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FOCUSED ON WHAT MATTERS MOST.

The Point of No Return...Again

It's hard not to feel some sense of déjà vu as we head into our 8th year of extremely loose monetary policy. The habit of warding off bad economic outcomes by lowering interest rates became a habit in the early nineties in response to the Mexican peso crisis in an effort to support U.S. banks, then a few years later in response to the emerging market debt crisis and Long Term Capital Management solvency debacle. The reasons for the intervention essentially boiled down to keeping the economy strong and moving full steam ahead. We saw additional intervention via low interest rates after the tech collapse in 2000 and of course again beginning in 2007.

There are two observations we should highlight here. First, this is good old-fashioned habitual behavior and as we're seeing now, habits are hard to break. Second, we can't help but think of the definition of insanity - doing the same thing over and over again and expecting different results. After the last couple protracted stretches of monetary wand-waving, we've been rewarded with well above average market downturns. The tech collapse from 2000-2002 wiped out nearly 80% of the Nasdaq and 51% of the S&P 500. The 2007-2009 collapse erased around 56% and 58% respectively. Expecting a different outcome this time around would certainly fit our definition of insanity. But, the urge to delay discomfort is simply too strong. The analogy of our easy money culture being like a drug addict is a fair one. If the addict stops using, bad things happen almost immediately. If he does keep using, really, really bad things will happen eventually. If the addict could think about things logically, there's no way he'd choose to continue using. The problem however is that he's already addicted, in the habit, and so the choice is only whether to feel terrible later today or not. For most unfortunately, this inability to evaluate the long-term consequences typically marks the point of no return.

The Last Point of No Return

When the tech bubble collapsed in 2000, the Federal Reserve chose to reduce rates aggressively in an attempt to staunch any impact falling stock prices had on

the economy. The objective of rate toggling is always to either stimulate borrowing or to deter it depending on which way rates are adjusted since that borrowing can have a direct impact on both the economy and financial markets. Realizing that most investors were hurt severely from the collapse in stocks, the Federal Reserve led by Alan Greenspan (and later Ben Bernanke) chose to revitalize the economy through rising home prices rather than stock prices. If the cost of a mortgage was lower, more people could borrow, which meant more demand for houses, which caused prices to rise, which meant homeowners could now borrow more money against the value of their homes to purchase goods and services, which of course would translate into economic growth. Bingo! Economic recovery through rising home prices.

Most members of the Federal Reserve past and present would tell you that monetary policy (their tinkering of interest rates in an effort to avoid anything bad and keep things perpetually good) had nothing to do with the financial crisis of 2007-2008. It was natural speculation in real estate that pushed prices higher that eventually led to the creation of all the nasty, esoteric financial products that permeated the financial world and led to all the carnage. They're partially right about that. Speculation did in fact play a part in the crisis. Our contention however, is that the speculation wouldn't have taken place to the extent that it did had interest rates not been pushed low enough to allow it to happen on a massive scale – rendering it anything but natural. Had rates been higher, fewer people would have bought homes they couldn't afford, putting a lid on price increases, while those already in homes wouldn't have had nearly the ability to borrow against their equity putting themselves deeper in the hole. Absent these things, financial instruments tied to housing would have stayed much more benign. So the Fed's low rate policy had much more to do with the financial crisis of 2007-2008 than they'd have you believe and the fact that they were openly targeting home price increases through lower rates indicates that. The problem the monetarists faced at the time was how to stop the runaway real estate train. If they fessed up to having a part in creating it, then they'd lose credibility and risk a sharp market reaction. Had they raised rates sooner and more aggressively in order to slow it, they may have ended up derailing it abruptly leading to market chaos and economic contraction. So the only choice was to deny and defer. Keep things going and hope for the best.

Current Point of No Return

The financial system crashes, the Fed takes drastic action to arrest the decline, and it seems to work eventually. Interest rates are first reduced in 2007, then by early 2009 financial markets stabilize and resume their uptrend. The Federal Reserve chooses to leave rates low until the economy gets back on track and demonstrates an ability to grow on its own. Eight years after the first interest rate reduction, the economy has failed to grow at acceptable levels, targets whereupon the Fed would begin to exit its easy policy have been met and moved, and the Fed finds itself again beyond the point of no return.

