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BALANCE IN A CHANGING WORLD
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THIRD QUARTER 2015 INVESTMENT ADVISORY REPORT

I Fought the Fed and the Fed Won!

The past quarter ending September 30 saw US and global equity markets endure their sharpest quarterly decline in four years. The S&P 500 fared the best, with "only" a 6.44% drop over the 3 month period (See Market Returns Data on the last page).[1] This compares with US small company stocks (as measured by the Russell 2000 index) which dropped 11.92% and the EAFE (Europe, Australasia, Far East) which lost.10.19%. Emerging Markets lost 17.78% paced by a 24.25% decline in the Latin American index.[2]

Past reports have repeatedly discussed the dual phenomenon of the strengthening US dollar (USD) and its mirror images - the unwinding of both a decade of emerging markets (EM) growth and a commodity "supercycle". These two latter trends were fueled, in turn, by the years of hyper-economic growth experienced by China. We have held virtually zero exposure to the EM and commodities markets, and minimal exposure to small-cap stocks. As a result, our portfolios fared relatively well during the quarter.

As of this writing, and in hindsight, we should have left well enough alone. By late summer we became increasingly concerned about the deterioration in the technical condition of the markets and by capital outflows from China and the EM region and consequently became even more defensive. However, shortly thereafter, ECB President Mario Draghi spoke out promising stronger monetary stimulus. As described in a commentary in the UK Telegraph, "It would appear that a Eurozone quantitative easing programme running to €1,100bn (£795bn) isn't enough. Having churned out €60bn of virtually printed money a month since March, and committed to maintaining that pace until September 2016, Draghi has now signaled there's likely to be even more"[3]. The result, according to this columnist, is "QE-to-Infinity is pumping up equity and bond markets, blowing an even bigger bubble than that which led to the Lehman

[1] http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups
[2] Ibid. #1
[3] http://www.telegraph.co.uk/finance/comment/11952876/Mario-Draghi-gives-the-V-sign-but-a-dangerous-QE-day-looms.html

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collapse". Perhaps, but in any case, the next day the Peoples Bank of China (PBOC) dropped their interest rates, continuing a series of rate cuts that in the past year have lowered their benchmark one-year lending rate from 6% down to the current 4.35%[4]. By this point, the markets had become fairly oversold, pessimism reached extremes, and the markets had already begun to rebound.

It should be noted that interest rates are *already negative* across a wide swath of Europe. Denmark eased rates below zero in 2012 and the key bank rate is currently at *minus* -0.75%. Sweden's rate is at –0.35% and Switzerland has had their rate pegged at –0.75% almost all year.[5] Currently, there are fourteen individual European countries with negative 2-year bond yields.[6] Thus, it's not at all clear what more ECB QE is supposed to achieve, let alone what assets will be bought in order to achieve it.

In any case, the back to back easing moves by two of the major global Central Banks (and more is anticipated from the Bank of Japan when they meet at the end of October) set off an explosive rally in the equity markets. There's an old Wall Street adage that says "don't fight the Fed". In this case, I'm borrowing that concept and extending it to Central Banks in general, and hence, with apologies and all due respect to the Bobby Fuller Four, who in 1966 popularized the Sony Curtis song "I Fought the Law", I fought the Fed and the Fed (at least for now, has most certainly) won.

However, in examining the recent rally and economic conditions, our longer term view remains unchanged. We will discuss this briefly, below, but we first want to address an issue that arose in 2000, around 2008, and is being expressed again. The issue concerns "market timing". The comments expressed maintain that it's impossible to successfully "time" market ups and downs, so why bother even trying – just remain fully invested in a diversified portfolio and, over time, you'll be fine. We'd point out that diversification – at least over the past several years – has not worked quite as the academics might have expected and instead has been more of a strong hedge against profits as opposed to reducing overall volatility and portfolio risk! That notwithstanding, we strongly agree that market timing is a doomed strategy. However, that is very different than "*managing risk"* which is something that we believe strongly in, given that we view our primary mandate is to protect our client's principal from permanent impairment. Regardless of the short term swings in the market, there are a number of reasons why we think the risk/reward currently facing investors calls for a restrained approach with less exposure to equities and risk assets, and a greater amount of cash balances.

