

Market Volatility

The first quarter of 2015 has been a period of substantial volatility with 200 to 300 point daily price swings being a common occurrence. The net effect of this heightened market activity has been a quarter without a discernible trend and ending with only a slight positive return, or in the words of Shakespeare: “Full of sound and fury, signifying nothing.”

As discussed in the January edition of this newsletter, heightened volatility was anticipated because the stock market is in the upper range of fully valued. Therefore, as economic reports or geo-political events (like the conflicts in the Mid-east) take place, the market experiences powerful gyrations without a clear direction.

The Primary Influence on the World's Stock Markets

Money creation or Quantitative Easing (QE) is still the dominant force affecting stock markets in countries all over the world. The example set by the US Federal Reserve by creating over \$3 trillion to combat the recession from 2008 to 2014 and reviving the American stock market is being viewed as the model for central banks everywhere. Following the FED's lead, the European Central Bank (ECB), the Bank of Japan (BOJ) and the People's Bank of China (PBOC) have embarked upon or are about to embark upon a massive QE program of money creation.

The four graphs shown to the right illustrate the point. The US stock market has soared to new highs – the US massively deployed QE from 2008 to 2014. The European index has yet to recover the 2007 highs, and the ECB has decided to add at least \$1.3 trillion in 2015 and 2016. The Japan index also has not yet recovered the 2007 highs – the government of Japan has decided to do a massive QE which is even named after its prime minister Shinzo Abe, thus dubbed “Abenomics.” Finally, China's stock market also has not surpassed its old highs and China is strongly considering an enormous QE program.

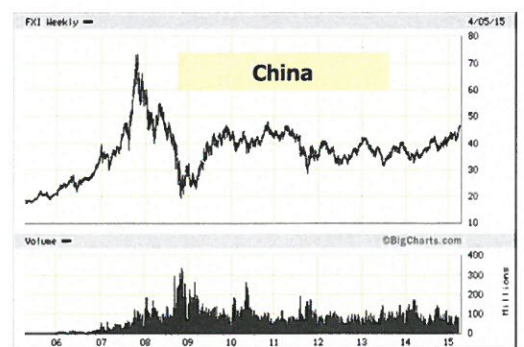
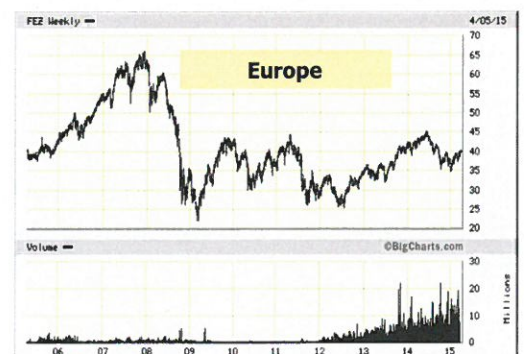
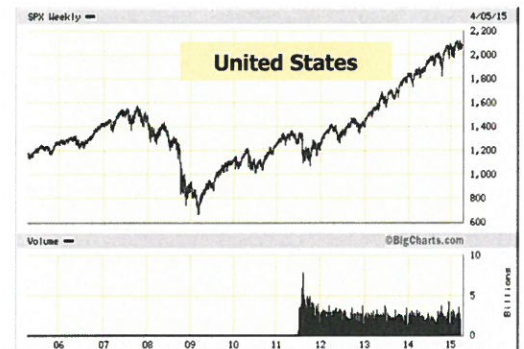
There can be no doubt that the global infusion of about \$8.4 trillion* from the expansion of major central bank assets since 2008 has brought about a global recovery (*Yardeni Research, Inc.). However, the world economy is now gradually slowing down and, even though the QE policy has ended in the US, it is now being taken up by the other major economic powers. The ocean of money or liquidity will continue to expand and support stock market prices even though the economic growth that normally causes equity prices to rise is lacking. The following three passages from *Bloomberg* and *The Guardian* give a good picture of the present and forthcoming QE programs.

Europe's QE Quandary

<http://www.bloombergview.com/articles>

by Jana Randow 3-9-15

It's the new conventional wisdom: When all else fails to make economies grow, create new money and buy government bonds. That's the formula dubbed quantitative easing, or QE. Most economists think it helped keep the U.S. and the other countries that used it — Japan and the U.K. — from tumbling into a catastrophic depression. Could it work in Europe, too? It's difficult for the 19-nation euro area to do the same



thing, partly because of different interpretation of European Union rules, and partly because of concern it could undermine efforts to push governments to do more to revive their economies. But now that the European Central Bank has exhausted most other options, it's pressing ahead with full-blown QE.