The details are different, but the story's the same. In an effort to stave off a recession and stimulate economic growth, the Fed has chosen to target stocks this time. The thinking goes, by keeping rates at zero, investors will be forced to speculate in riskier assets in order to realize any gain on their capital. If enough investors move into these riskier categories (stocks and real estate), then prices will rise, and through the wealth effect, people will spend more money, thus stimulating the economy. Asset price increases are the key piece of this equation for the Fed, which means that in addition to price stability and full employment, stock market gains are now part of its charge. This is a Fed-driven market, just as the real estate market was from 2001-2007. Natural speculative behavior would look quite different if it weren't – which is the very nature of today's massive problem. Central banks around the world know very well that it's primarily their actions that have caused markets to rise in recent years. If there's any doubt about this, then it may be easier to understand by looking at market downturns since 2009 – or the lack thereof. Every time it has looked like markets may be losing confidence, central bankers react with either words or

actions in an effort to quell the selloff. Last week Mario Draghi at the European Central Bank spoke of new, bolder actions that will be taken in December if conditions don't improve and blamed slowing growth in China for Europe's problems. The next day, China chose to lower interest rates and bank reserve requirements in an effort to stimulate growth through lending – a very panicky action to take for a government that only days prior was talking about how the 6.9% GDP growth figure recently reported was essentially 7%, the government's stated growth objective – so all is good. Well, their actions tell us otherwise. Bottom line, central bankers are faced with an epic dilemma of their own making. Either accept that monetary policy doesn't have the magical ability to eliminate the unpleasant downward stroke of a natural market cycle and back off, or deny and defer. Given the fact that humans are proud and stubborn creatures by nature - especially well educated, highly specialized academicians – and that removing a force that has undoubtedly held markets at lofty levels for so long would most likely catalyze a tremendous adjustment in asset prices globally, deny and defer is the most likely option. Just like deferring responsible action in the past, and the repeated attempts to ward off all things unpleasant ultimately led to the financial crisis, the current deferral won't lead to anything good.

So here we are approaching eight years of low interest rate policy and the global economy continues its fight for life, which suggests two things. First, central banks cannot eliminate the downward leg of a business cycle. They may be able to distort things for a period of time, but ultimately that downward cycle will occur. On the flip side, economic activity can be filliped in the short term, but eventually getting corporations, governments, and consumers to spend money they don't have and can't afford to borrow becomes very difficult. This is what we're witnessing now. Second, asset prices are not a reflection of the underlying economy. They are a reflection of central bank policy which will persist until something goes wrong. That something could be practically anything, so it's really a fool's errand to make predictions as to what the catalyst might be.

The visual we get is one of a ship and gale force winds. When the wind's blowing strong and steady from one side of the ship, it can make sense to get everyone on the windward side of the deck to keep from listing too heavily and getting blown over. However, if that wind shifts quickly or even just lets up a bit in intensity, the tremendous misallocation of weight on deck is exposed. It should also be recognized that under normal conditions, nobody in their right minds would find crowding onto one side of a boat to be a good idea. These aren't normal conditions. If the Fed shifts its monetary winds one bit, it knows full well the ship may capsize. So it'll continue to blow and hope for the best. Far be it from the Fed to control all those other factors that could foil the plan. Whatever else ultimately causes the vessel to topple can be blamed on somebody else.

Key Takeaways

- Central banks can create the conditions necessary for asset bubbles to form, but it cannot stop them from bursting. Since the Federal Reserve has been liberal and loose in its application of monetary policy over the last 20+ years, we've seen two of the biggest bubbles in history as well as two of the biggest market crashes.

- Don't expect central banks to recognize bubbles publicly and take action to reduce them. It's up to investors to recognize their existence and risks. The Fed can help you reap quick gains, but it can't help you keep them.

