2015 4th Quarter Stock Market Commentary

CENTRAL BANKER WARDROBE: SUIT, TIE & FLIP-FLOPS

> "Children are unpredictable. You never know what inconsistency they are going to catch you in next."
> - Henry Ward Beecher

In 1973 political scientist Greg Markus at the University of Michigan collected political opinions on a variety of social issues from more than 2,000 parents and their offspring. Did they favor legalization of marijuana, did they think women were discriminated against in the workplace, was the criminal justice system biased too heavily in favor of defendants rights as opposed to those of victims. Markus then asked the same individuals for their opinions on these same issues nearly a decade later in 1982. Not surprisingly the results showed both parents and their children became more conservative as they got older. But more interestingly, when asked to recall the beliefs they had espoused ten years earlier, more than two thirds of the people could not correctly report their positions. They routinely guessed that that their remembered attitudes were more similar to their current opinions than they actually were.

This fallacy of memory is called the Consistency Bias, the commonly held belief that we are more consistent in our opinions than we actually are. It applies to much more than political beliefs. For example, if we like chocolate we usually assume that we have always liked it and will continue to do so in the future. A brief glance at your high school year book picture should show, though, that your tastes actually change considerably over the years (at least with regard to clothes and hairstyles).

A related cognitive bias is called the Projection Bias, in which one assumes that others have the same beliefs and attitudes you do, even when there is no evidence that they do. The consistency bias is self-referential, while the projection bias considers others.

These musings were prompted by the current chorus from business leaders, economists and Federal Reserve officials about the perils to the U.S. business recovery posed by the surging U.S. dollar (and the concomitant devaluation of the Chinese yuan). In order to understand what all the fuss is about, it will be useful to make a small digression and work through an example. Consider two sneaker manufacturers who compete against each other every day: New Balance, headquartered here in Massachusetts with five manufacturing plants in the U.S., and Adidas, headquartered in Bavaria, Germany. For simplicity, let's choose to ignore the fact that New Balance actually manufactures the majority of its sneakers in China and Vietnam while Adidas sources all of their footwear from over 1,100 factories in more than 61 countries. Let's simply pretend that New Balance sources and manufactures in this country, and Adidas does the same in Germany.

One year ago, in December 2014, the euro was worth roughly $1.25. Suppose at that time that a pair of Adidas running shoes cost the manufacturer 60 Euros to produce (raw materials plus labor), and that they sold them to American retailers for 80 Euros. In manufacturing lingo, this represents a 25% gross margin (a profit of 20 euros as a percentage of the selling price 80 euros). If New Balance incurred costs of $75 to produce a similar sneaker, and sold them for $100, the margin would also be 25%. An American retailer could then choose to buy either pair at a similar cost - 80 euros for the Adidas, or $100 for the New Balance and those two currency amounts are equivalent since each Euro was worth $1.25.

Now fast-forward to today, when a euro is only worth $1.08. If a retailer wants to buy a pair of the Adidas sneakers, they need only pay 80 euros x 1.08 dollars/euro, or $86.40. New Balance has to either slash its selling price, or cede sales to its now cheaper rival, or both. The stronger dollar has made U.S. goods relatively expensive, and given overseas manufacturers a huge cost advantage. As a general rule of thumb, the greater the percentage of foreign sales a U.S. based company has, the greater the headwind they face from our strong currency.

Data provider FactSet has reported that the companies in the S&P 500 reported an earnings decline of 2.2% for the third quarter of 2015. But for companies that generate more than 50% of sales inside the U.S., like banks and utilities, the blended earnings growth rate was 4.8%. For companies that generate less than 50% of sales inside the U.S. (such as information technology and healthcare), the blended earnings decline was -10.6%. The revenue profile was similar. The sales decline for the overall S&P 500 for Q3 2015 was -3.7%. For companies that generate more than 50% of sales inside the U.S., the sales growth rate was 1.0%. For companies that generate less than 50% of sales inside the U.S., the estimated sales decline was a whopping -12.5%.

