CORE Comments
ON PLANNING AND INVESTING FOR THE TWENTY-FIRST CENTURY

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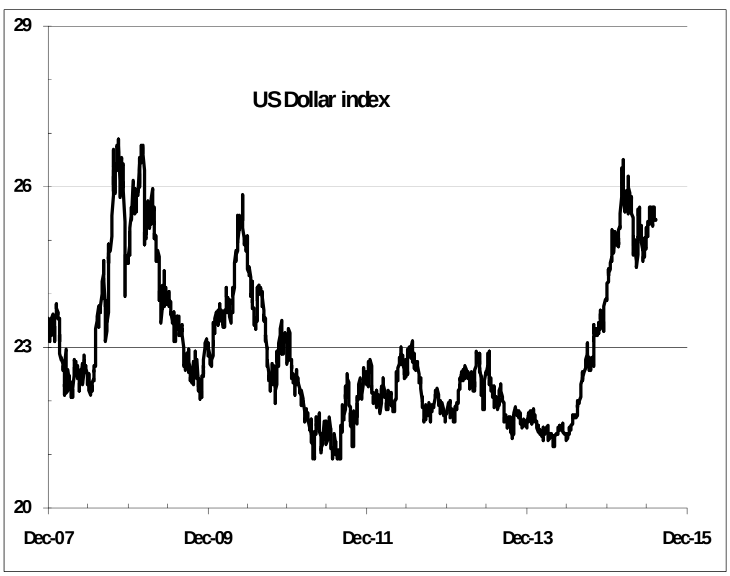
The Fed, China... and the Failure of the European Project

The US dollar rose sharply from the middle of 2014 through March of this year, largely because of the relatively stronger US economy and the Fed's move toward tighter monetary policy. The repercussions of a rising dollar are felt around the world.

The time approaches when the Federal Reserve begins to raise short-term interest rates. These have stood near zero since the early stages of the financial crisis and have not been raised in almost a decade. Given recent comments by Fed officials, there is a fair chance that at its September meeting, the Fed's Open Market Committee will make the first rate increase. US short-term interest rates will still be very low after the initial increase and the process of raising rates to 'normal' levels--perhaps two or three percent--will take many months, even years. However, the very fact that the US is considering raising rates and tightening ultra-loose monetary policy shows the difference in economic conditions between the US and those in Japan and the European countries that use the euro. Those economies remain weak and their central banks are nowhere near consideration of tighter monetary policy.



The very long period--since the beginning of 2008--of radical monetary policies during and after the financial crisis leaves financial markets vulnerable. To date we have seen some significant effects; almost certainly there will be more over the next year or two. The principal direct effect of the prospect of tightening policy has been the appreciation of the US dollar. During the long period when the Fed was buying huge quantities of US assets, increasingly its balance sheet five fold to four trillion dollars, many developing economies experienced huge inflows of foreign capital. They took advantage of ready and cheap money by issuing enormous quantities of new debt. Now with their currencies falling against the dollar and with slow economic growth around the world, there is growing risk of crisis in some developing countries.

By

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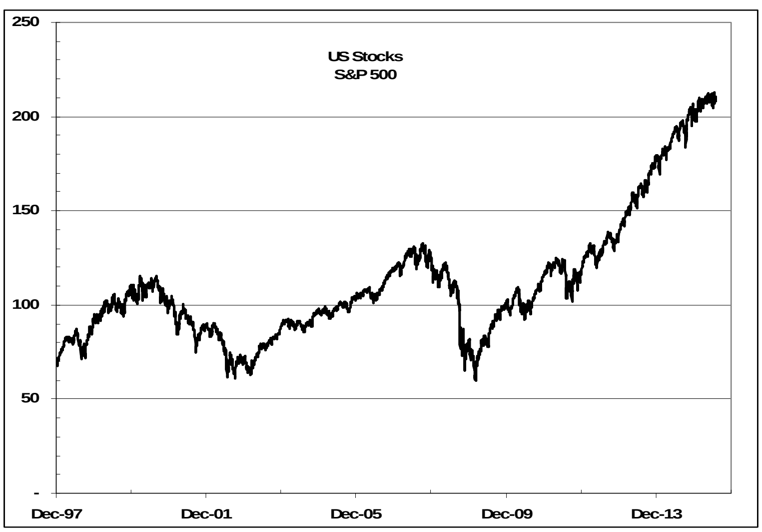
China and the dollar. On Tuesday, China delivered a shock to financial markets, by allowing the value of its currency to decline by about 2% against the dollar. A slightly smaller decline came on Wednesday, then another lower fixing on Thursday, followed by a press conference to give assurance that China was not beginning a large devaluation of the renminbi. The actions occasioned a big sell off in stock markets world wide, and concerns about renewed currency wars. By week's end, markets had calmed--and the S&P rose on the week. The initial market reaction and the somewhat desperate rhetoric accompanying it seem quite overdone, in that China has maintained a managed peg to the dollar over recent years, so that, as the dollar has strengthened, China's currency has as well. China's has been one of the very, very few currencies in the world that has not dropped significantly against the dollar in the last year and, because it is a major exporter, its rising currency has been a drag on its economy and exports. Consider that since the end of 2010, the renminbi has appreciated against the dollar by 3.1%, even after the devaluation this week. Over the same time, the Japanese yen has declined by a whopping 52.8% against the dollar and the euro by 19.8%. As was remarked by James Macintosh in the *Financial Times*, if this is its approach to the 'currency wars,' China brings a knife to a gun fight.

