Katonah Capital Group, LLC
BALANCE IN A CHANGING WORLD
Jason@KatonahCapitalGroup.com
80 Business Park Drive, Suite 304 • Armonk, NY 10504
p (914) 219-5880 • f (914) 273-6806

FIRST QUARTER 2016 INVESTMENT ADVISORY REPORT

THE GREAT REBALANCING or GREATER BUBBLE?

For the past two years the market (at least as represented by the S&P 500) has essentially gone sideways. The S&P closed on April 15 of this year at 2,080.73. On April 15th of 2015, the close was 2,106.63,[1] representing a negligible decline of 0.01% on a year over year basis. This otherwise uneventful performance belies the underlying volatility experienced along the way, as the S&P experienced sharp swings in between a range around 1825 at the lows and 2130 at the highs. In fact, according to Howard Silverblatt, Senior Index Analyst at Standard & Poor's, the 10.03% decline in the Dow Jones Industrial Averages at the start of the year was the worst decline since 1897 (-note: that is not a typo- and the S&P's 10.5% decline during the first 12 days of the year was second only to the 10.85% decline in 2009).[2] Equally impressive was the rebound off of the lows with the S&P gaining 6.6% in March alone – again, one of the best advances since perhaps the gains of 2009.[3]

Given our cautious stand on the markets for the past year, most of our portfolios performed well during the declines, but lagged during the rebound. We now find ourselves back up near the top of the trading ranges and while we still feel the evidence supports the argument that we're in, or entering into, a primary bear market, there are two items in particular that we are closely monitoring and which could cause us to change our tactical allocations.

First and foremost is our long favored barometer of "global-liquidity", the US Dollar (USD). There are of course many ways to measure the dollar – vs. the Euro, vs. gold, vs. a basket of various currencies, and so on - with each measure conveying different macro stories. Below are two data series from the Federal Reserve Bank of St. Louis showing the USD against a basket of other currencies based on the amount of trade conducted – i.e. a "trade weighted" index. [4,5]

[1] Data from Worden Bros. TC2000 Charting Service
[2] https://twitter.com/hsilverb/status/689834645962297344?ref_src=twsrc%5Etfw
[3] http://performance.morningstar.com/Performance/index-c/performance-return.action?t=SPX®ion=usa&culture=en-US
[4] https://research.stlouisfed.org/fred2/series/TWEXB
[5] https://research.stlouisfed.org/fred2/series/DTWEXM

