needs to be financed because governments almost never pay down their debts. Ultralow interest rates have allowed countries to increase their debts substantially without incurring higher total interest costs to date. But the piper will have to be paid.

Another factor that contributes to QE programs' instability is the tendency of the markets to rise slowly and correct more rapidly. It would not be surprising to see a correction in the market over the next five years in order to bring interest rates up to levels that are more normal. Defining normal has become problematic. Initially, is it the level at which bonds traded before central banks first started their QE programs in late 2008? This would take long-term Treasury interest rates back up to 4.5%. Although markets correct quickly, they tend to overshoot. So would 6.5% to 7.5% interest, the level that pension plans need in order to meet their actuarial assumptions, be considered "normal"? Higher interest rates would rapidly increase costs because governments have significantly increased their borrowing in recent years. Some governments, particularly those in emerging markets that have borrowed some of their debt in U.S. dollars, could default.

Governments have a history of accumulating more debt than they can support. Argentina, for instance, has defaulted seven times in the past 200 years. Although no significant country defaults have occurred in the past 10 years, excess debt and rising interest rates could trigger one. Sovereign government defaults are likely to strike countries such as Venezuela and Greece, and they are also likely to plague a number of state, local and municipal governments in the U.S.

Furthermore, central banks are just now beginning to realize the unintended consequences of their actions. QEs created low interest rates that undermine the stability and viability of pension plans, insurance companies and banks, all of which need a steady flow of interest income to support their activities. Central banks now find it difficult to generate the income they need, so they have begun to buy common stocks to meet their financial return objectives.



Municipal governments now must consider the possibility that their overly generous benefit programs and wildly opportunistic assumptions about investment returns will create a pension crisis. For example, Illinois has only 37% and New Jersey has only 38% of the assets needed to meet their current municipal pension obligations, due in part to private companies' successful restructuring of their pension plans in bankruptcy.

Perhaps an even more striking example of a pension crisis occurred in the 1980s, when a number of U.S. sectors, including the steel, automotive, railroad and airline industries, suffered such serious employment declines that current employees could not support their predecessors' retirement benefits. Whole industries defaulted to restructure their pension plans and other debts. Unions, weakened by a loss of members, redoubled their efforts to organize state and local government employees. Governments proved to be a soft touch, readily agreeing to increase pension benefits and then passing the issue of their funding on to the succeeding administrations. This was not only an important step, but also a necessary one, because municipal employees were an integral part of the election campaign process. Compensation for government employees rose from 90% of their private-sector counterparts' compensation to 145%, with health and retirement accounts responsible for most of the additional costs. Generous benefits, as well as low interest rates and returns, have brought the pension crisis to a head.

Interest rates are also a key determinant of real estate prices because values are computed in relation to 10-year interest rates. Properties sold at lower capitalization rates are forcing new owners to raise rents to ensure a competitive economic return. Commercial and industrial U.S. real estate has become a staple for international public pension plans. Foreign public pension plans are likely the final buyers because they are benefiting from the rising value of the USD. Rising interest rates are likely to result in declining real estate investment values.

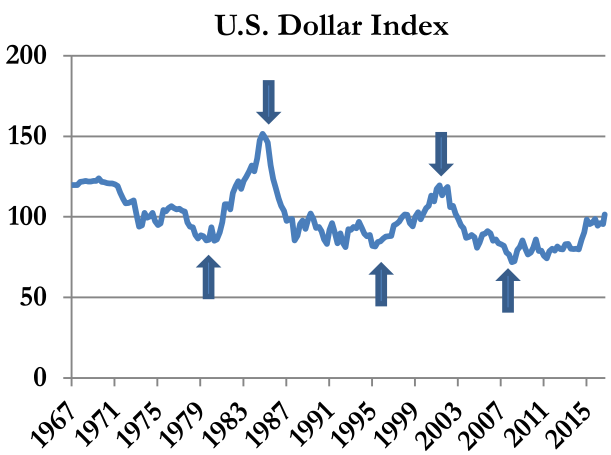
Strong U.S. Dollar

The U.S. Dollar Index (DXY), currently at 100, is in a strong rising pattern and is likely to exceed its 2001 high of 121. Currencies, like other financial markets, follow cyclical patterns and are driven by capital flows, which are attracted by investment opportunities.