Japan

<http://www.theguardian.com>

by Katie Allen 1-22-15

QE was effectively born in Japan, a country plagued in recent history by deflation and rolling recession. The phrase "quantitative easing" was coined to describe Japan's efforts to kickstart growth and get prices rising again, starting in 2001 and lasting five years. That programme failed to rid the world's third largest economy of its persistent deflation, a record that was repeatedly cited by QE's critics as the policy was mooted in the UK and US at the onset of the global financial crisis.

The Bank of Japan's most recent QE

programme began in April 2013, when central bank boss Haruhiko Kuroda promised to unleash a massive QE programme worth \$1.4tn. It formed part of a set of policies known as Abenomics, formulated by Japan's prime minister Shinzo Abe. Under the QE plan, the Bank of Japan (BoJ) vowed to buy ¥7tn yen of government bonds each month using electronically created money.

To put Japan's scheme in context, the US Federal Reserve at the time was spending only a little more per month at \$85bn, compared with \$70bn in by the BoJ. But the US economy is almost three times the size of Japan's.

Is Chinese QE Next?

www.bloombergvew.com/quicktake by William Pesek 3-2-15

Over the weekend, China's second rate move in three months made clear how concerned leaders in Beijing are about sliding growth. And Saturday's quarter percentage-point cut is probably only the beginning. As data on manufacturing,

property and consumer prices take a dramatic turn toward contraction, there's every reason to think China's one-year deposit and lending rates — now 2.5 percent and 5.35 percent — could head toward zero, just as in neighboring Japan. After that, can quantitative easing with Chinese characterizes be far off?

Clearly the world is and will be awash in central bank created money. This will help to push stock prices higher and interest rates even lower if that is possible. For example: the 7 year bond in Germany has a "negative" yield meaning that it actually costs an investor money to own that bond. Unfortunately, on an historical basis massive money creation has not been very effective in bringing about true economic growth or in enabling the underlying economy to wean itself off of dependence on the QE. The real test will come after all of the QE programs are finished.

Outlook

The first quarter was positive although the volatility, especially in January, caused some anxiousness. The economy moved toward gradual but increasing strength through the end of 2014 which was anticipated to continue into 2015. This positive direction was noted by Janet Yellen (Chairperson of the Federal Reserve) and was going to be the rationale for gradual increases in interest rates. However, the economic numbers in the US have been weakening to the extent that the first quarter of 2015, according to many experts, may only show GDP rising at less than a 1% rate. Unfortunately, this same phenomenon is showing up globally. There is speculation that Ms. Yellen may have to postpone the rate increase until later in 2015 or possibly until 2016. Sluggish economic growth will be one of the important factors affecting market performance in 2015.

Another factor that may have a dramatic impact on the market is the geo-political turmoil that is erupting in many places. The raging conflicts in parts of the Islamic world are spreading and pose great dangers for the world economy, especially if the flow of oil from the Mid-east is disrupted. These conflicts are presently escalating and, if they continue to do so, will become problematic for the equity markets. Also, Putin's aggressive behavior (territorial expansion and

saber-rattling) is adding another element of uncertainty to potential market nervousness. The specter of a major regional war would certainly put downward pressure on the market.

The predominant factor (the theme of this newsletter) is the massive global liquidity that already exists (\$13.9 trillion) and the additional amount (QE) about to be created. The fact is that all of this money has to go somewhere. There are only 3 asset classes that offer deep and liquid markets that can deal with the enormity of the existing money and that which is being created. These are cash which pays virtually nothing (think bank accounts and money market funds), bonds which pay very little and represent a great deal of interest rate risk and equities (stocks) which have yields that are in line with bonds but also have growth potential. Therefore, it is likely that equities would be the primary beneficiary of newly created QE money.

Our conclusion is that equities will float higher on the massive liquidity but will be subject to the turbulence of volatility due to economic softness and geo-political fallout. We believe, at least in the near term, that the conflicts around the globe will be contained. Nevertheless, we are watching the events around the world to determine if defensive measures will be needed.