The first concern is technical in nature and can be seen in the three charts below – courtesy of Worden Brothers TC2000 - all as of the close of trading on Friday, October 23. The first chart is the S&P 500; next is an un-weighted, or equally weighted, version of the S&P 500; and the last chart is the Russell 2000 which is an index of smaller stocks. It is important to note that the

[4] http://www.tradingeconomics.com/china/interest-rate
[5] 'The Great Negative Rates Experiment"; Bloomberg Businessweek; October 26 – November 1, 2015; pg.15
[6] http://seekingalpha.com/article/3612376-the-undersea-world-of-negative-interest-rates

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S&P 500 is a “cap-weighted” index – i.e. is ranked by market capitalization (note: market cap = the price of the stock (x) the number of shares outstanding). So, a $1 change in the price of the stock of Apple Computer, with a market cap of $679 billion, has a hugely greater impact on the S&P index (or any cap-weighted index) than an equivalent move in the stock of, say, Hasbro or Staples, with market caps of around $8-9 billion.[7] The differences in the three charts are subtle, but significant, and can be seen by observing the most recent price movement (on the right side of the charts).

The first chart – the traditional, cap-weighted S&P 500 index – has significantly outperformed the second chart - the equal-weighted S&P 500 index. And, the equal-weighted S&P 500 has, in turn, outperformed the third chart – the Russell 2000 chart representing 2000 smaller company stocks.

The key takeaway here is the recent rally in the familiar “headline” indexes – such as the Dow Jones Industrials, or the S&P 500 – have really been driven by the performance of a small (and shrinking) group of very large stocks (read: Apple, Facebook, Google, Netflix, Amazon…) which, due to the nature of these cap-weighted indexes, have a disproportionately large influence on the overall index performance. A recent Barron’s column, citing Howard Silverblatt of Standard & Poor’s, observed that for the week ending October 23rd, while the entire S&P 500 *index* gained 2.1%, *roughly half of the index gain was accounted for by just three stocks* – Microsoft, Amazon and Alphabet (formerly known as Google).[8]

This same phenomenon is seen in the last chart of the Russell 2000 which, as its name suggests, is an index made up of 2000 individual stocks. These are stocks of smaller companies such as WellCare Health Plans, Buffalo Wild Wings, Janus Capital, Sotheby’s, or IMAX Theaters. According to data from Worden Brothers TC2000, this index was virtually unchanged over the same time period. Thus, if you owned any of the 2000 stocks in the Russell 2000, odds are, on average, that you read about huge gains in the “stock market”, but unless you owned Microsoft, Google or Amazon, you probably saw no gains in your own portfolios. If you owned thousands of other stocks, even larger “blue chip” names such as Walmart, IBM, Citigroup, Caterpillar, Procter & Gamble, Exxon, Halliburton, Merck, Goldman Sachs, Berkshire Hathaway, Johnson & Johnson…you’ve experienced losses in your portfolios for this year.

[7] Data on Market Capitalization from Morningstar.com
[8] “Harsh Realities May Stay the Fed’s Hand”; Barron’s; October 26, 2015; pg.7

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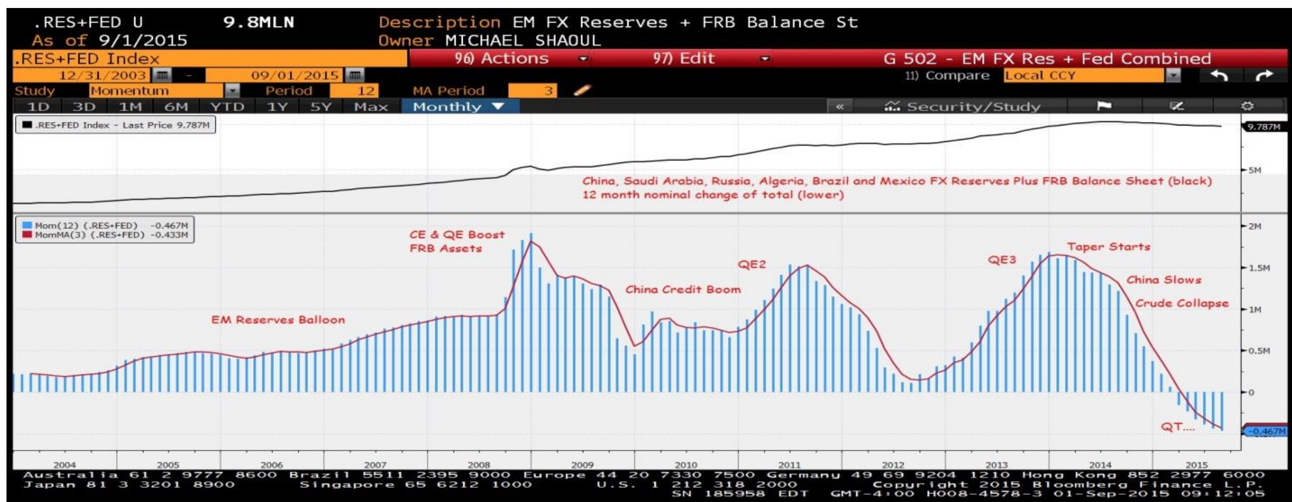
This deterioration in the broader market can be observed in a number of technical indicators. It is not the sign of a broad-based healthy market, but rather the type of action observed in aging bull markets that are in the process of putting in major cyclical tops. Further, this concentration of outperformance by a smaller and smaller group of large growth stocks can continue for a very long period of time, as witnessed in the NASDAQ bubble in 2000 and in the "Nifty Fifty" growth stocks in the '60's and early '70's. So admittedly, yes, the timing is difficult, and it's anyone's guess whether further Central bank easing will continue to prop up financial assets. However, as we constantly scour the investment landscape for signs of excess, mispricing or mere delusion, it strikes us that while it cannot be argued that there's euphoria in financial markets, there's clearly a "bubble mentality" that exists when it comes to having faith in governments and central bankers ability to "fix" what's wrong. We find that dangerously misguided and, as we argue below, rapidly approaching a testing point.