In 1978, with inflation raging, the DXY hit a low of 82. Lack of domestic private investor interest in U.S. Treasuries forced the U.S. to sell its debt denominated in Deutsche Marks to international buyers. Interest rates rose in the early 1980s under Chairman Volcker's Federal Reserve (Fed) policies. He stanched inflation by raising interest to the highest real levels among developed countries. Capital flowed into the U.S., doubling the value of the DXY to 165 by early 1985. In September of that year, the Plaza Accord marked a coordinated intervention that halved the value of the DXY, which reached a low of 82 in 1992. A strong stock market, led by the Nasdaq and by technology, media and telecom stocks, brought strong capital flows back to the U.S., raising the DXY to its aforementioned high of 121 in 2001.

Beginning in 2000, the rising growth of the global middle class, particularly in Asia, led to a surge in resource investments in emerging markets, causing the DXY to fall to a low of 71 in fall 2008. China changed its economic policy in 2010 by moving from an export-led economy to a consumer-spending-led economy focused on developing its own infrastructure. This move led to a decline in commodity prices and a collapse in emerging market growth.

The DXY began its first significant rally in mid-2014, when Saudi Arabia decided to increase its oil production and claim a larger market share. As a result, oil prices fell from $90 per barrel in mid-2014 to a low of $27 per barrel in January 2016, coinciding with the end of the initial phase of the DXY rally. The U.S. had planned to raise interest rates in early 2016, but it postponed implementing this decision because of weakness in the U.S. stock market, and it postponed it another six times because of weakness in the foreign financial markets.



Meanwhile, other countries have experienced significant capital outflows. Although China has intervened to stem capital outflows, its foreign exchange reserves have shrunk from a peak of $4 trillion in 2014 to $3.2 trillion at the end of September 2016. Foreign central banks sold $375 billion of U.S. Treasury bonds over the past year to support their currencies and fund the outflows. These sales are responsible, in part, for the partial retracement of the U.S. dollar's gain in 2016. Declining currency valuations are one of the prime motivations for capital outflows. Investing in the assets of a country with a rising currency is like having the wind at your back, enhancing returns. Investors who are already attracted to higher U.S. interest rates are expected to begin moving an increasing amount of capital into U.S. financial markets.

Japan is facing its own crisis, having failed to stimulate economic growth since its stock market peaked in 1989. A stronger yen in 2016 undermined the Bank of Japan's efforts, so the country is now working diligently to weaken the yen, raise inflation and promote economic growth. Similarly, China is devaluing the yuan and restricting outflows to protect their foreign exchange reserves.

In Europe, the refugee crisis has brought the economic divide in the EU to a head. Germany has been the primary beneficiary of the EU since the union's creation, while less-industrialized countries, including Italy, Spain, Portugal and Greece, have suffered economically since becoming EU members. In June, Brexit rocked the EU, and now other European countries are debating their own referendums. The refugee crisis, along with weak economic growth in Europe, may well presage an end to the EU and the euro as they are currently constituted.

Donald Trump's presidency will bring with it a new U.S. economic policy with fewer growth-inhibiting regulations and an increased inward focus on manufacturing and infrastructure development. An immediate impact of Donald Trump's election can be seen in companies that had been considering outsourcing their production to Mexico, such as Carrier, but have now reassessed their plans. In addition, companies such as Apple's primary Chinese supplier, Foxconn, are said to be considering moving some of their production to the U.S. because wage rates are escalating quickly in China. These potential moves indicate that economic growth and opportunity for capital investment are likely to be better in the U.S. going forward, thereby creating a self-reinforcing cycle.