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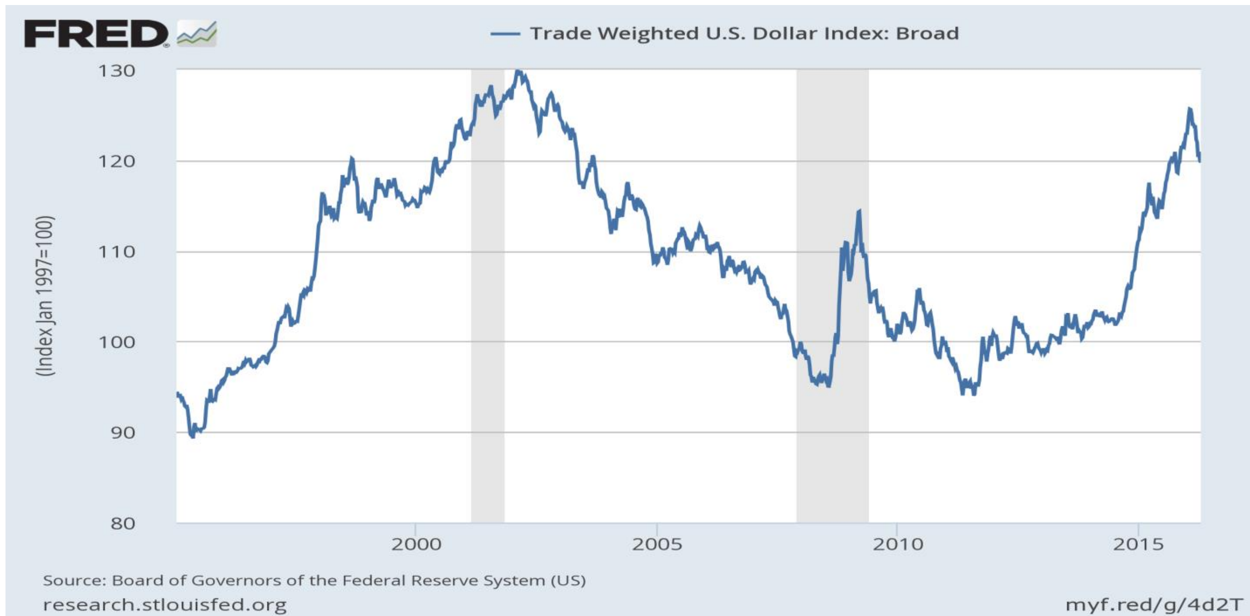
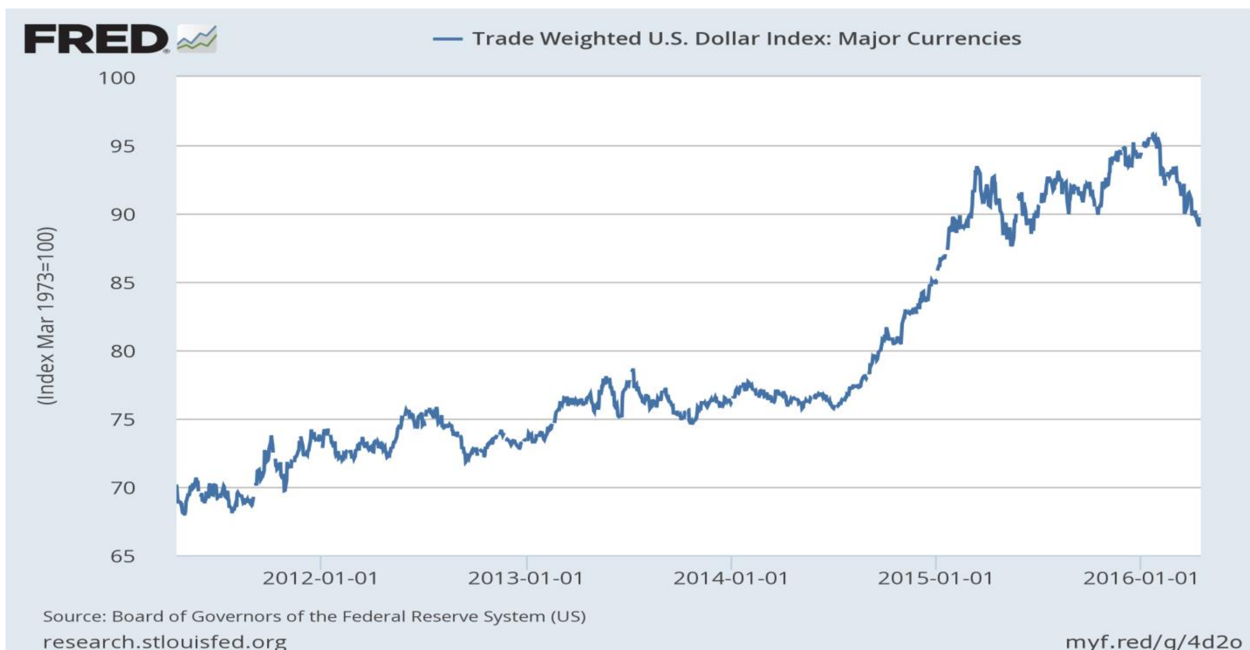


The first chart shows 20 years of data for a broad basket of the currencies of US trading partners vs. the USD. It clearly shows the steep run-up in the USD during the past few years. Note that previous run-ups and subsequent peaks in the USD were associated with recessions in the US (see the shaded areas on the chart around the 2001, and 2007-08 periods). Also note that recessions are always recognized and recorded in hindsight – not a prediction here, just an observation.