Essentially, it is our belief that despite the unprecedented quantities of monetary stimulus provided by world central bankers since the 2008 financial crisis, global liquidity is actually *contracting.* The chart below is the creation of the folks over at Marketfield Asset Management.[9]

It uses an index they developed that aggregates "FX reserves of China (31.9% of global total), Saudi Arabia (5.9%), Russia (2.7%), Algeria (1.3%), Brazil (3.2%), and Mexico (1.6%), which together represent just over 46% of global FX reserves at $5.3 trln."[10] Obviously, this is an arbitrary aggregate – it is biased towards oil/commodity exporters and excludes many other large reserve holders – but if you are a commodity producing country then this matters. It starkly depicts a world tipping into a contractionary monetary environment and *it represents capital flows that will no longer be recycled into our asset markets.*



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[9] "Global Correction and Quantitative Tightening"; Marketfield Daily Update; September 1, 2015, pg.1
[10] Op. Cit. # 7

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The global ramifications of this are so broad and profound that it's hard to know what to focus on first. Clearly, the 800 pound gorilla in the FX reserve playground is China. The composition of their reserves is a state secret, and thus the reporting of the totals is opaque, but as of last year, China's reserves had been widely estimated to be around USD $4 trillion. In an article entitled "Concerns Mount over China Forex Reserves", the FT reports that "…investors are wondering how long China's dwindling forex reserves – down to $3.5tn from a peak of $4tn in June 2014 – can hold out. Capital is flowing out of China at a record pace and the central bank is drawing down reserves to support the Renminbi after its recent dramatic fall."[11] As noted above, it's not just China that's experiencing outflows. The FT also reports, "Saudi Arabia has withdrawn tens of billions of dollars from global asset managers as the oil-rich kingdom seeks to cut its widening deficit and reduce exposure to volatile equities markets amid the sustained fall in oil prices. The foreign reserves of the Saudi Arabian Monetary Agency have dropped by nearly $73bn since oil prices started to decline last year as the kingdom keeps spending to sustain the economy and fund its military campaign in Yemen."[12]

And there's no immediate end in sight to this trend. Reporting on a recent IMF study about this, Bloomberg states "Saudi Arabia may run out of financial assets needed to support spending within five years if the government maintains current policies, the International Monetary Fund said, underscoring the need of measures to shore up public finances amid the drop in oil prices. The same is true of Bahrain and Oman in the six-member Gulf Cooperation Council, the IMF said in a report on Wednesday. (Kuwait, Qatar and the United Arab Emirates have relatively more financial assets that could support them for more than 20 years, the Washington-based lender said).[13]

The results are as one would expect. Asset managers such as BlackRock and Franklin Templeton have reportedly seen billions of dollars of redemptions from foreign Gulf State clients.[14] It is true that other buyers are stepping in, as risk capital seeking safer havens flow into the US Treasury market. However, the chart below depicts an alarming trend. As the WSJ reported, "Central banks around the world are selling U.S. government bonds at the fastest pace on record, the most dramatic shift in the $12.8 trillion Treasury market since the financial crisis. Sales by China, Russia, Brazil and Taiwan are the latest sign of an emerging-markets slowdown that is threatening to spill over into the U.S. economy. Previously, all four were large purchasers of U.S. debt.[15]

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[11] "Concerns Mount over China Forex Reserves"; Financial Times, October 19, 2015; pg.2
[12] "Saudis Pull Billions from Global Asset Managers to Fund Deficit"; Financial Times; September 28, 2015; pg.1
[13] http://www.bloomberg.com/news/articles/2015-10-21/saudis-risk-draining-financial-assets-in-five-years-imf-says
[14] Op. Cit. #12
[15] http://www.wsj.com/articles/once-the-biggest-buyer-china-starts-dumping-u-s-government-debt-1444196065