A strong rise in the USD is expected to result in lower dollar prices for bulk commodities because they can be offered by producers in countries with lower currency prices. The exception to this would be for metals that are in short supply and critical to clean-technology applications.

In summary, increased capital flows are expected to drive the DXY to at least 120 over the next two years. The euro is likely to decline to .80 and the Japanese yen to rise to 150 to the U.S. dollar over that time period. The U.S. dollar would rise significantly higher if emerging market countries and lesser European countries were to experience defaults or if the EU and/or the euro no longer offered the financial stability investors sought. Overall, conditions indicate the pump is primed for a significant U.S. dollar rally, a rise in U.S. interest rates and an increase in U.S. stock prices.

Bond and Stock Outlook:

There is a belief among long-term investors that bonds are safer than stocks are. This belief has been reinforced by a 35-year bull market in bond prices and the central banks' QE bond purchases. Central banks have stretched their balance sheets by buying bonds to levels that will challenge their resources to maintain orderly financial markets, their primary function. While the Fed stopped buying bonds in 2013, European and Japanese central banks have continued to buy, but it is becoming increasing apparent that their purchases will need to be wound down in 2017.

As 2016 draws to a close, the Fed was expected to raise interest rates before year-end. The Fed realizes that interest rates must be normalized in order to protect the financial integrity of pension plans, insurance companies and banks that are essential to the U.S. economy and its financial system.

There is an additional risk to the value of bonds as credit quality deteriorates. The rise in 30-year Treasury yields from 2.1% in July 2016 to 3.1% in December 2016 has already seen a 15% loss in bond value. A rise to 4.5%, the level that prevailed before QE started, would result in another 20% decline in price. However, the greater risk is credit, as many governments have taken on more debt than they can afford, particularly if maturing bonds need to be refinanced at higher interest rates. The issuers that are most at risk are emerging market countries that have borrowed in U.S. dollar. A rising U.S. dollar would make it more difficult to service their debts.

To mitigate credit risk, investors may prefer corporate bonds over government bonds. The difference between a default on a corporate bond and on a government bond is that there is a higher price recovery from corporations that are involved in reorganization or liquidation, whereas governments must continue to operate and may extend maturities and/or lower interest rates. In some cases, government defaults have resulted in a complete loss of principal.

Stock prices are generally driven by increased corporate earnings during an expansionary economic cycle. Growing concerns about currency stability or the safety of government bonds, however, can be a catalyst for stock purchases. This is because investors know that companies can survive economic disruption, while government debt and currencies might not. It is for this reason that people who live in economically weak EU countries are becoming concerned about the value of their currency.

An additional factor that influences the price of stock is taxes. Under Trump's plan, U.S. corporate taxes are expected to decline from 35% to about 15%. Lower taxes will translate into higher earnings, which will support higher dividends or increased stock buybacks. Corporate buybacks could also be enhanced by the repatriation of a portion of the $2.5 trillion currently being held offshore by corporations avoiding the 35% corporate tax. A low tax rate is expected to generate a substantial repatriation of funds, a portion of which is expected to be used for corporate stock repurchases, as they were in 2004.

Stocks at risk are large international corporations with a substantial portion of revenues derived from international sales. They may suffer from lower earnings, particularly if they are in a sector with strong international competition. Sectors that are sensitive to rising interest rates, like real estate, may also suffer as QE programs are unwound.

International investors will favor companies that are cash flow positive and focused on serving domestic customers. These would include companies that provide essential services and build infrastructure, which is expected to benefit from the U.S. government's proposed stimulus programs. Investors are also expected to favor companies with electronic, financial and clean technologies that reduce costs and improve services.

Conclusion

Looking ahead, the expected rise in interest rates and the USD, together with lower taxes and less regulation, are expected to be of great benefit to select sectors of the U.S. stock market.