# "By the Way"

## January 2015

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**Vice President**

Despite the recent rise in market volatility, 75% of the S&P 500 stocks remain in an uptrend, signaling the ongoing bull market is intact. However, it would be imprudent to ignore the volatility; as such an increase is often a precursor to a change in market direction. We will lay out here a watch list of factors which may help us decide which direction the market will take from here. Since the U.S. is our favorite market, much of the discussion will center on that country and its interaction with the rest of the world economies and markets.

### The FEDeral Reserve


Perhaps of most significance for investors is the timing and pace of an increase in regulated interest rates. The longer a zero rate policy continues, the more the FED backs itself into a corner. The FED realizes that the behavior and psychology of investors is distorted toward risk taking under the current policy. In addition, if the economy were to become weak again, there is no room to use rates as a tool to stimulate the economy. Taken in isolation, factors such as good GDP growth, low inflation, and decreasing unemployment would suggest raising rates immediately. However, there are still many factors that suggest it will be better to delay such a change in policy. The economy, while growing, is certainly not overheated; inflation is low, but there are concerns it is too low; and there is risk of "contagion" from the weak economies in the rest of the world. To that point, it is worth noting that FED Vice-Chairman Fischer ran the International Monetary Fund during the 1997 Asian crisis and the Russian default of 1998. He is very aware of the risks inherent in the interconnection between various global economies. We watch and wait but assume there will be a move by September.

### Europe – The Economy and Quantitative Easing


The European economy continues to stagnate, and the potential for deflation is increasing. Industrial production was negative (0.1%) in November, and the most recent 2014 estimates have Eurozone GDP growing at just 0.8%. On the deflation watch, headline CPI was actually negative (0.2%) at the last report. Youth unemployment in France is 25.4% in Italy 43.9%; and in Spain 53.5%. And while the U.S. frets over a "participation rate" of 62.7% (percent of population working or looking for work); Italy comes in at 49.8%. Everyone, with the exception of Germany, is looking toward the European Central Bank to begin injecting liquidity by buying bonds to stimulate the economy and fight off growth-crippling deflation. ECB Chair Draghi's so-called "open mouth operations" have worn out their welcome, and real action is being demanded. Without the support of Germany the Bank's commitment may be seen as weak, and lose much of its potential to promote growth. It remains questionable if a policy of QE will be that successful anyway. There is little guarantee the liquidity will be used for productive investment, but more likely hoarded in view of the weak economic environment. The economic weakness does not necessitate stock market weakness, especially if the influx of liquidity comes to pass.

### China

Chinese industrial production peaked most recently at 18% in 2010, averaged about 9½% through 2012 and 2013 and now is at 7.2%. The question is not whether the economy is growing more slowly, that is a given, but will there be a hard or soft landing. While the almost universal

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### Forward Looking Information and Disclaimer


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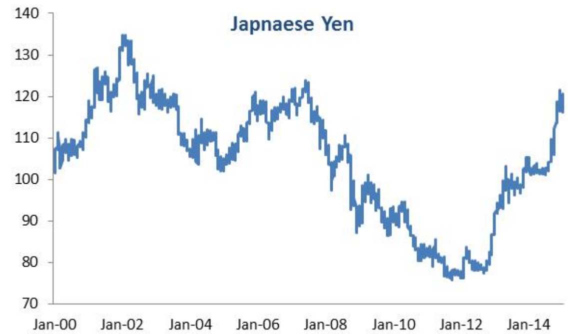
consensus is for a soft landing, other countries that have experienced rapid growth while becoming major global economies (such as 18$^{th}$ century USA) experienced periods of crisis and should raise one's skepticism. Pay attention to market forces such as the direction of the Yuan, not official government pronouncements, as a guide of China's future.




Japan

The world's third largest economy continues to fight the good fight to escape the 25 year stagnation of the economy and the specter of spiraling deflation. Prime Minister Abe won a comfortable majority in the recent snap election, and will continue the aggressive monetary policies. The Bank of Japan's assets are 57% of GDP as of September up from 34% only a year and a half ago when the policy was introduced. In comparison the FED stands at 25%. To this point the economy has not responded positively to the stimulus, and the Yen continues to fall. There is no indication the government intends to back down.

US

Despite all the weakness around the globe the U.S. economy continues to grow. The World Bank recently reduced its global economic outlook from 3.4% to 3% in 2015, but added the U.S. is "the one cylinder" working in the car. Still, the risk to the economy from foreign economic weakness must be monitored closely, and the effect of the crash in the price of oil is also a possible concern.

Oil

The effects of the price decline to the economies of countries such as Russia, Venezuela and Canada are obvious, so I won't belabor them. From a stock market point of view exposure to energy (a month ago) was: Canada 20.6%, UK 14.5%, China 13.6%, and the U.S. 8.0%. Therefore, the U.S. with almost 70% of its economy consumer related benefits the most and gets hurt the least by the lower price. But it is not immune to the effects of the decline, since the beginning of the financial crisis in 2008 nearly 80% of the non-farm payroll increase came from 9 "energy states" and the lion's share of that from Texas. What the result will be to the national economy remains to be seen. We do have a pretty good idea already about Alberta.

Canada

The oil debacle is somewhat offset by the improvement in the manufacturing sector given the decline in the Canadian dollar. Also the volume of energy products being exported is increasing. However, given Canada's energy, commodity, and trade dependence, the negatives seem to outweigh the positives in the current environment.

Geopolitical

Over the course of the current bull, the market has dismissed or disregarded many disturbing events that would have done severe damage to a less robust market. We should not become too complacent as there are still many potential crisis situations that could affect financial markets:

Russia – the global slowdown, low oil prices, and sanctions have crippled the economy,

Ukraine – not front page anymore, but not over either,

Europe – if Greece leaves the Union will others follow? Anti-European union parties are gathering strength in many countries,

U.S. Politics – can the Democrats and Republicans keep the peace and govern effectively,

China/Japan – tensions have escalated as China pushes for control of territorial waters and Japan passes record high military budget.

All of the above adds up to one being a more nervous and wary bull, prepared to change if required, but still a bull nonetheless.

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