Artemis
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Market Outlook & Strategy

First Quarter of 2016

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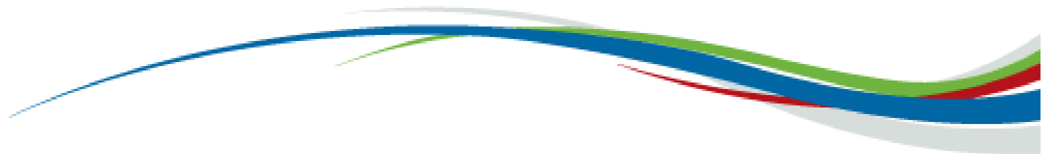

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Executive Summary

- The quarter got underway with a steep drop in global equities, but bounced back sharply in the second half as the Federal Reserve stepped with a more “dovish” tone and late-cycle economic indicators improved. In the end, the overall U.S. equity market gained 0.8% for the quarter.

- Indeed, almost all equity classes rallied in the second half of the quarter with the sharpest increases in the very asset classes that had declined the most in 2015: commodities, oil, emerging market equities and non-U.S. currencies.

- Central bank activity also engineered solid returns in bonds as both the European and Japanese central banks introduced negative interest rates to spur lending and economic activity. International bond returns were magnified for U.S. investors as the dollar declined by over 4% against a basket of its trading partners.

- We did not do much to our portfolios during the quarter as it is risky to do much when markets are whipsawing (and economic fundamentals aren’t driving the results!) We are also broadly happy with our current risk posture and like many, would dearly like to see faster growth and better earnings.

- In this issue, we focus on the promise and pitfalls of negative interest rates. A whopping 30% of the total stock of government debt around the world is now trading at negative nominal yields and even some European corporate bonds are trading in negative territory. Central banks are engineering negative rates to increase lending, and keep their currencies competitive.

- While the experiment is very new, it has already engendered some counterintuitive results – Swiss mortgage rates are higher today, the Japanese yen has appreciated against most currencies, and it’s unclear whether lending has accelerated at all.

- As for the average investor, low and even negative interest rates makes retiring with enough money that much harder, forcing folks to save vs. spend more. This does not sound like a recipe to foster growth.

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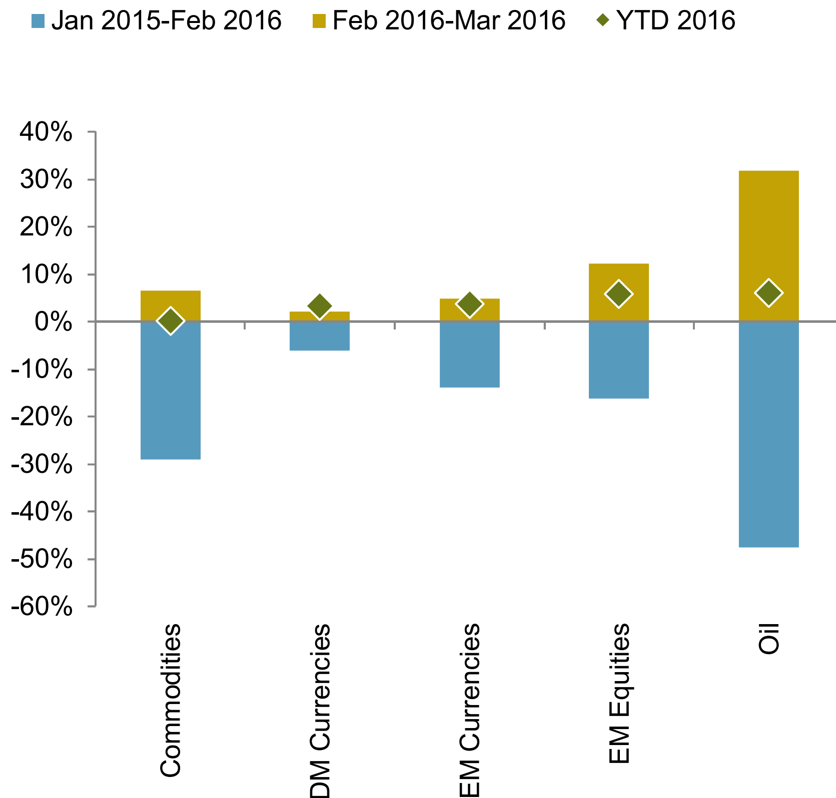
Quarter in Review

It was an interesting quarter to say the least, but not one for the meek. The quarter got underway with a steep drop in global equities as fears about China and slow global growth weighed on investor sentiment. The market also appeared to be revolting against the Federal Reserve's move in December to increase short-term rates for the first time in 10 years. Indeed, by mid-February, the Fed was already signaling that future rate hikes would be "data-driven" and pretty much took the prospect of another rate hike in March off the table. This, plus improving late-cycle indicators, led the U.S. market to rally sharply in the second half of the quarter, virtually erasing all of the losses year to date. As a result, the overall U.S. equity market managed a small gain of 0.8% for the quarter. See figure 1.

