OVERVIEW

Economic Analysis and Market Review

Q2—2016

- Negative interest rates
- Bond interest rates
- Quantitative easing

As I survey the economic and political landscape today, I'm certain we've fallen through the white rabbit's hole. I just saw a hookah smoking caterpillar sitting on a mushroom. How did we come to Alice's dream world? In Europe and Japan the central banks have initiated a negative interest rate policy (NIRP) – you pay them interest to hold your invested capital. In simple terms, negative rates act like a tax on the bank's reserves. They're punished for keeping reserves at the central bank which they're required to do. The banks can pass the "tax" on to borrowers by charging them a higher interest rate on a loan or higher fees for processing the loan; however, bank lending hasn't improved and because banks have generally been unable or unwilling to pass this tax on to customers, their profit margins have been squeezed.

These are very interesting times, indeed. No one knows exactly what happens next. We're living through the largest monetary experiment in history. Examples of the craziness are in Europe and Japan. The British government just issued its lowest yielding bonds since 1694! And two years ago, if you had put 100,000 euros into an Italian bond with an interest rate of 1.26%, you'd have ended up 1,260 euros richer. Today, that same government bond would leave you 410 euros poorer. You wouldn't do much better in Germany. The German government's 10-year bond yields -.18% but the prize goes to Switzerland's 50-year bond which currently has a -.003% yield. You read that right. If you hold the bond to maturity, 50 years, you will receive no interest but instead, pay interest for the privilege of owning a Swiss bond.

Headlines last week noted that floating rate mortgages holders in Denmark, Belgium and Netherlands are receiving checks from the bank because the interest rates on the loans they took out are now negative. A story in the Wall Street Journal noted that European consumer-goods company, Unilever, just sold 300 million euros of 5-year bonds that yield virtually nothing, a coupon of 0%. These bonds are one of the lowest-yielding euro corporate debt sales on record.

Finally, as the European Central Bank (ECB) pursues its policy of quantitative easing by printing money and buying bonds, it is now buying corporate bonds as well as sovereign bonds. Recently it bought some Telecom Italia notes. These are not rated investment grade. So now you have the ECB printing money and buying junk bonds. What could possibly go

- Japan's economy
- U.S. economy

wrong? Think of this: the ECB has a balance sheet of $3.5 trillion and capital of just $12.2 billion which it would need to back-stop failing banks. Its leverage then is almost 287:1. If the ECB then were a real bank rated by any regulator, it would be declared insolvent by any measure.

In another struggling economy, the Bank of Japan has initiated a negative interest rate policy in an attempt to revive their economy and stave off deflation. The Japanese 10-year government bond now has a negative yield of -.28%, Federal Reserve Chairman Ben Bernanke launched a zero interest rate policy (ZIRP) eight years ago after the financial crisis of 2008 to help stimulate bank lending activity and avoid a more severe recession. It helped but never had the impact that was anticipated. Our economy continues to plod along at 1.5% to 2% rate, not the 3%+ rate that was hoped for.

He then followed that with several stages of "quantitative easing" where he pumped $85 billion each month into the system to provide liquidity and add more stimulus to the struggling economy. Now Europe and Japan, whose economies are mired in the doldrums, are employing their own quantitative easing policies in an attempt to restore more robust growth to their economies. There you have it, the ZIRP isn't doing the trick so let's try NIRP. Isn't this like if the plane doesn't fly, just add another wing?

At this point in time, countries that are operating with negative interest rates account for one quarter of the world's GDP or more than $13 trillion – and growing! And if more countries succumb to NIRP policies, can the U.S. avoid it? Only time will tell. I think I hear the Queen off in the distance shouting "Off with her head".

As our economy lazily moves forward, we're picking up mixed signals. In the job market, unemployment hovers around 4.7%, near what the Fed would call full employment. However, announced job cuts are running ahead of last year's pace. U.S. firms announced 65,141 cuts during April which was a 35% increase over the previous month (48,207). And so far, this year overall job cut announcements are running 25% higher than for the same period in 2015. U.S. firms are laying off people at a rate we haven't seen since the last financial crisis.

Many, if not most of the announcements are from energy companies as the 50% decline in oil prices has caused many drillers to shutter their operations for economic reasons. The rout in crude prices is snowballing into one of the biggest debacles in the history of corporate America with 70 oil and gas companies now bankrupt and the wave is not over yet. Between 2010 and 2014, the peak years of the oil and gas boom, US energy companies sold about $350 billion in debt and roughly half of that was rated junk. Now it's time to pay the piper. The leverage in the high yield (junk) bond market is enormous and we're about to witness a substantial increase in defaults.

