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Investment Commentary—April 2015

It seems like only yesterday that former Fed chief Ben Bernanke launched the third and final round (for the U.S. at least) of quantitative easing, prompting a firestorm of criticism that he was engineering a weaker dollar in order to boost the U.S. economy at the expense of its trading partners[1]. Brazilian Finance Minister Guido Mantega warned of an impending currency war in which central bankers would engage in competitive devaluation. As predicted, QE3 did cause the dollar to weaken, with the Euro climbing over the subsequent eighteen months from $1.30[2] in the fall of 2012 to around $1.39 last spring.

But a funny thing happened on the way to the currency war. After several years of tepid growth the U.S. economy strengthened over the course of 2014 while Europe, China and Japan weakened. Last December, as the Fed made its final bond purchases under QE3, the European Central Bank began to signal that it would initiate its own program of quantitative easing. Suddenly the shoe was on the other foot. The perception had been gradually building for months of a divergence between the U.S. and other developed economies. The advent of European QE catalyzed this change of sentiment. Central banks, which had been diversifying reserves away from the U.S. dollar for years, shifted course and moved reserves from euros to dollars. The euro plunged from $1.25 to $1.07 in a mere three months--pretty dramatic stuff in the world of foreign exchange!

The impact of the soaring dollar was felt far and wide. Certainly U.S. investors with unhedged foreign holdings experienced losses (with foreign investors with unhedged U.S. holdings reaping corresponding gains). But the other effects were no less significant. Much of the increase in dollar reserves was through U.S. Treasurys, which put immense pressure on already low bond yields. U.S. companies, having only recently given analysts "guidance" on what they would achieve in revenues and earnings for 2015, quickly lowered forecasts. Some of that was the accounting effect of revenues earned overseas translating from other currencies into fewer dollars. But some of the impact was more fundamental as a stronger dollar made U.S. goods more expensive in foreign markets, putting pressure on sales volumes[3].

[1] A cheap dollar means that the euro, peso or yuan in the pocket of overseas consumers or businesses buys more U.S. goods, boosting sales of U.S. exporters.

[2] It's customary to use the dollar/euro exchange rate as a proxy for the strength of the dollar and to focus on the value of the Euro in U.S. dollars. When the dollar is weak this value goes up; correspondingly when the dollar is strong it declines.

[3] On the other hand, companies that import raw materials from overseas benefit ….

The likelihood of declining exports may have led Bernanke's successor Janet Yellen to recalibrate. At one point many observers (yours truly included) thought the Fed would lift the Fed Funds rate at its June 2015 meeting after years at the so-called zero bound. The U.S. is much less dependent on exports than most countries, and the economy is fundamentally strong: witness the creation of over three million jobs in 2014, something that last happened in 1999. But with inflation still quiescent (for now) and the economy facing a new (if modest) headwind, the Fed may be in less of a rush to raise rates.

In communications following its March meeting the Fed signaled as such, lowering its estimates of future GDP growth and inflation as well as its own forecasts of how quickly it will raise rates. Since the headlong rush into the dollar was based on confidence in the U.S. economy, not to mention the prospect of increasing interest rates, the slightly pessimistic signals from the Fed caused the dollar to retreat a bit. But currency markets are notorious for overshooting and with European QE just getting underway we wouldn't be surprised if the dollar has more room to run.

The recent surge in the dollar and its impact on the Fed reminds us of a debate that began shortly before the financial crisis and carried on in its aftermath. The question then, with various emerging market economies—China in particular—rebounding sharply, was whether emerging markets could "decouple" from developed markets, i.e. whether the former could grow briskly while the latter struggled. Like most academic debates, the question was never settled, but those arguing against the possibility of significant and/or extended decoupling pointed to a variety of mechanisms, including currency, that would tend to constrain differences in growth between regions. With a healthy banking system, consumer balance sheets in pretty good shape, very solid job creation and steadily building demand for new home construction, the U.S. economy is fundamentally sound. But when declining demand from China helps trigger a collapse in oil prices and the launch of European QE triggers a massive rally in the dollar, we're reminded that decoupling has its limits.

The fact that the dollar/euro exchange rate allows weakness in Europe to bleed into the U.S. and strength in the U.S. to seep into Europe is generally positive for both stocks and bonds. Mr. Market likes moderate economic growth—fast enough to keep corporate revenues and profits climbing but slow enough to keep interest rates under control. From that perspective, Europe needed a boost and the U.S. was at some risk of growing too fast. A weak euro/strong dollar helps on both counts. Growth in Europe, which had been flirting with a triple dip recession, also makes it a bit easier to forestall a "Grexit," i.e. Greece leaving the Euro, if only by giving policy makers a little more room to make politically difficult choices.

In recent commentaries we've discussed two scenarios: one in which a robust U.S. job market finally triggers wage inflation and the Fed finds itself behind the curve in raising interest rates and another in which the economy remains tepid enough to allow the Fed to raise rates very gradually. The latter scenario enables the bull market in equities and fixed income to continue to run while the former is risky for each. For the time being at least, the bullish scenario remains intact.

With the U.S. stock market setting another all-time high in early March we were inspired to update a chart we consult from time to time. The enclosed graphic illustrates the cumulative total (including dividends) real (inflation-adjusted) return of the S&P 500 over the last 135 years. The total real return trend is around 6.4% and has been remarkably persistent. As measured by the inflation-adjusted value of $1 invested in the equivalent of the S&P 500 in 1880, returns rarely go more than 100% above the trend or 50% below the trend. Although that provides a wide channel within which share prices can move pretty dramatically, it exerts a sort of gravitational pull on longer term returns. As the blue line moves significantly higher than the black line, a period of subpar returns becomes increasingly likely in order to get back on trend. Correspondingly, as the blue line moves significantly below the black line, there is an increasing tendency toward better than normal returns. Case in point: we first put the chart together in April 2009 to persuade clients that after the severe bear market ushered in by the financial crisis the prospects were bright for superior stock returns going forward. From the 2009 low, returns on U.S. equities for the last six years have in fact been superb.

Including reinvested dividends has an enormous impact and is largely responsible for the powerful tendency for total real return to revert to trend. To see why, consider what happens when the stock market surges or tumbles. If stocks climb too rapidly and get out of line with company earnings and cash flow, dividends can't keep pace. As growth in the share price and dividend diverge, reinvested dividends buy fewer and fewer shares, and returns suffer. By the same token, when share prices endure a protracted decline, reinvested dividends buy more shares and returns are enhanced. In a very fundamental and important sense, **stock market returns are self-correcting**. The same dynamic, in which reinvested dividends go further when share prices are low, applies to share repurchases. In the latter stages of a bull market for example, companies that use cash flow to buy back stock end up repurchasing fewer and fewer shares. One might hope that company boards would be sensitive to this sort of thing and approve smaller buyback programs as share prices become more dear. Unfortunately such boards are few and far between, perhaps because CEOs are typically incented on changes in share price alone and not on total return.

Turning our attention back to the chart, it appears that U.S. stocks may be getting a bit ahead of themselves, with the cumulative total return 25% above trend as of March 31st. If we were able to exclude energy shares, which have been crushed by the collapse in the price of oil, the gap would be somewhat wider. While nowhere near the level of overvaluation seen in the tech bubble and still somewhat short of where things stood just prior to the financial crisis, it is worth factoring valuation into your asset allocation and expectations for future returns. We never counsel trying to time the stock market but if you've been meaning to lower your exposure to U.S. stocks, now wouldn't be a bad time to do it.

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