Figure 1: Asset Class Performance in Q1 2016 (percentage points)

This same trend was noticeable across several other asset classes. The worst performers in 2015 – emerging market equities, oil, and non-U.S. currencies, suffered further losses in the first several weeks of 2016 before rebounding sharply to finish with gains. See figure 2.

Figure 2. 2016 vs. 2015 Performance Trends



Source: Fidelity

International developed markets, namely Europe and Japan, were not so lucky. While they rebounded in the second half of the quarter, they still ended up with losses as growth continued to be slow and inflation continuing to fall. In Europe, security concerns also dominated the headlines following the terrorist attacks in Brussels in March. In Japan, despite the introduction of negative interest rates, the stock market fell sharply and the yen appreciated. (The promise and pitfalls of negative interest rates is discussed in full in the final section of this report.)

The other notable trend during the quarter was that central banks around the world were very active purchasing more bonds and driving down interest rates. Interest rates dropped

throughout the first quarter, resulting in long-term U.S. Treasury yields posting their steepest quarterly decline in more than three years. Most credit spreads[1] also narrowed slightly, which boosted the returns of the emerging-market debt and investment-grade corporate credit sectors. Also running counter to a longstanding narrative, the WSJ Dollar Index, which measures the dollar against a basket of 16 currencies, fell about 4% during the quarter. This provided a boost to returns for U.S.-based investors and turbocharged foreign bond returns (in US dollars). See figure 1.

Artemis Strategy

For the most part, our portfolios performed in line with their benchmarks in Q1. We did very little trading is risky to do much when markets are whipsawing. The only move we made was to improve the balance between credit and interest rate risk in our fixed income allocations. We did nothing on the equity side, and were pleased to see value-oriented stocks outperform growth-oriented stocks for the first quarter in quite some time.

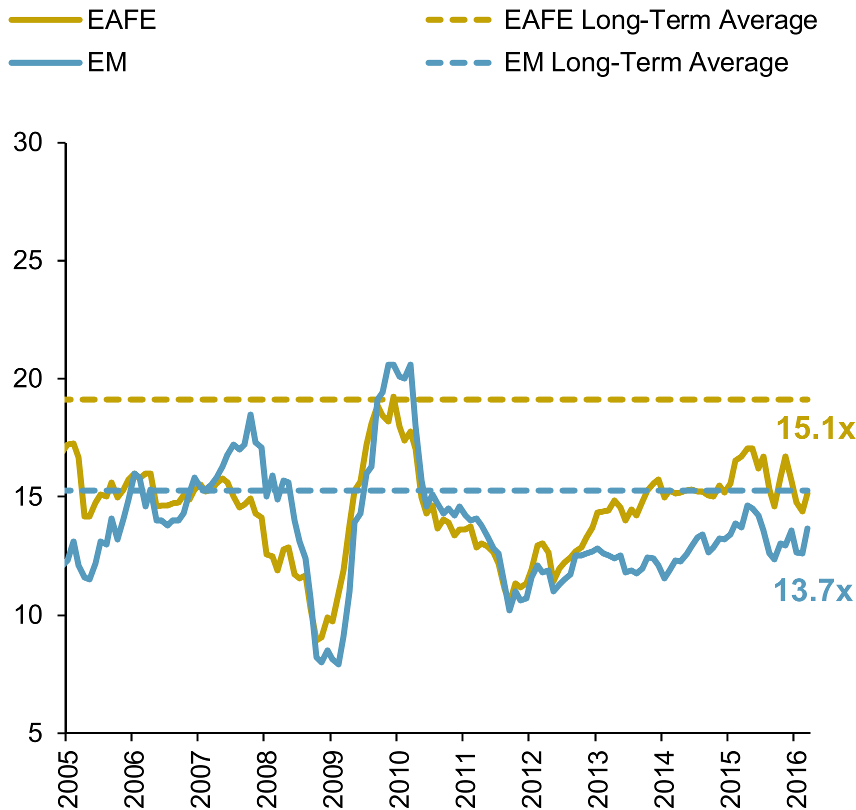
We are sticking to our international equity allocations based on the fact that valuations of international developed and emerging markets are both below U.S. multiples and are at the lower end of their 20-year average. See figure 3 (next page). Thus, we do expect international returns to outperform US equity on a 3-5 year horizon. However, we are not ready to reduce our underweight to emerging markets as emerging markets are not out of the woods and will likely be hurt again by resuming dollar strength, somethings we fully expect in the coming months once the Fed renews its commitment to increasing interest rates.