The US stock market is shown below, the S&P 500 with dividends reinvested. As can be seen, the bull market that began in March 2009 has run for a long time. Stocks are not cheap by any means, and, with interest rates likely to rise over the next couple of years from rock-bottom levels, caution is warranted.

In the developed countries. So far, this has been an usually quiet year for American stock and bond markets, despite the always-present knowledge that Fed policies are changing. The S&P 500 is up all of 2.8% for the year with dividends included, and the broadest measure of tradable American bonds is up by 0.3%, interest payments included. Nor have there been any significant price swings along the way. The S&P has varied by less than 4% from its opening level in 2015; bonds by a mere 2%. Things have been less placid and more productive in Europe and Japan, whose stock markets have been stronger, particularly when the currency translation effects are hedged away. (The strong dollar and the still-loose policies of European and Japanese central banks have driven down the exchange rates of the Euro and the Yen this year.)

Core has had currency-hedged investments in Europe and Japan all year. As a result, and despite the drag from weak bonds, clients' equity-oriented portfolios have achieved gains in excess of US stocks and US bonds. (Please remember that there are variations in returns among clients' accounts, arising from considerations of willingness to accept investment risk, individual circumstances and predilections, and a host of other reasons.)



Economies and Central Banks in the Developed Countries. The key elements to the markets lie in the small differences among economies of the developed countries and the larger differences in the responses by their respective central banks. (We will certainly look back on these years during and after the acute financial crisis and note the exceptional actions by central banks in response. It is too soon to write with any confidence about the long-term effects of the radical policies; suffice it to say that central banks have loomed large--very large, especially in financial markets, since 2008.) At present, the US looks back on moderate growth since 2009 and looks forward to the continuation of modest economic growth.

By contrast, Europe and especially the countries using the euro (the 'Eurozone countries') endured several rounds of follow-on recessions and crises occasioned in large part by the politics of the euro. In 2010 came a large stock market retreat; in 2011 and 2012 came a more severe one. Mario Draghi stabilized matters and ignited a large recovery in financial markets with his undertaking in the summer of 2012 'to do whatever it takes...and it will be enough' to preserve the euro and Europe in the acute phase of the Eurozone crisis. Things in Europe improved after Draghi's promise, only to be dragged down again to a smaller degree in the last year in the context of the latest round of the crisis with Greece. Since Draghi's undertaking, Europe's stock markets have kept pace with America's.

Japan's central bank and its markets have provided even a stronger contrast to the US. Japan's real estate and stock market bubble burst in 1989. In the decades since, Japan has suffered long bouts of deflation--falling prices--and periodic recessions. Under the government of Shinzo Abe, Japan's central bank has pushed down the value of the yen from 80 yen to the dollar in late 2011 to 125 now. Concurrently, with spending and tax policies, Japan seeks to stimulate Japan's economy and inflation. Whatever has been the effect on Japan's real economy, the combined monetary and fiscal actions have caused its stock market to rally to levels not seen in years.

After the Fed begins to raise rates. The strong dollar has already reduced foreign earnings of the many American companies that do business abroad. This explains some of the weakness in US stocks this year. The anticipated rise in interest rates comes after six years of rising stock prices. (The chart on the preceding page show the extent and duration.) US stocks are not cheap. Many sectors of the US bond market have been weak in anticipation of rising interest rates. The bonds of developed countries trade at historically high prices; much government debt in Eurozone countries provides negative yields. That is to say, one pays Germany for the privilege of lending to it for a five-year period.