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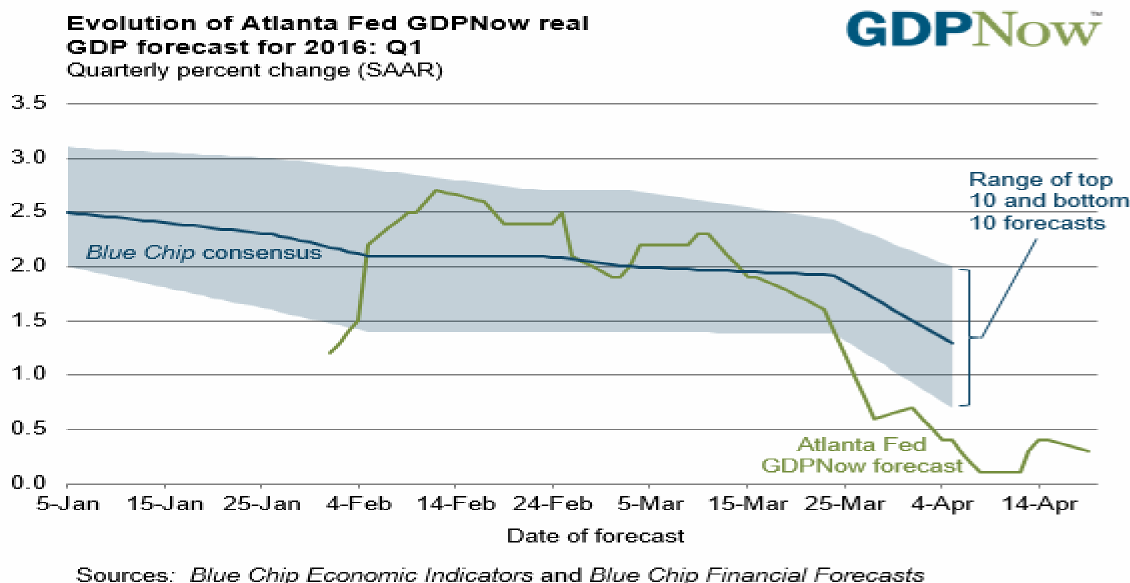
The second chart is a shorter term view showing 5 years of data for the USD against other major currencies. This shows an overall stalling of the USD rally, and a significant weakening in this most recent first quarter. This is something we're following extremely closely. A softer USD at this point reduces enormous stress from the global financial system. If the trend continues, it would mean a sea change in our view towards energy, basic materials and emerging markets. It is not difficult to envision a scenario of weak economic growth along with rising price pressures – particularly on production inputs such as basic raw materials and labor costs. In other words, "stagflation".

There does seem to be enough underlying pockets of strength in the domestic economy to argue against outright recession (defined as two quarters or more of negative growth). However, in past reports we've referenced the GDPNow series put out by the Atlanta Fed, and it's interesting to note that their forecast for GDP growth is currently scraping along just above zero![6]



The USD exchange rate, and foreign exchange rates in general, takes on added significance in this current environment. A weaker currency will typically spur exports and have thus become a significant monetary lever for generating growth. The primary tools traditionally used by central bankers to conduct monetary policy have involved interest rate adjustments. As you approach zero percent, lower interest rates become less and less effective in stimulating new economic growth. The concept of "negative interest rates" – now actually employed by the central banks in Europe and more recently Japan – is a phenomena that we find truly surreal, the final chapters of which have yet to be written. We will not explore this in depth here, other than to note that on January 29th, the Bank of Japan (BOJ) shocked the markets by announcing that they were going to begin a policy of ***charging banks*** 0.1% for excess reserves that the banks held with the BOJ – i.e. the banks would receive a negative interest rate![7]

[6] https://www.frbatlanta.org/cqer/research/gdpnow.aspx?panel=1
[7] http://www.reuters.com/article/japan-economy-boj-idUSKCN0VP08T

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One would expect this extreme act of monetary easing to significantly weaken the Yen. However, the reaction has been the exact opposite. According to Reuters, "In the 11 days since the BOJ board's announcement, the benchmark Nikkei index has fallen 8.5 percent...while the yen has climbed 6.5 percent against the dollar."[8] The chart below shows the Japanese Yen (JPY) vs. the USD.[9] A lower price means it takes fewer Yen to purchase one Dollar, or a stronger JPY. Note the sharp initial spike (drop) in the JPY on the day of the announcement, and the subsequent reversal back towards a strengthening Yen. Also note that the Yen had already been in a well-defined strengthening trend even before the announcement, despite the fact that the BOJ has been adding monetary stimulus for several years now.

A chart of the Euro would tell the same story. This past March, European Central Bank chief Mario Draghi announced dramatic Quantitative Easing measures which one would expect to weaken the Euro and boost European stock markets. Once again, the results boomeranged.

According to the UK Telegraph;

> "The European Central Bank has pulled out all the stops to avert a dangerous deflation-trap, launching a blast of triple stimulus despite angry criticism from Germany that it is entirely unnecessary and will do more harm than good.
>
> The markets reacted wildly to the package of measures, surging at first and then plummeting on creeping fears that the bank has exhausted its policy options and may be defenceless against a fresh shock.