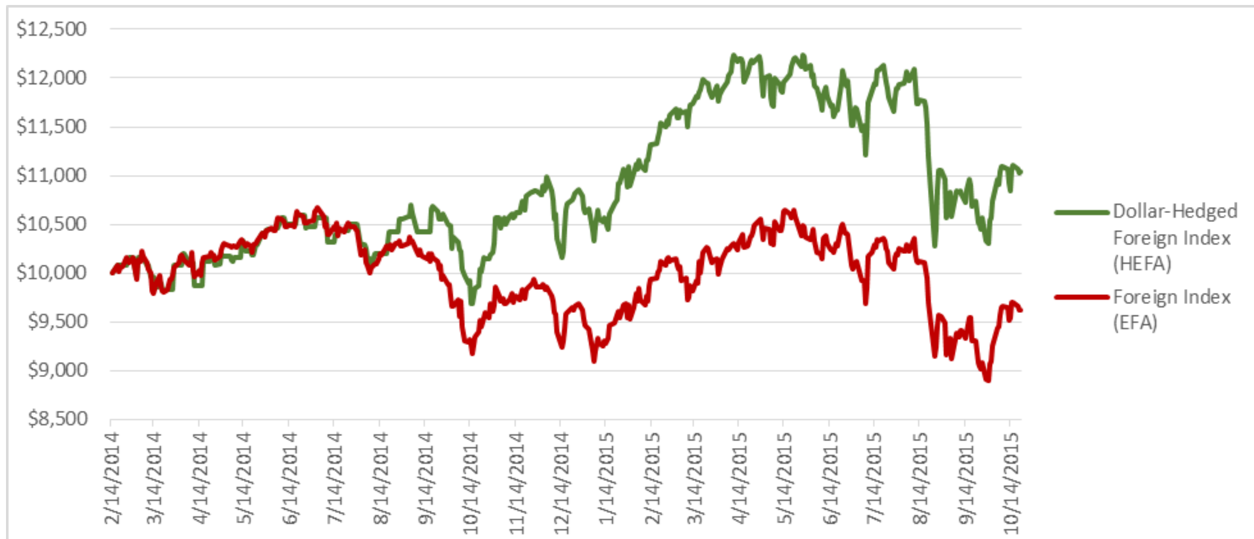
How Foreign Currencies Can Affect Investment Returns

When most people read the words "diversified portfolio" they think of a mix of stocks and bonds. Our clients may go so far as to also think of alternative investments, as we believe in the added benefit of diversifying with additional asset categories and by now most of our clients are aware of our exposure to those non-traditional areas. However, there are many ways to diversify a collection of investments, be they financial investments or tangible physical property. One such way that affects traditional and non-traditional portfolios alike is the role currencies play in investment returns.

Case in point: An American investor interested in buying 1,000 shares of BMW stock on January 1, 2009 would have needed just under $29,500 to convert into the €21,610 needed to buy those 1,000 shares. If the investor held that stock until the end of 2009 and sold all the shares, the resulting proceeds would have been €31,800, for a nice gain of over 47% in Euro terms. After exchanging those Euros into dollars, the investor would have been left with $45,600. That's a percentage gain of nearly 55% in dollar terms. Because the dollar lost value relative to the Euro over the course of 2009, an American investor converting back into dollars would have made 8% more than a European investor or any investor keeping the proceeds in Euros on the exact same investment due solely to changing currency values.

Of course, the process of converting from dollars into euros and back into dollars would chew some of those extra gains up, as currency transactions aren't free. There are more readily accessible tools that allow an investor to own foreign investments in either foreign currency or dollar terms. One such investment is an exchange traded fund, or "etf", that invests in a basket of foreign stocks known as the MSCI EAFE Index, which stands for the Morgan Stanley Capital International Europe, Australasia and Far East Index, with the ticker EFA. When an investor buys EFA, the returns of the investment are subject to both the returns of the individual foreign stocks that make up the index, as well as the currencies in which those stocks are owned by the index. Just like the BMW example above, investors will get an extra boost in return when they own EFA in a year where the US Dollar is depreciating relative to foreign currencies.

But what happens when the US Dollar is strengthening relative to foreign currencies as it has over the last 15 or so months? Predictably, those inherent currency conversions will subtract from the investment's return to the investors, but there is a way to protect against that currency drag. Instead of owning EFA, an investor can own HEFA, which is nearly the exact same index as EFA, but with the added benefit of being denominated in US dollar terms. When currency moves are substantial, the currency in which a foreign investment is owned can make a large difference over the short-term. Consider the following graph:



If you had invested $10,000 in EFA, the foreign-denominated index, on Valentine's Day 2014, you would be down nearly 5% as of last week. However, had you invested that $10,000 in HEFA, the dollar-denominated version of the same index, you'd be up a little over 10% at this point. You would have seen a 15% difference in gain based solely on currency.

At Cadence, we usually consider owning securities in their native currencies as another beneficial way to diversify a portfolio, as the dollar strengthens and weakens over time. Frequently the factors that cause those moves are beyond the financial realm, like geopolitical instability, and therefore difficult to anticipate. However, we are certainly willing to take advantage of currency moves if we find enough compelling data to make us feel like hedging against falling foreign currencies will benefit our clients.

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Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.