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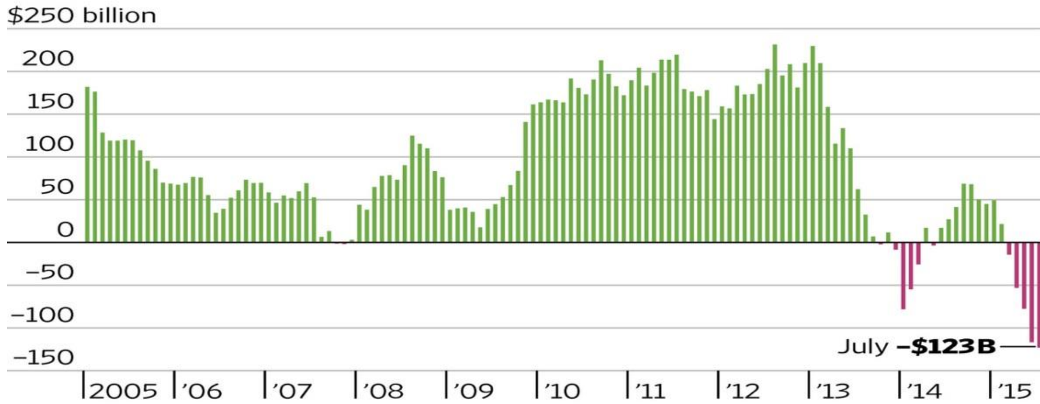
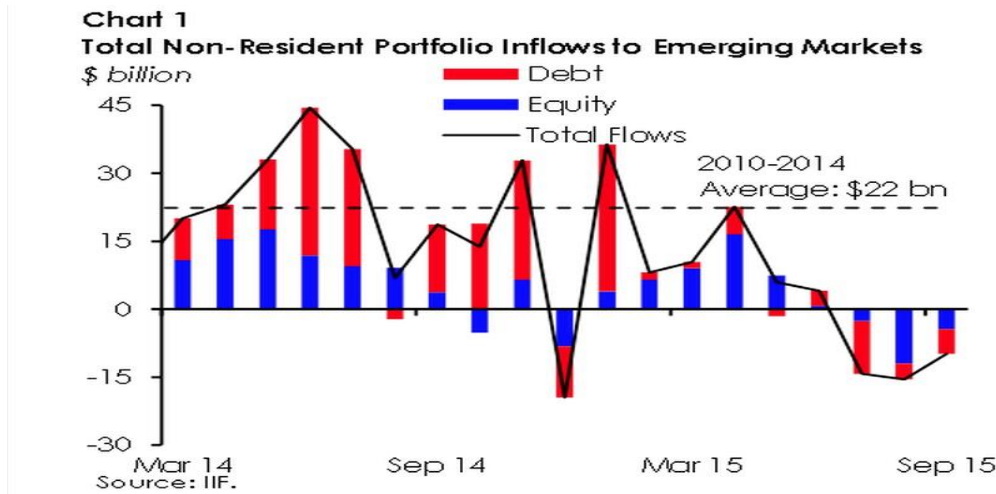


The fallout from all of this extends far beyond our shores – and then back again, because global markets are so inextricably connected nowadays. In a report entitled "Is this the mother of all warnings on EMs?", CNBC.com reports that "Net capital flows for global emerging markets will be negative in 2015, the *first time that has happened since 1988*, the Institute of International Finance (IIF) said in its latest report. Net outflows for the year are projected at $541 billion, driven by a sustained slowdown in EM growth and uncertainty about China, it added."[16] This is shown in the below chart:



[16] http://www.cnbc.com/2015/10/01/emerging-markets-to-post-first-negative-year-of-net-capital-flows-since-1988.html

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The ramifications of this cycle are captured in the following news headlines:

- *"Alarm Sounds on Emerging Markets and US Slowdown Despite Fed Decision";* (FT 9/22/2015; pg. 1)
- *"Capital Flight Darkens Economic Prospects for Emeging Markets"*; (FT 10/2/2015; pg.1)
- *"Emerging Market Currency Wars Threaten to Cut Back World Trade";* (FT 9/1/2015; pg.1)
- *"Asian Currencies End Quarter at Six-Year Low";* (FT 10/1/2015; pg.26)
- *"Fears Over High Level of Company Debt in Indonesia";* (FT 10/5/2015; pg.18)
- *"Abenomics Under Threat from China Slowdown";* (FT 8/28/2015; pg.2)
- *"Japan Business Sentiment Hurt as Conditions Stagnate";* (FT 10/2/2015; pg.6)
- *"China Manufacturing Activity Shrinks for Second Month";* (FT 10/2/2015; pg.6)