- Brexit
- Global uncertainty

The big oil companies will survive and the price of oil should stabilize at $48/barrel. In the past few years, roughly 2 million barrels a day was produced in excess of demand. Now however, in spite of Iran entering the market with additional supply, there have been disruptions in supply from Canada's wildfires, Nigeria's guerrilla attacks, Venezuela's economic collapse and Libya's unrest so that today, a deficit of 2 million barrels per day exists. Global demand is up 1.6 million barrels per day year over year as China's demand has held and India's is gaining strength. Demand is relentless and supply will follow.

The global economic backdrop is rife with uncertainty and potentially disastrous consequences. Oh, did I mention "Brexit"? Add that to the mix. The UK voted to leave the European Union on June 23 and on Friday, June 24, more stock market wealth was lost than on any other day in world history. How this will affect the companies that derive significant revenue and profits from their business in the UK and the Continent is a big question mark. Over half of the S&P 500 fall into this category. Brexit could be devastating for these companies but I'm inclined to think that the UK will come out of this upheaval in good shape. One of the big unknowns is will this encourage other countries like Spain or Italy to exit as well. Will this be the death knell of the euro? Interesting times indeed.

As the world's economies struggle to regain their footing with convoluted monetary approaches, you would think that this would directly translate to the investment markets – and it has. Never before in history have the stock and bond markets broken records at the same time. Recently the stock market reached a new all-time high while yields in the bond market reached all-time lows. That's not supposed to happen. Stocks are a risk-on investment and bonds are considered risk-off. But that's the world we live in today and as you may surmise, confusion reigns. The "bond king", Bill Gross, founder of PIMCO and now with Janus Capital, believes bonds are a dangerous investment now as interest rates are likely to rise from current levels which would bring prices down (with bonds, yields and prices move inversely).

The "bond god", Jeff Gundlach, who manages over $50 billion, believes that interest rates could move slightly lower but is not recommending bonds per se. He's touting closed-end funds that invest in bonds and trade on the New York Stock Exchange. Closed-end funds, unlike regular or open-end mutual funds, where the shares are bought from the fund family, issue a set number of shares and trade on the stock exchange. Since the number of shares are fixed, they can trade at a premium if there is great demand or at a discount to their net asset value if the demand is weak. At this time, they are trading at a discount of roughly 10%. The fund he mentioned in the Barron's article is Brookfield Total Return fund which trades around $22 a share and pays a 10% dividend. Its net asset value is around $25.75.

- U.S. stocks
- Gold

The U.S. stock market has been treading water for the first half of the year as investors try to make sense of an investment world gone upside down. For most of last year and this, investors have been pulling money out of stock mutual funds for safer havens. Now, at this writing, the stock indexes, the S&P 500 and the Dow Jones Industrial Average, are hitting new highs in a post-Brexit world. It could be that investors looking for income have given up on bonds and are now picking companies that pay good, steady dividends. And investors overseas where interest rates are negative and currencies are weak might be finding the U.S. market the safe haven du jour.

One asset that has had a stellar gain so far this year is gold. Gold has been in a slump since 2011 and finally hit a bottom in 2016. Perhaps with all the fear of a negative interest rate end-game, investors are seeking the ultimate safe haven. It's often said "Why invest in gold? It doesn't pay a dividend." Well, now, neither does a money market fund or even a bond, for that matter. Leading the way in this area is billionaire investor, George Soros, who came out of retirement to take over his family fund and loaded up on gold and gold miners. One of his former portfolio managers of the successful Quantum fund, Stanley Drukenmiller, also a billionaire, has also taken a large position in gold.

There's so much uncertainty now as we enter uncharted waters with monetary policies that have never been tried before, perhaps following these proven winners deserves more than just casual consideration.

(By the way, the King pardoned everyone the Queen ordered sent to the gallows.)

Index Performance

INDEX	Q2'16	1 YEAR	3 YEARS	5 YEARS
Dow Jones	2.1%	-1.7%	4.2%	5.4%
Russell 2000	-1.5%	-3.2%	6.5%	9.2%
EAFE	-3.0%	-9.6%	1.4%	2.5%
Aggregate Bond	2.2%	5.9%	4.1%	3.8%
Treasury Bills	0.05%	0.19%	0.05%	0.06%
REIT Index	6.8%	20.3%	12.5%	11.3%

1. Dow Jones is a benchmark of 30 big US companies
2. Russell 2000 is an index of 2000 small capitalization companies
3. EAFE (Eur. Australia Far East) is an index of developed international markets
4. Aggregate Bond is an index of investment grade corporate bonds
5. Treasury bills are short term (3 mo.) US debt obligations
6. REIT Index is an index of public commercial properties