[8] Op. cit. # 7

[9] http://www.barchart.com/charts/forex/%5EUSDJPY

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> Mario Draghi, the ECB's president, no longer seems able to conjure confidence with his former panache. His magic has, for now, deserted him."[10]

And, of course, you have the US Fed talking about actually tightening monetary policy, which would be expected to strengthen the USD, but as discussed, the opposite is occurring.

This has led many to question whether the central banks have "run out of bullets". According to Scott Minerd, the CIO at Guggenheim, "For the first time since the Great Depression, the world is in a global liquidity trap…The BOJ is buying almost all the Japanese government bonds that are issued every year, and has resorted to buying exchange traded funds to expand its balance sheet. The ECB continues to broaden the definition of assets that qualify for purchase, as sovereign debt alone cannot satisfy its appetite for QE. As options for further QE diminish, negative rates have become the shiny new toolkit of monetary policy orthodoxy."[11]

Focusing in on a metric called the "velocity of money" (see note below)[12], Minerd states that "There is a strong argument that when rates go negative it squeezes the speed at which money circulates through the economy, commonly referred to as the velocity of money…The empirical data support this view…Each dollar generates less and less economic activity, so policymakers pump more money into the system to generate growth…But, when monetary policy is the only game in town, negative rates are likely to beget even more negative rates, creating a perverse cycle with important implications for investors."[13]

Lacey Hunt and Van Hoisington elaborate on this point, looking at global economic growth, declining velocity and the inexorable build up in the levels of debt. In their recent Quarterly Review, they write "Velocity, or the turnover of money in the economy…constitutes a serious roadblock for central banks that are trying to implement policy actions to boost economic activity. Velocity has fallen dramatically (in Japan, China, the US, and the EU) since 1998 (see chart below).[14] Connecting the effects of over-indebtedness to velocity, they write "Functionally, many factors influence V (velocity) but ***productivity of debt is the key*** (emph. added). Money and debt are created simultaneously. If the debt produces a sustaining income stream to repay principal and interest, then velocity will rise since GDP will eventually increase by more than the initial borrowing. If the debt is a mixture of unproductive or counterproductive debt, then V will fall. Financing consumption does not generate new funds to meet servicing obligations. Thus, falling money growth and velocity are both symptoms of extreme over-indebtedness and non-productive debt."[15]

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[10] http://www.telegraph.co.uk/business/2016/03/10/the-most-difficult-central-bank-meeting-in-history-ecb-keeps-inv/

[11] Splurge on Negative Rates is Deepening the Global Liquidity Trap; Scott Minerd; FT; April 7, 2016; pg. 20

[12] According to the Federal Reserve Bank of St. Louis, "The **velocity of money** is the frequency at which one unit of currency is used to purchase domestically- produced goods and services within a given time period." (https://research.stlouisfed.org/fred2/series/M2V)

[13] Ibid. # 11

[14] http://www.hoisingtonmgt.com/pdf/HIM2016Q1NP.pdf; pgs. 4-5

[15] Op. cit. # 14

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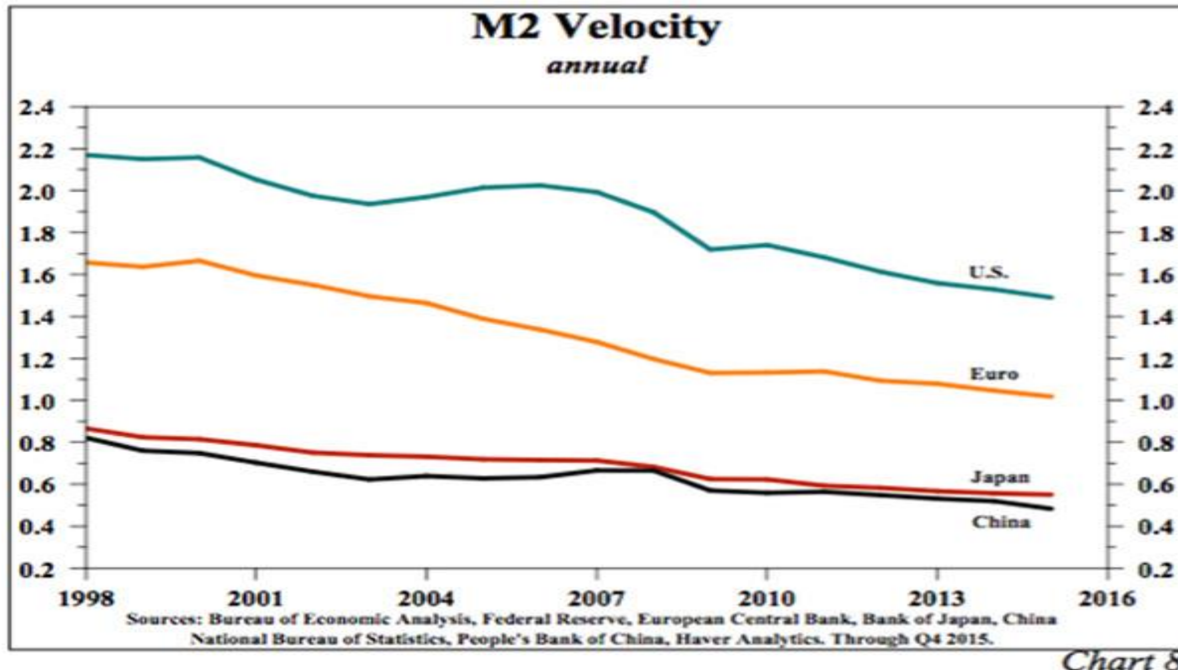

