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ASSET MANAGEMENT

"By the Way"
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There are two events taking place this week that could have a negative impact on financial markets. The FOMC meeting and the Scottish referendum. The Federal Reserve meets with three main items to update:

1. Projections for Fed funds rates into 2017;
2. The exit strategy for the balance sheet built up during quantitative easing; and
3. Possible change in forward guidance language.

The market knows QE is ending and rates will be increasing. The uncertainty is when the rate increases will take place. Watch the wording of the release carefully for signs the Fed is more hawkish than the market is anticipating; in particular if the words "considerable time" have been removed and policy is more data dependent.

The Scottish independence referendum takes place on September 18th. Most observers (including ourselves) assumed a "no" vote was almost a sure thing, until a recent poll showed the "yes" vote slightly ahead. Such polls are notoriously inaccurate, but did have the effect of putting downward pressure on the pound and moving the story to page one. A "yes" win would increase uncertainty in Europe and will be a negative for the U.K. economy, increase the risk of Britain exiting the EU, and encourage other independence movements such as the one in Catalonia, Spain. We hope and expect the "no" vote will prevail.

The European Central Bank has faced up to reality and introduced a policy of quantitative easing and lowered its main refinancing rate to 0.05%. The bank could no longer ignore Europe's worsening inflation expectations (deflation risk) and weakening growth momentum. The success of these new policies will play out over time, but the immediate effect has been to lower the price of the Euro.

Which brings us to a discussion of the U.S. dollar? Yogi Berra once said "you can observe a lot by watching". I'm confident he was trying to say if you pay attention you might learn something. I recommend keeping a close eye on the U.S. dollar as it will give an indication as to what is happening in financial markets and economies globally. The trade-weighted dollar bottomed in August, 2011 and is up 10% since; in particular the dollar has risen almost 8% versus the Euro since May of this year. Most analysts expect this rally to become a longer term trend (although a contrarian would note that those bearish on the Euro are down to 21%). Why is the dollar strong, and what are the investment implications if this is a new dollar bull market? The reason for strength is simple….demand, caused by the relative outperformance of the U.S. and the economic weakness and geopolitical uncertainties in the rest of the world. In addition, as the Fed moves towards monetary tightening while Europe begins to ease (as is Japan and possibly China), rate differentials cause an increase the flow of funds into the dollar. In anticipation of the change in Fed policy, two year U.S. Treasury Yields have broken out to the upside, five year rates look ready to follow, and ten years are up to 2.6% from a recent low of 2.4%. Yield spreads have widened between the U.S. and Europe, making an obvious carry trade of borrowing in Europe and buying in the U.S., which results in U.S. dollar strength. Still, this flow of funds will keep interest rates in the U.S. from rising too fast, and along with lower commodity prices, in particular oil, keep inflation at bay. Consequently, U.S. companies and consumers have lower costs and more money in their pockets. Therefore, we like U.S. companies that benefit from a stronger consumer or lower input costs. We are concerned about U.S. companies with large offshore revenues, such as McDonalds which gets about 40% of its revenues from Europe. We are wary of the so-called commodity countries like Australia, Russia and even Canada. These trends are in place currently, watching the U.S. dollar should give us an advanced warning of change.

Finally, geopolitical risk, particularly in the Ukraine and Middle East still threatens any positives.

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