For this same reason, we also expect to see more volatility in equities in the coming months. The Fed is still expected to lift rates this year (the new consensus is two, not four rate increases) raising the prospect of further dollar strength. It’s quite possible then that we have a repeat selloff in equities, just as we have been through, driving the Fed to slow down the pace of increases leading the markets to rally again!

Likewise, bond returns are also likely to continue to flip back and forth as they have for the past year, due in part to fluctuating signals and actions from the Fed. Some believe the coming months could bring an intense shakeout in the bond market, echoing the “taper tantrum” of mid-2013, as a pickup in economic growth pushes inflation higher and spurs a

[1] A credit spread is the difference in yield between two bonds of similar maturity but different credit quality.

Figure 3. Trailing 12-month Price-to-Earnings Ratios in International Markets



Note: EAFE is Europe, Australasia and the Far East; EM is Emerging Markets.
Source: Fidelity

selloff in longer-term government debt, sending U.S. Treasury yields higher. Yet others predict Europe and Japan will move deeper into negative interest rates, spurring greater demand for U.S. securities and bonds even as the Federal Reserve prepares to raise short-term rates. I tend to believe the latter scenario is more probable but it's not going to be a smooth journey.

In brief, absent better growth in real GDP and improved corporate earnings, markets are likely to be volatile and range bound over the next months. As always, we will be using the bouts of volatility to tax loss harvest where opportunities exist and to deploy new cash as it arrives.

We are, however, considering adding additional inflation protection to our portfolios. This must sound like a strange idea given that most of the developed world is struggling with just the opposite. In the U.S., however, there has been a recent uptick in core inflation to its highest level for 5 years (core inflation excludes volatile components such as food and energy), due in part to a tightening labor market. But it's early days yet so we are still in the monitoring phase.

Promise and Pitfalls of Negative Interest Rates

This quarter's outsized bond returns are due in part to the rapid acceleration in the use of negative interest rates to spur lending and economic activity. Remember, when yields of bonds decline, their price increases leading to capital gains, especially on longer-dated bonds. In this section, I take a closer look at negative interest rates, how the policy is unfolding and what it might mean for the average investor (us!)

Wouldn't it be lovely to open your mortgage statement and find out that the bank is paying you to have a mortgage versus you paying them for the privilege? That's exactly what is happening in Denmark right now and, as you can imagine, the country is facing a growing real estate bubble. Yet in Switzerland, where the central bank has also engineered negative interest rates, the banks are so concerned about a potential profit squeeze that they have actually increased mortgage interest rates to offset some of their losses! And in Japan, where the government introduced negative interest rates in late January to foster increased economic activity, the stock market immediately sank and the yen strengthened, not weakened.

Such is the bizarre world of negative interest rates, a policy so new that we are learning quickly how little we know about whether it will be helpful. Nor do we have any idea how sustained negative rates might affect routine transactions. For example, with negative interest rates wouldn't it make sense to prepay your utilities or cable bill for a year, rather than get charged for holding cash in the bank? As such, would vendors prohibit pre-payment or charge for the privilege? Likewise, would folks start purchasing physical objects (gold, art, etc.) as stores of value on which banks can't charge a negative interest rate. It's all a bit mind boggling.

To be clear, we are talking about negative nominal interest rates, not real rates. The real interest rate is the nominal interest rate (the sticker price) minus inflation. Economists are used to seeing negative real rates (typically only on shorter-term bonds) but not negative nominal rates. As many of my readers know, my Ph.D. is in economics yet I cannot remember a single lecture, paper, or even mention of negative nominal interest rates

during my studies. (This may partly be due to the fact that I studied in the 1980's when interest rates were in the double digits.) As such, I did a quick review of the literature and discovered that the idea of using negative nominal interest rates was first proposed in the late 19th century but the author of the idea was later labeled a 'typical monetary crank'[2]. Nevertheless, in the 1930's when deflation in the U.S. was the rule of the day, several small experiments in taxing cash were tried in various municipalities (the so-called stamp script movement) but the implementation was so spotty, they didn't work.