Commenting specifically on the US, Hoisington and Hunt write that "During the four and a half decades prior to 2000, it took about $1.70 of debt to generate $1.00 of GDP. Since 2000, however, when the nonfinancial debt-to-GDP ratio reached deleterious levels, it has taken on average, $3.30 of debt to generate $1.00 of GDP. This suggests that the type and efficiency of the new debt is increasingly non-productive.[16] They conclude that "…velocity appears to have dropped even faster in the first quarter of 2016 than in the fourth quarter of 2015. Thus, nominal GDP growth should slow to a 2.3% - 2.8% range for the year. The slower pace in nominal GDP would continue the 2014-15 pattern, when the rate of rise in nominal GDP decelerated from 3.9% to 3.1%. Such slow top line growth suggests that spurts in inflation will simply reduce real GDP growth and thus be transitory in nature.[17]

A simpler way of looking at this is the Jos. A. Bank analogy, created by Vitaliy Katsenelson. He writes,

> "Earlier this month Men's Wearhouse…owned up to the reality that Jos. A. Bank would have faced on its own if it had not been acquired: that the Jos. A. Bank brand is basically worthless. It was destroyed by endless sales… The irony of QE (ed. note; Quantitative Easing) or of Jos. A. Bank's marketing strategy is that neither started out as an indefinite adventure. QE 1 was launched as a way to restore liquidity and prevent a run on the banks in the midst of the financial crisis. QE 2 and the rest that followed were the Fed's attempt to engineer greater economic growth… What do we learn from Jos. A. Bank's sad story? Temporary-turned-permanent solutions may postpone the inevitable for a long time… But eventually, temporary-turned-permanent solutions lose their potency, as they are just papering over a core problem that they were never designed to solve, and that ugly reality comes to the surface. Ben Bernanke skillfully

[16] Ibid # 14; pg. 1
[17] Op. cit. # 14

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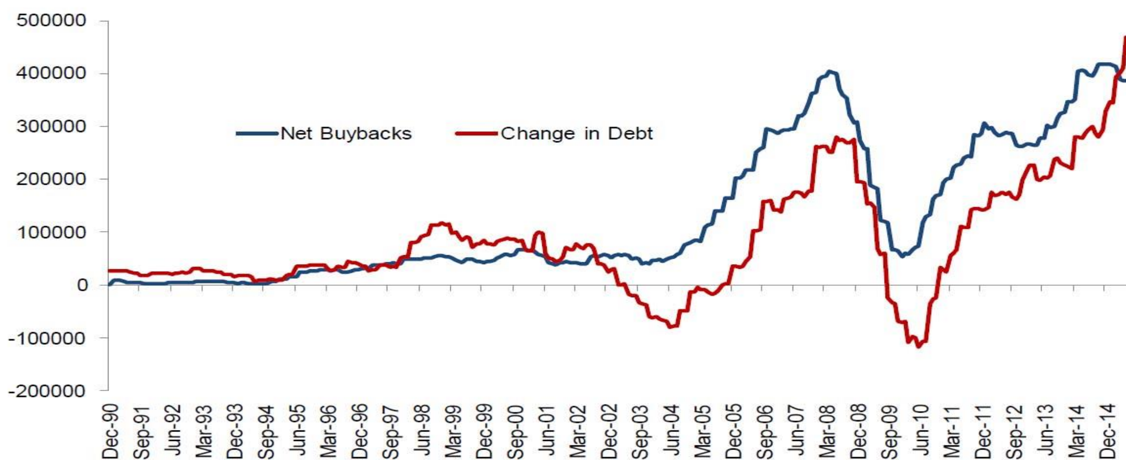
passed the Fed chair baton to Janet Yellen in 2014, but, as we learned with Jos. A. Bank, ownership of an unresolved problem doesn't change the problem.[18]

