The motto of my college translates to a voice crying in the wilderness. A secondary translation would be an opinion not in the mainstream. To these translations I plead guilty. For some time I have been urging caution in one’s investment strategy because of the plethora of extraordinary circumstances that exist outside of the traditional fundamental economic and security analysis process. It is pretty obvious that this caution is not shared by most of Wall Street, many economists, and most of the mutual fund industry, particularly those companies that don’t offer alternative strategy funds. For the uninitiated, “alt funds” are supposedly designed to perform when the market doesn’t.

The early predictions for 2014 were that the year was likely to experience significant stock market volatility. In actuality, for most of the year the market was orderly, creating a sense of complacency amongst investors. The end of QE 3 even came without a repeat of the disruption that followed much earlier comments and concerns when the Fed merely talked about ending its market support. This in itself was unique as our research indicated that the main reason for the big market increase in 2013 and the 13% follow-on gain in 2014 was QE and the artificially low interest rate environment created by the Fed. Until the 3rd quarter of 2014 the markets performed well ahead of the economy. If we can believe the 5% GDP growth in the third quarter and the decline in the unemployment rate to 5.6%, then the market and the economy finally seem to be in sync.

A look beneath the surface of the above numbers, however, raises a few concerns. The decline in unemployment benefitted from an increase in the number of people who have withdrawn from the active job search market. A recent study indicated that if all the people who have stopped searching for a job since 2008 were still counted, then the unemployment rate would be 10 percent. But the press and the administration were quick to take credit for an economic miracle of sorts. Jeffrey Gundlach, the other bond guy besides Bill Gross, recently made the point that since 2007 all new jobs in the economy came from the Texas and North Dakota energy resurgence. The corollary to this fact is that if energy provided all the new jobs then the rest of the economy had no job growth at all. Now that Saudi Arabia’s actions and the oversupply of oil have driven the price of oil to levels that threaten the sustainability of energy industry jobs, how can we rationally celebrate the current unemployment numbers? I would suspect that Schlumberger’s recent announcement that they were laying off 9000 employees is somehow related to the current oil price collapse. And a closer look at the 5% GDP number shows that it is not all that it appears to be on the surface. Sixteen percent of the quarter results were due to government expenditures, primarily for the military. Personal Consumption Expenditures accounted for 44% of the GDP and more than half of that was for services, most of which was for health care and insurance (read Obamacare). A major gain in the quarter was the large increase in Net Exports of Goods and Services, another 16% of the final GDP. Unfortunately the word net means exports minus imports.
and the gain resulted from a decline in imports, not an increase in exports. Lest you think I am piling on, if growth were really 5% we would expect to see an increase in long term bond yields, reflecting a hotter economy. Instead we saw a rather significant decline in interest rates reflecting a continuing concern for the domestic and world economies. I must have missed the headlines on this latter occurrence. Instead we saw forecasts of when the Fed was going to start raising rates because of the stronger and sustainable economy.

NYU professor Nuriel Rubini recently provided an analysis of frailty of the European economies. This frailty and continuing fear of deflation (in the economy, not footballs) led to the European Central Bank announcing its own version of Quantitative Easing to try to generate some economic momentum and dampen the deflationary fires that are present throughout Europe. We know the minimal effect of QE in the US and it is difficult to imagine how the European model could be more successful with all its unique difficulties. It would be a challenge to believe that the European QE would succeed where similar efforts in Japan have failed to achieve the desired results. In both cases, however, the planned transfusion of money into the two economies has likely dampened the expected negative stock market action after the US stopped its own experiment in October of 2014.

In Project Syndicate, Mohamed A. El-Erian summarized the risks we now face in an article entitled “What Are We Betting On?” The first part of the bet is that government actions around the world will lead to materially higher and more inclusive global growth. Secondly the bet assumes that the world’s policy makers will be able to avoid mistakes in the application of their experimental actions, and thirdly that if mistakes do occur we will be able to prevent market accidents. El-Erian’s conclusion is that “these bets are far from reality and that bets on them, without some hedging, could prove exceedingly risky for current and future generations”. At best the Central Banks’ experiment is but a finger in the dike to hold off disaster while governments put fiscal and structural changes in place to help provide future economic security. So far no significant fiscal efforts have materialized that would take pressure off the Central Banks’ rescue mission in the US, Japan, or Europe.

In my opinion it is time to heed El-Erian’s warning and look to hedging risk because it is wishful thinking to assume that the disparate Central Banks could all conduct error-free experiments to rescue their economies from the jaws of deflation. Further compounding these risks are the issues we have discussed in the past; high margin debt, well above trend corporate profit margins, low wage growth, a deflation of undetermined length in oil prices and its negative effect on capital spending, and the additional impact of the oil price deflation on employment. Now is the time to lock the barn doors before the horses run away.

In 2014 the markets outperformed expectations with the DJIA returning 10.03%, the S&P 500 13.70% and the Barclay’s Intermediate Government Index 2.68%. The Barclay’s index was most surprising as pundits were almost universally calling for a negative performance in the bond market. The outlook for 2015 – uncertain with a chance of blizzards.

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