After this period, the idea went dormant. It was only the current crisis with central bank rates close to zero and stagnating growth rates in many developed economies that the possibility of negative interest rates began to gain a wider audience.

And the audience has become very wide indeed. A figure 4 shows, a whopping 30% of the stock of government debt around the world is now trading at negative yields and even some European corporate bonds are trading in negative territory. That said, to date negative interest rates have generally only been applicable to bank-to-bank transactions; the average depositor at XYZ bank in Europe is not having to pay their bank for holding cash. Nevertheless, with some 30% of global debt carrying negative rates, some private purchasers of bonds are now accepting probable losses.

Why are central banks doing this? The theory is that the lower interest rates are, the more investors will move into higher risk-taking activities, and the more companies will deploy the cash that they hold on their balance sheets. In addition, if you can get your interest rates to be very low or negative and others don't follow you, you can also weaken your currency. All of this should help foster economic activity and growth and hopefully some inflation along with it.

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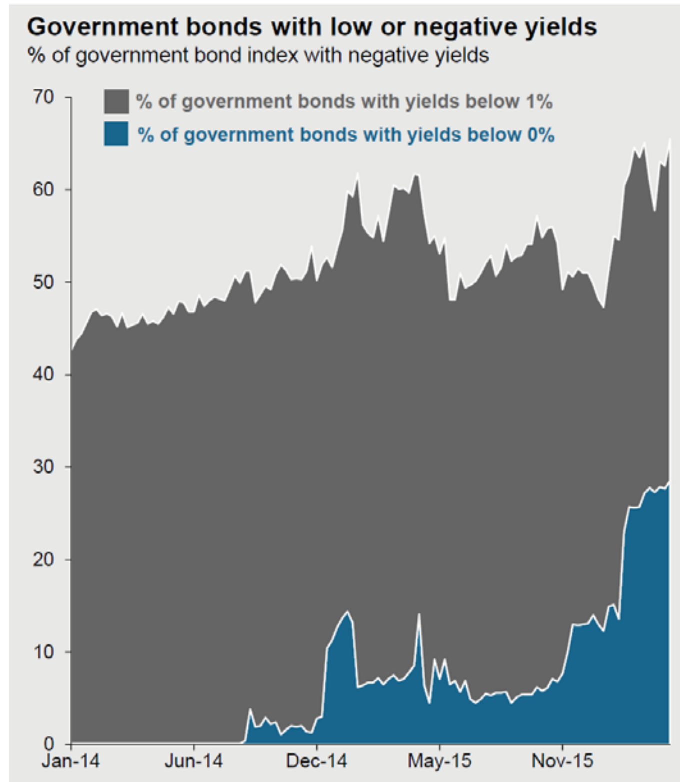
[2] If you are a geek like me, you might enjoy reading a working paper by Cordelius Ilgmann and Martin Menner, "Negative Nominal Interest Rates: History and Current Proposals", CAWM Discussion Paper No. 43, Department of Economics, University of Muenster, Germany, January 2011, easily retrievable via simple Google search.

Figure 4. Current Interest Rate Dynamics



Source: JP Morgan

The problem is that the policy has its limits and it might not work. First, if interest rates go too negative, and banks actually make customers pay to hold their money, cash may go under the mattress instead, robbing lenders of a crucial source of funding. But if banks absorb the cost of negative rates themselves, this squeezes their profit margins, which might cause them to be even less willing to lend! And if more and more central banks use negative rates as a stimulus tool, there is concern the policy might ultimately lead to a currency war of competitive devaluations.

Are negative rates coming to the U.S.? My view is that it is unlikely that the U.S. is going to need to resort to negative rates but Fed Chair Janet Yellen isn't ruling them out. Nevertheless, bond markets are global, and those negative rates abroad are a key factor depressing interest rates in the U.S.

Thus, the biggest problem with negative rates is that they fail to lift growth and spending. As Larry Fink, the head of Blackrock recently warned, low rates will prevent savers from getting the returns they need to prepare for retirement, and will force them to divert money from spending to savings. This does not sound like a sure fire tool for growth.