If the trillions in new liquidity provided by central banks have not gone towards generating organic economic growth, then the obvious question is what has the historically unprecedented expansion of central bank balance sheets actually accomplished. Much has been (and assuredly will be) written on this, but clearly a large portion of this has merely fueled company stock repurchases. Zero Hedge recently reprinted a chart from Societe General making this case:[19]

AND BUYBACKS ARE MAINLY FUNDED BY DEBT

Net buybacks and change in debt from US companies report and account



Source: SG Cross Asset Research/Equity Quant, MSCI

Zero Hedge writes; "The chart (above) shows something *absolutely amazing*: while there are clearly other fungible "*sources and uses of funds*", what all the leveraging activity of the current century boils down to is the following: **virtually every single dollar raised through issuance of debt has been used for one thing - to buyback stock!**

"To be sure, other sources and uses of cash can be comparably tracked, and this is not to say that companies haven't used their own organic cash creation, declining as it may be, for other purposes such as spending on CapEx and M&A, but the chart does show that in isolation from all other sources and uses of funds, several trillion in ***fungible*** debt has had just one simple use - to boost stock prices, and to

[18] http://www.institutionalinvestor.com/blogarticle/3541354/blog/jos-a-bank-and-the-folly-of-quantitative-easing.html#.VyE2zdQrJhE

[19] http://www.zerohedge.com/news/2015-11-12/amazing-chart-showing-what-all-debt-issued-21st-century-has-been-used

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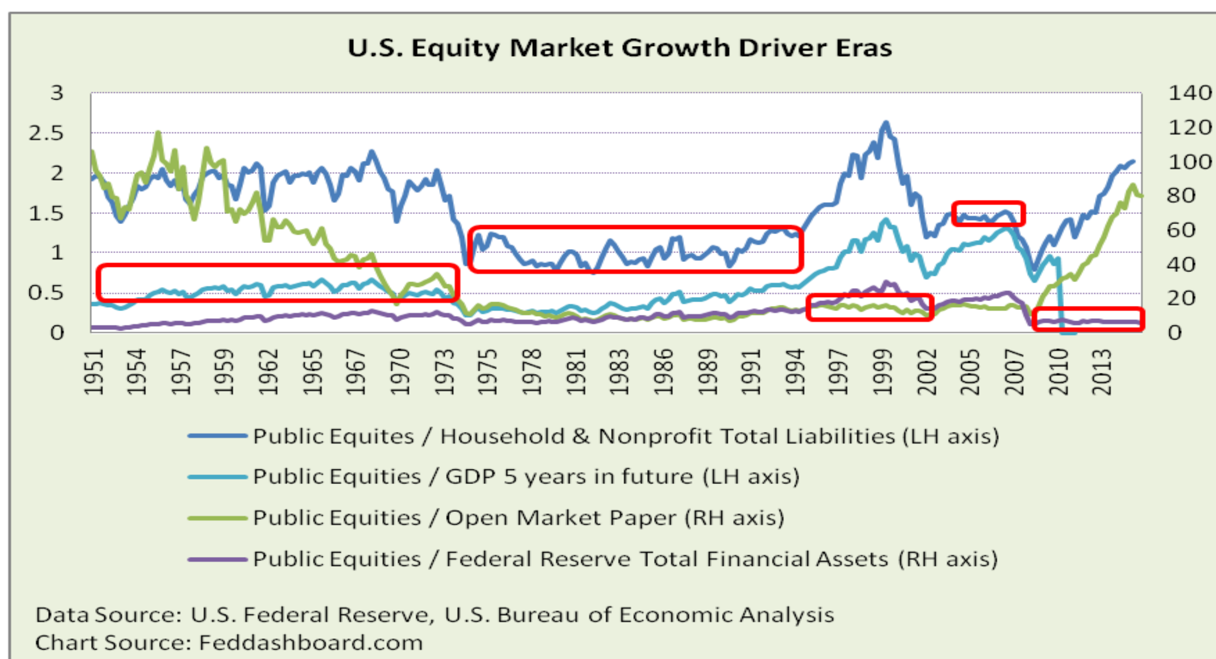
make management teams richer, while letting bondholders managing other people's money foot the bill for record high management bonuses and stock prices."[20]

