Another Wall of Worry

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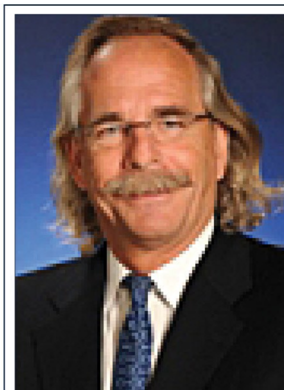
Investors faced with market uncertainty


Thomas Sowanick
Chief Investment Officer

Investors are once again faced with a growing wall of worry concerning emerging market volatility, geopolitical tensions between Russia and the West, sharply declining oil prices and a flattening of global yield curves. We will attempt to address each one of these concerns.

Worries that an emerging market implosion could lead to a broader disruption of risk assets has forced investors to remember the 1998 collapse of global emerging markets. The difference between 2014-2015 and 1998 is the divergence of global economic activity and the sharp reduction of Wall Street's leverage.

Certainly, a move to normalize interest rates by the Federal Reserve will likely keep downward pressure on many emerging country currencies. We do not believe that all emerging markets should be treated equally. Most importantly, energy importers (ie: China) will likely benefit significantly from lower energy prices while energy producers, such as Russia and Venezuela, are likely to come under severe economic and financial pressures.

In the current cycle, China has already begun to lower interest rates to ease concerns that its economy would also move closer towards recession. China will likely move interest rates aggressively lower, should non-manufacturing data continue to show signs of weakness. The fact that China has ample room in its monetary policy tool kit to ease further, should give reason for the markets not to conclude that the current cycle will be the same as the 1998 cycle.

Geopolitical tensions between Russia and the West have clearly escalated. This is evidenced by the very sharp depreciation of the Ruble over the past several weeks which forced the Central bank to raise interest rates from 10.5% to 17.0% in an attempt to stabilize its currency. In addition, oil (the lifeblood of the Russian economy) has also fallen sharply, reducing needed revenue to the Russian economy. Countries that are still linked to Russia and Eastern Europe will be negatively impacted while importing countries in Asia should be little affected by what has been taking place in Russia. Consequently, investors in emerging markets need to be disciplined on their regional focus rather than simply purchasing broad index replicating investments.

The flattening of the US yield curve has raised concerns for many investors about the change in the yield curve which is indicating weaker economic activity on a forward basis. However, it is our view that the recent flattening of the yield curve, which has been led by declining long term interest rates, is actually a statement about declining inflation expectations.

This difference of opinion can lead to a startling difference in the outlook for investment performance between asset classes. In the case where the yield curve is believed to indicate economic weakness, investors would be well served by purchasing long term high quality fixed income assets vs. lower quality assets such as high yield and small cap equities.

However, if the yield curve is indicating a decline in inflation expectations, then investors would be better served by focusing on risk assets or lower quality assets. It is our belief that the yield curve is indicating a decline in inflation expectations which has resulted from a decline in commodity prices and a rise in the US dollar. We believe that there is further scope for the US dollar to appreciate, especially against the euro and the yen in the coming months.

It is also our view that the current wall of worry is scalable and will lead to further gains in equity prices over the months ahead.