As Gillian Tett observed in her excellent commentary entitled "The Credit Bubble, the Bears and the Central Bankers":

> "What happens when emerging market private money creation slows or goes into reverse?...
>
> "Growth is slowing everywhere from China to Peru. In addition, it is becoming clear that emerging markets have become caught up in a new credit bubble. And the consequences — like those of the western credit bubble of the previous decade — could be deeply destabilising for the global economy and unpleasant for investors…
>
> "…as the IMF notes in its latest financial stability report, betweeen 2004 and 2014 emerging market corporate debt increased from $4,000bn to $18,000bn, with much of the growth ocurring after 2008.
>
> "This gross number conceals big variations…but measured overall, the IMF calculates that emerging market liabilities are now twice the size of their equity; a mere four years ago, they were at par.
>
> "…Citi(bank) has tried to calculate global private-sector money creation and reached a startling conclusion: three-quarters of all global private money creation in the past five years has ocurred in emerging markets. More specifically, since 2000 $8,000bn of flows have gone into emerging markets — and this has generated $5,000bn of private emerging market credit each year.

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> "This raises a crucial question: what happens when this process of emerging market private money creation slows or goes into reverse? Some policymakers hope any shock could be contained by more money creation on the part of western central banks — a bit more QE might calm markets, or so the argument goes. But Mr King of Citi doubts this will work: the emerging market bubble is so big that it is far from clear central banks could plug the gap if (or when) this money creation slows down; the world is reaching a point of "credit exhaustion"."[17]

The last paragraph raises *the* "crucial question". Indeed, what does happen when this process of emerging market private money creation slows or goes into reverse? It's entirely possible that the gap will continuously be filled by Central bankers – QE Infinity as some pundits have predicted. Or, perhaps the private sector rides a surge of productivity and technological innovation and generates a profound and offsetting surge of economic growth. We believe that latter scenario is in fact beginning to play out, however, it's being retarded and probably overwhelmed at this point by the excess supply of productive capacity, financed by years of misallocated capital, all stemming from misguided Central bank policies. Perhaps we're beginning to see the (ultimately) cathartic unwinding of all this. If so, then our caution will have paid off. And, if our "timing" (and/or thesis) proves to be wrong and the bull market trend continues unabbated, we will change our risk allocations accordingly.

All of us here at Katonah Cpital Group hope you enjoy the upcoming fall festivities, pumpkin pie, apples and the beautiful autumn foliage for those in the Northeast. I know we'll all be "thankful" for the lower price of heating oil this coming winter, one bright spot resulting from this narrative.

Sincerely,

Jason Waxler

[17] "The Credit Bubble, the Bears and the Central Bankers"; Financial Times; October 2, 2015; pg.11

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Index	Total Returns Third Quarter 2015	Year-to-Date
DJIA	-6.98%	-6.95%
S&P 500	-6.44	-5.29
Nasdaq Composite	-7.35	-2.45
S&P MidCap 400	-8.50	-4.66
Russell 2000	-11.92	-7.73

Index	Third Quarter 2015	Year-to-Date
Barclays U.S. Aggregate Bond Index	1.23%	1.13%
Credit Suisse High Yield Index	-5.17	-2.42
Barclays Municipal Bond Index	1.65	1.77
Barclays Global Aggregate Ex-U.S. Dollar Government Bond Index	0.64	-4.82
J.P. Morgan Emerging Markets Bond Index Global Diversified	-1.71	-0.07

	Total Return	
MSCI Index	**Third Quarter 2015**	**Year-to-Date**
EAFE (Europe, Australasia, Far East)	-10.19%	-4.91%
All Country World ex-U.S.A	-12.10	-8.28
Europe	-8.66	-4.75
Japan	-11.70	0.48
All Country Asia ex-Japan	-16.94	-12.30
EM (Emerging Markets)	-17.78	-15.22

	Total Returns	
MSCI Index	**Third Quarter 2015**	**Year-to-Date**
Emerging Markets (EM) Index	-17.78%	-15.22%
Asia Index	-16.89	-12.55
Europe, Middle East, Africa (EMEA) Index	-15.97	-12.52
Latin American Index	-24.25	-28.97

http://individual.troweprice.com/public/Retail/Planning-&-Research/T.-Rowe-Price-Insights/Market-Analysis/Quarterly-Wrap-Ups

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