In fact, work by economist Brian Barnier, founder of [FedDashboard.com](http://feddashboard.com/), concludes that ***93% of the entire stock market move since 2008 was caused by the Fed***![21] Barnier first gathered data for the total value of publicly-traded U.S. stocks since 1950. He also looked at hundreds of different economic factors and graphed each one against the stock market performance (i.e. stock market performance was the numerator and the economic factor was the denominator). If the resulting chart was flat, this implied that both the economic factor and the stock market were changing at the same rate. Barnier also uses regression analysis to help determine which factor generated a "best fit" explanation for causing stock market trends. Causality is debatable, but the factors generating the most robust correlation include data series such as household debt, future economic growth rates, credit issuance, and the Federal Reserve's balance sheet. Even if the causality is questionable, the correlation is not, and clearly there are central key factors at work here. The chart below shows Barnier's work. The "flat-line" areas outlined in red highlight the "best fit" factors driving stock market returns over various time periods.



So, for example, during the 70's and 80's, Barnier's work shows that 95% of the stock market's movements were explained by changes in Household Liabilities. During this time, increased consumer use of credit cards and mortgages for home purchases fueled increases in consumer debt. This lasted until the real estate crash of the early '90's. As for the current period, according to reporting on this from Yahoo Finance, "Barnier sees the Fed as responsible for over 93% of the market from the start of QE until today. During the first half of 2013, the Fed caused the entire market's growth… Since the Fed

[20] Ibid. # 19

[21] http://feddashboard.com/

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stopped buying bonds in late 2014, the S&P 500 has been batted around in a 16% range and is more or less where it was when the QE came to a close. Investors need to anticipate the next driver, said Barnier. '***Quantitative easing has stopped, but now we're into the interest rate world,' he said. 'That means for any investor trying to figure out what to do, step one is starting with a macro strategy*** (emph. added)***.***'"[22]

We could not agree more, and macro strategy is where our research always begins. (However, I think we'd replace "interest rate world" with the foreign exchange rate world). The other major piece to this macro puzzle - and the second item we're closely monitoring - is the Chinese markets and the exchange rate of their currency, the Yuan (CNY). In past reports we've discussed China's debt build up and their attempt to restructure away from an export oriented / manufacturing based economy to a more domestic consumption / service based economy. China's determination to see this adjustment through caused tremendous disruption, both domestically as well as in the entire emerging market space. As capital began to flee China, the Chinese central bank (PBOC) was forced to draw down nearly $1trillion of its foreign exchange reserves in order to defend their currency and offset an identical level of capital outflows.[23] Clearly, the Chinese authorities have blinked. In the past quarter or so, they have backed away from this stance and have aggressively attempted to re-liquefy their economy. This policy shift has coincided with the recent weakening of the USD, and has led some pundits to claim that global central bankers struck some sort of accord during a G-20 meeting in Shanghai in February.[24]

While generally steering clear of conspiracy theories, we find ourselves sympathetic to the speculation that there was indeed some sort of "Shanghai Accord" reached. Whatever the case, the Chinese policy was effective – at least for this past quarter. According to the FT, "China's foreign exchange reserves rose in March for the first time in five months, as the value of the renminbi (CNY) gradually increased and the country's manufacturing sector stabilised."[25] Michael Shaoul, from Marketfield Asset Management recently wrote "China's monetary and credit data can only be described as buoyant…the trends towards looser credit conditions and faster money supply growth now seem to be well established…Overall Aggregate Financing for March was 2,340 bn CNY, blowing through estimates of 1,400 bn CNY and the 5th strongest month on record." Shaoul writes "Monetary data was as strong as was credit, with M1 surging 4.86% MoM and 22.1% YoY… We like to use the spread between M1 and M2 as a rough proxy for the looseness or tightness of monetary conditions in China. This spread was negative between January 2011 and September 2015 but has now moved up to 8.7%, the widest positive spread since May 2010." And, he concludes "Overall our sense is of an extremely aggressive effort to utilize both fiscal and monetary stimulus in an attempt to stabilize the economy…the overall effect is bullish for China and China related asset prices."[26]

However, not all observers are so sanguine. IBD recently carried a column entitled "China Stimulating Global Economy, but For How Long?" They report "But even setting aside the usual doubts about whether Chinese economic statistics can be trusted, some analysts worry that increasing financial

