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Update on Current Market Conditions

Mark Burkhardt, Portfolio Manager — April 15th, 2015

Over the last few months investors have had to contend with higher than usual levels of market volatility both here at home and abroad. It is important to realize that much of the market's movement both to the upside and the downside is directly linked to the almost daily dramatic changes in the values of the US dollar versus the world's other major currencies. Just in the first three months of 2015 we have seen the US Dollar Index increase by over 9%, an extraordinary move in such a short period of time. While a strong US dollar has many benefits for us as consumers here at home, every coin has two sides. The negative effects of a strong currency also carries real risks for the global economy, which could eventually have an adverse impact upon our own. When you hear economists discuss the risks of a strong dollar there are several key points that I want you to be aware of and how they can affect your portfolios. The most obvious risk is that as the dollar increases in value and other currencies decline in value, products that we produce in this country that we want to export, become much more expensive for those foreign buyers.

Just as an example, if you were running a large construction project in Africa and you needed to purchase some new bulldozers, you are now more likely to buy one made by Komatsu of Japan rather than a more expensive one made by Caterpillar here in America. Why? Because the value of the Japanese Yen has continued to tumble while the value of the dollar has steadily increased. If you are in charge of purchasing new planes for an airline, the sharp decline in the value of the Euro when compared with the dramatic increase in the dollar has quite possibly made that European built Airbus plane a more compelling value than a similar one made by Boeing here in the US. These are just two obvious examples, but that same scenario and the resulting negative impact upon a company's sales is being played out in the corporate headquarters of literally thousands of American firms who are trying to remain competitive with their global rivals. There are a number companies like McDonalds that have shown little growth in their more mature domestic market and have been counting on international sales for new profits. Even as the US dollar rises in value, those overseas sales take place in each particular country's home currency. When those sales are eventually converted back into more expensive and therefore fewer dollars, the company's overall profits are then negatively impacted.

For every negative there are always positives especially when it comes to deploying assets in portfolios. As a result, certain sectors are net beneficiaries of this stronger dollar. Companies which derive almost all their revenue from within the US are in many ways almost immune and can even benefit from our strong currency. For many retailers, like Walmart or Target Stores the strong dollar allows them to buy their same products from their overseas manufacturers but are paying less for them as every dollar can buy more of each item. So for that clothing store or shoe retailer, not only do their products cost them less to import them, their customers have more money to spend because the drop in gas prices has given them extra cash to spend. All are very direct benefits of a stronger dollar. While US based multinationals are being hurt, European companies with a global revenue base are seeing their sales surge. Not only are their products much more competitive due to the fall in the value of the Euro, their foreign sales are being converted into a greater number of Euros, causing their overall profitability to rise.

While we all know that many large US companies derive a substantial amount of their total revenue from these overseas sales, few may know just how large an amount it really is. The most common index that investors use to determine their portfolio's performance, the S&P 500, which is made up of the 500 largest publicly traded corporations in the country, shows us how important this foreign revenue component has become. Using the most recent data available, over 46% of the S&P 500's revenues come from outside our borders. Certain sectors, such as technology, healthcare and the industrials have an even higher level of exposure creating even greater uncertainty with regard to their profit outlook. Currently tracking results for the first quarter of 2015, US multinationals that derive more than 50% of their sales outside the US are showing revenue declines of 10.8% on average. This impact on corporate revenues will eventually have a negative effect on corporate earnings. We can see this by the recent and substantial reduction in S&P earnings estimates for 2015. Four months ago consensus estimates for S&P 500 earnings were looking for a year over year gain for 2015 of 10.2%. Due to a combination of an expected drop in oil companies' earnings and the overall impact of the rise in the dollar, today that index is now estimated to only show an earnings gain of a mere 0.3%.

The strong dollar also creates enormous financial stresses on the many emerging market countries and their economies. Many of these nations are not as financially well-established or as economically diversified as the more developed nations have become. All too often, many of these countries are what we call natural resource dependent. That means that their main export isn't intellectual value, technology or manufacturing but rather the export of raw natural resources. Russia, Venezuela and many countries in the Middle East are economies that are completely dependent on their sale of crude oil. Brazil and many nations in South America and Africa are equally dependent upon exporting iron ore, industrial metals, timber and agricultural products like coffee. How does the strong dollar hurt them? In almost every way, because all the world's commodities are priced in US dollars. As the dollar climbs in value each dollar can buy ever greater amounts of these commodities, meaning that these countries get fewer and fewer dollars for each unit they sell. As the dollar has risen, look at how the price of oil, steel and other commodities have fallen in price. Good for us as consumers of those goods but that creates a very difficult operating environment for those countries who are producing them.

This brings me to my next point which also affects many smaller economies throughout the world not just emerging markets. That concern is the growing financial stress regarding many of these nations' ability to service their outstanding sovereign debt due to rising interest costs. Unlike the US where the debt the Treasury Department issues is denominated in dollars, many smaller countries who have limited finances and therefore weaker credit ratings have a harder time issuing debt especially to potential foreign buyers. The most common way to make this type of debt more attractive to investors is to make these new bonds denominated in US dollars rather than their own home currency. That is the interest payments that are made to the holders of this debt are paid in US dollars rather than in the issuing country's own local currency. If the valuation of the issuing country's currency and the US dollar remain relatively stable then it remains an excellent way for a country to issue new debt. Unfortunately if the country's currency declines or the value of the dollar increases, then the cost of servicing that debt can increase dramatically often at the expense of forcing that government to reduce spending on services that their citizens have come to expect and depend upon.

The last point I want to discuss deals with ongoing efforts of many of the world's central banks to devalue their currencies, which has had the effect of forcing down their long term interest rates to nearly zero. Currently the yields on both the German and Japanese 10 year bonds are hovering around the 0.20% to 0.30% rate. When you factor in each countries' underlying inflation rate the real rate of return is actually negative. This creates an unusual situation where we are seeing large inflows of foreign money moving into our bond market where our 10 year bond offers a much higher rate of return of around 1.85% by comparison plus the additional appreciation due to the increase in the dollars value. Therefore the global search for yield has the unintended consequence of making US debt very attractive by comparison and therefore keeping our long term rates artificially low.

This puts our Federal Reserve in the unusual predicament that if they raise short term rates, the dollar rises in value and our long term rates fall further as our debt becomes ever more attractive. Ultimately the growing underlying strength of the US economy should more than offset those headwinds created by central bank currency manipulation. When compared to the rest of the developed world, that growth will continue to be supportive of our equity markets. However, I expect that there will be a number of compelling opportunities for us to build positions in high quality, foreign based corporations. Many which when compared to our markets, trade at valuations that I find historically very attractive. As always, our vigilance of an ever changing world is essential in safeguarding your investments and earning the trust that you have placed in us.