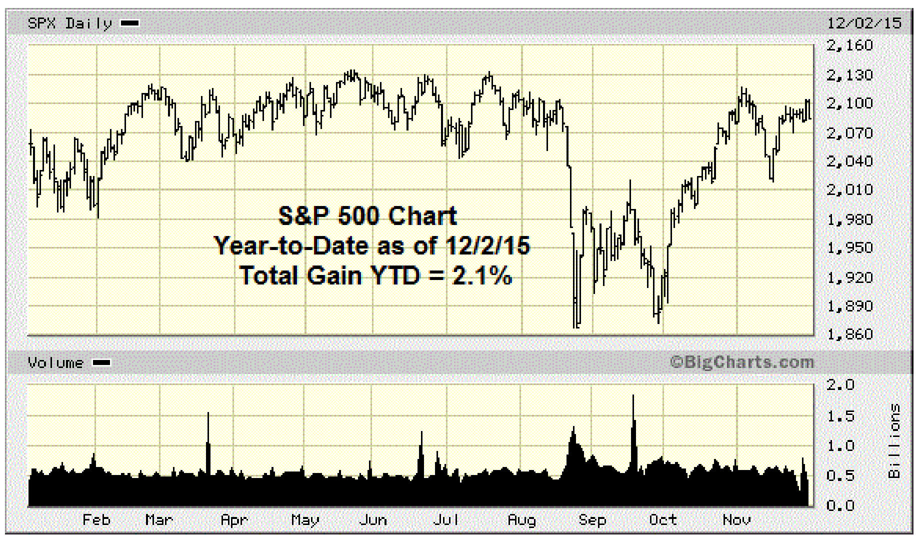
December Update December 2, 2015

Waiting for the Big Day

Elf on a Shelf: The Christmas "tradition" of ***Elf on a Shelf*** is in full force. In case you aren't familiar, the elf is one of Santa's helpers who sits in various places around a house and reports the day's goings-on back to the North Pole each night for the ultimate assessment of what goodies will be delivered come the big day. (If you are a recent parent/grandparent, you know about these things!) This year, the financial markets have their own version of the Elf: Janet Yellen and her merry pack of Fed Governors are busy assessing the economy and markets daily to assess if they will deliver an interest rate "gift" in December. It is hard to distinguish investors from the anxious children as they all await the results. Investors, however, don't have to wait as long; the Fed is expected to finally announce its interest rate decision in its meeting of December 15-16.



If you are not part of the financial media or a financial professional, you may ask why there is so much fuss about the Fed and interest rates. We agree, a small bump in the short term rates should not be an earth-shattering event. Up until the recent financial crisis, the world survived just fine with much higher interest rates. And, of course savers and bond buyers would love to see higher interest rates. There are, however, reasons for concern relating to this certainty that interest rates will eventually rise.

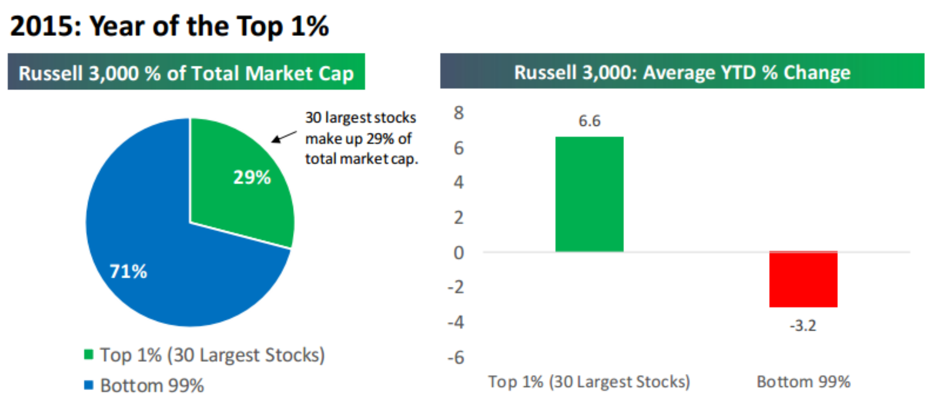
First, it has been nearly ten years since the Fed last raised rates or "tightened" policy. Over that period, the economy suffered, and is still recovering from, the worst economic recession since the 1930's. Simply the fact that rates have been so extraordinarily low for so long means it will be an unaccustomed adjustment for markets to deal with higher rates. Second, the ultimate objective is to combat inflation by slowing the economy and/or addressing imbalances in the economy. There definitely are imbalances in our economy: with the unemployment rate about to break below 5.0% for the first time since 2007, employment is one imbalance. Employment conditions are tight in spite of wage inequalities—which are a related but different imbalance. The "concern" of combating inflation or slowing the economy is that there are still many sectors of our economy which remain fragile: agriculture, energy and commodity sectors top that list but even retailers and manufacturing have pockets of weakness. Will higher rates create greater pain in those areas and possibly snow-ball over the entire economy?

The single biggest concern is the likely effect higher rates will have in the already super-strong U.S. Dollar. Most economists agree that the U.S. Dollar is currently the instrument driving all the other inter-related economic issues around the world. The dollar is nearly 14% higher in 2015 (compared to other major currencies) after it surged 12% in 2014. Currency values are all relative so strength in one currency means weakness in another. Thus, it is good news for some, bad news for others. The huge move in the Dollar over the past two years benefits U.S. consumers through lower priced foreign goods (nearly everything we buy) or travel abroad. But a strong Dollar increases the price of goods we export and compresses corporate sales and profits.

Dollar strength is also an important component to the collapse in oil prices which began shortly after the dollar started to rise in 2014. The double-edged sword the low oil prices is also, now, very obvious. We benefit from $2.00 (and below!) gasoline but the once-booming oil industry is on its knees. More critical than the impact on the U.S. economy, the strong

Dollar is a tremendous burden on emerging economies (i.e. developing economies in Asia and South America). Just a few years back, emerging economies were the growth drivers of the global economy. Now they suffer because most of them are heavily dependent on commodity production and they carry large amounts of U.S. Dollar denominated debt.

Dollar strength over the past two years occurred without any increase in interest rates. As U.S. rates increase, it makes investing in our currency more attractive-thus driving the Dollar even higher. At some point, the Dollar strength could crush the countries and industries which have been feeling the ill effects for two years already.



Of course there are positives other than low prices at Walmart and bargain travel. A strong Dollar correlates closely with a strong U.S. stock market. Returns in 2014 moved in tandem to the Dollar's rise. This year, the dollar impact has been harder to discern because most stocks have declined while strong gains in the largest stocks buoyed the broad market (S&P 500) back to near zero.

This dispersion in returns is one of the most interesting—and frustrating—features of the 2015 market for investors. For various reasons, a few mega-sized stocks have provided great returns while returns of the large majority of stocks have been negative—some hugely negative. Above, we provided an illustration from ***Bespoke*** on the impact of this phenomena on the Russell 3000 index. It illustrates that 30 of the 3,000 stocks (or 1% percent) represent 29% of the market cap (or market value) of all stocks. And, those 30 stocks have an average year-to-date GAIN (as of November 30) of 6.6% while the other 99% have an average LOSS of 3.2%. It is difficult to understand the many factors driving this imbalance in stock performance but it is a major issue we are working to understand and deal with going into 2016.

Meanwhile, we await one elf or the other (or, perhaps both!) to learn how bountiful December might be. ***We hope your elf delivers the very happiest and healthiest of holidays and we sincerely thank you for your continued business!***

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Questions or comments?

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