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[22] http://finance.yahoo.com/news/the-fed-caused-93--of-the-entire-stock-market-s-move-since-2008--analysis-194426366.html#
[23] A Currency Affair; Up & Down Wall Street; Barron's; January 11, 2016; pg. 7
[24] http://www.marketwatch.com/story/did-central-bankers-make-a-secret-deal-to-drive-markets-this-rumor-says-yes-2016-03-18
[25] China's Forex Reserves Rise for First Time in 5 Months; Financial Times; April 8, 2016; pg. 6
[26] The Daily Speculator; by Michael Shaoul; Marketfield Asset Management; April 15, 2016

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leverage and escalating real estate prices are propping up China's economy."[27] The FT reports that "Beijing is juggling spending to support short-term growth and deleveraging to ward off long-term financial risk. But as fears of a hard landing have intensified, it has recently shifted decisively towards stimulus…There is agreement that the health of the economy is at risk. Where opinion is divided is on how this will play out. At one end of the spectrum is acute financial crisis – a "Lehman moment" reminiscent of the US in 2008, when banks failed and paralysed credit markets. Other economists predict a chronic, Japan-style malaise in which growth slows for years or even decades."[28]

The FT continues, "While the absolute size of China's debt load is a concern, more worrying is the speed at which it has accumulated…'Every major country with a rapid increase in debt has experienced either a financial crisis or a prolonged slowdown in GDP growth' Ha Jiming, Goldman Sachs chief investment strategist wrote in a report this year."[29] And, China's problems extend to the broader Emerging Market (EM) space. Although outflows from EM economies are expected to be less severe in 2016 than experienced last year, observers are still expecting around $500 billion of capital to flow out.[30] As a result of this stress, the World Bank has seen their lending to cash strapped EM economies increase to the highest level since the 2008 financial crisis.[31] And, all of this is unfolding in an environment where global trade has been slowing and is set to mark its fifth consecutive year of sub-par growth. Reporting on recently released forecasts of global trade by the World Trade Organization (WTO), the FT writes that "The global economy will see its fifth consecutive year of below-par growth in international trade this year, marking its worst period since the 1980'…'Such a long, uninterrupted spell of slow but positive trade growth is unprecedented,' WTO economists wrote."[32]

So, while we're continuously on the lookout for "green shoots" of increased economic growth, trade, and other signs of increased global demand, we remain very sympathetic to Hunt and Hoisington's thinking regarding the "productivity of debt", and the current lack thereof. We also continue to embrace Warren Buffet's first two most important rules of investing which are; rule #1, don't lose your principle and rule # 2, never forget rule #1. Consequently, at least as of this writing and in terms of risk versus expected reward, we continue to feel that cash offers compelling value here and we remain underweight risk and risk assets. Thanks for reading and, as always, please don't hesitate to contact us with any questions.

Regards,

Jason Waxler

[27] China Stimulating Global Economy, But For How Long?; Investor's Business Daily; April 18, 2016; pg.1
[28] Rapid Climb in China's Debt Raises Concern Over Economy; FT; April 25, 2016; pg. 3
[29] Ibid. # 28
[30] Ems Braced for $500bn in Net Outflows; FT; April 9-10, 2016; pg. 13
[31] World Bank Loans at Record Level Since Financial Crisis; FT; April 11, 2016; pg. 3
[32] Global Trade set for Fifth Year of Slow Growth; FT; April 8, 2016; pg.6

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FIRST QUARTER 2016 INDEX REVIEW[33]		
U.S. Stock Market	***Q1 2016***	
Dow Jones Industrial Average	2.20 %	
S&P 500 Index	1.35	
Nasdaq Composite Index	-2.75	
S&P MidCap 400 Index	3.78	
Russell 2000 Index	-1.52	
U.S. Bond Market	***Q1 2016***	***YTD***
Barclays U.S. Aggregate Bond Index	3.03%	3.03%
Credit Suisse High Yield Index	3.11	3.11
Barclays Municipal Bond Index	1.67	1.67
Barclays Global Aggregate Ex-U.S. Dollar Bond Index	8.26	8.26
J.P. Morgan Emerging Markets Bond Index Global Diversified	5.04	5.04
International Indexes	**Total Return**	
MSCI Index	***Q1***	
EAFE (Europe, Australasia, Far East)	-2.88%	
All Country World ex-U.S.A.	-0.26	
Europe	-2.37	
Japan	-6.38	
All Country Asia ex-Japan	1.80	
EM (Emerging Markets)	5.57	

[33] https://www4.troweprice.com/gis/fai/us/en/insights/articles/2016/q1/quarterly-market-review.html

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