The Fed's intends to raise rates in the context of generally weak global economic activity, very low and still falling commodity prices, and now, China's possible currency devaluation. With economies in such febrile condition, a Fed campaign to raise rates, however slowly, may exacerbate economic weakness and deflationary forces. The action of long-term treasury bond yields, which have been falling again, suggests that bond investors fear deflation and even slower growth. Consider as well the reasonable likelihood of some market chaos created by the shift in Fed policy. It is not hard to imagine that market turmoil in the context of weakening global economies may well give rise to a bear market in bonds and in stocks.

Core's investments. We have been reducing stock investments in stages since May. We have altered the mix of our fixed-income investments and sold outright a position in high-yield bonds. The effect has been to raise cash in client accounts. Given that money market funds still yield nothing, the cash does not provide investment income for us. It does, however, provide safety. Capital preservation is again important.

Greece and Germany; the IMF's dilemma.

Early this week, Greece and its creditors reached agreement on the plan put forward in mid-July for further loans to and further fiscal restrictions upon Greece. On Thursday, Greece's parliament passed the plan. On Friday, the finance ministers of the Eurozone countries approved the plan. Hence, €86 billion will be loaned to Greece, some of it quite soon. The initial tranches of the new money will be used by Greece to repay its creditors amounts from the two earlier rounds of lending to Greece.

The whole enterprise has been extremely dispiriting in so many ways that it is hard to unpack the ways in this brief note. Over the weekend of July 17, the framework for a deal to lend the new €86 billion to Greece was hammered out. Greece capitulated utterly to the demands of its stern creditors, led by Germany. I wrote a long letter about this shortly after the weekend, but on re-reading it before sending it out, I realized that I had expressed my anger about Germany's actions in rather strong terms. I consigned the screed to deep storage.

The northern creditor nations, including Germany, Finland, the Netherlands, Austria and others, insisted upon further extreme fiscal austerity conditions and an exceptionally intrusive oversight regime. Given the 25% contraction of Greece's economy over recent years, worsened substantially by onerous fiscal conditions imposed in the first two loans, it is essentially impossible for Greece to repay the previous loans. The International Monetary Fund ('IMF'), one of the lenders to Greece in the 2010 and 2012 rounds, recognizes that the debt cannot be repaid and has argued forcefully for substantial debt forgiveness in this 2015 round. Indeed, IMF rules for lending forbid IMF loans unless repayment is feasible. The Germans and their allies have been adamant that no discussion of rescheduling the existing debt can occur until after Greece's implementation of the new demands placed upon it. (Will Germany agree to write off some Greek debt? Don't bet on it.)

The matter of IMF participation is up in the air. Without it, the Eurozone countries and the European Central Bank will find it politically difficult to win approval in various parliaments. This gives the IMF leverage to win meaningful debt reduction. (The United States, although not a participant in the Greek lending, except as the IMF's largest shareholder, argues strongly in favor of writing off a good deal of Greece's debt.) It is a tautology that debt that cannot be repaid will not be repaid. But the benighted proponents of cutting government spending in order to stimulate economic growth--the Germans and their allies--still do not recognize that their rules constrain economic growth, despite years of evidence to the contrary across many European countries. Politics and ideological obtuseness consign Greece and its people, who have suffered through six years of economic depression and high unemployment, to more of the same.

The European project that gave rise to the European Union and the euro, begun after the World War II, has had two principal goals, firstly to end the terrible cycle of disastrous wars that crippled Europe and much of the world, and secondly to improve living standards for Europeans. This latter goal was stopped by the financial crisis of 2007 to 2009, the debt crises among the 'peripheral' countries, and the accompanying recessions. One unfortunate feature of the various crises arising among the peripheral countries is the undemocratic nature of the process. Germany and its allies have sought to change governments in indebted southern nations--consider the virtual expulsion in 2011 of (the unlamented) Silvio Berlusconi in favor of Mario Monti in Italy. The decision-making process in the European Union must seem quite remote from the people affected by the decisions. To the extent that the process seems undemocratic, to the extent that the economic effects constrain the economic well-being of Europeans, to the extent that Germany is seen to impose its rules-based approach on Greeks and others, the entire decades-long European project is threatened. Alas.

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