The impact of dollar strength versus the currencies of our principal trading partners has been so powerful that it has even impacted Federal Reserve monetary policy. The Fed was created by the Federal Reserve Act of 1913. Congress defined its objectives for monetary policy as follows: maximum employment, price stability and moderate long-term interest rates. The first two of these are generally referred to as the Dual Mandate. By any objective analysis, the Fed has achieved its goals in the aftermath of the financial crisis. The unemployment rate, at 5.0%, is only slightly above its low over the past decade. Prices are so stable that Social Security will not be giving a Cost-of-Living Adjustment for 2016, only the third time that this has ever occurred. In point of fact, though, the Fed has interpreted "price stability" to mean 2% per year inflation, so that inflation is modestly below its self imposed target. Despite this, the Fed saw fit in both its September and October meetings to keep interest rates at zero, primarily because of the strong U.S. dollar. They did finally raise short-term rates by 0.25% at the December meeting.

The dollar had climbed by about 13% against a basket of other currencies over the six months ended March 31, 2015. Some of the effects appeared quickly. In March, the U.S. trade deficit rose to $51 billion, its widest gap since 2008, as U.S. exports became more expensive and imports became cheaper. The economy contracted by a 0.7% annual rate in the first quarter, nicked in large part by a 14% decline in exports, the biggest drop in six years.

According to the model used by the Federal Reserve to predict the effects of shocks to the financial system, a 10% increase in the exchange rate moves through the economy slowly. In the first quarter after the shock, the model predicts growth will be reduced by a negligible 0.08% and the inflation rate by 0.1 percentage point. But the impact grows steadily for three years, as producers, exporters, importers and consumers adjust their habits. After two years, about 0.75% will have been lopped off GDP at an annual rate. It is simply more expensive to buy U.S. products, cheaper for U.S. people to buy foreign products.

Given the unanimity of opinion, it is hard to remember that it was not long ago that U.S. officials were bemoaning the fact that the dollar was too weak and urging action. In the aftermath of NAFTA in 1994, Mexico's current account deficit soared. In order to correct the imbalance, the government devalued the peso by roughly half, sending inflation soaring and the economy into a steep recession. The Clinton Administration (that's the Bill Clinton Administration) decided to bail out Mexico, which other bankers interpreted as an open-ended pledge to a country in crisis. The result was a collapse in the U.S. dollar versus the currencies of our other trading partners. Our currency was being deserted by investors seeking safety, along with the Mexican peso and Italian lira. The Fed, under Alan Greenspan, had already raised rates seven times and was being urged to do so again to defend the dollar. Treasury Secretary Robert Rubin spoke about the need for a stronger currency, and the Fed and other central banks were forced to intervene in currency markets to support the dollar. A weak dollar, it was argued, would only raise the cost of imported goods, leading to higher consumer prices, and higher interest rates. It was argued that foreign investors would be reluctant to finance our then enormous $200 billion deficit (which looks almost like a balanced budget after the swollen deficits of the last few years).

It is similarly hard to remember that in the late 1990s, during the Asian currency crisis, U.S. policy makers were urging the Chinese government to devalue its currency. The crisis started when the Thailand government was forced to let its currency, the baht, float freely after they ran out of foreign currency reserves to support its fixed peg to the dollar. The economic turmoil soon spread throughout Southeast Asia, causing sharply falling demand in the region. President Bill Clinton and other high level members of the Administration urged China to devalue the yuan (also known as the renminbi) to stimulate demand, a request that President Jiang Zemin and Premier Zhu Rongji wisely resisted.

Today, the rhetoric is in the other direction. Politicians and policy makers are accusing China of currency manipulation for taking an action that they previously urged.

Congressman Sandy Levin, Democrat from Michigan, said "Given China's history of devaluing its currency to gain an unfair export advantage, today's actions by the Chinese government raise serious concerns. There is reason to be skeptical of believing that the largest devaluation of the Chinese currency in over two decades is merely about moving to a market-based exchange rate." The Obama administration has consistently referred to the Chinese yuan as "significantly undervalued."

The reality is that a weak currency is a two-edged sword. A devalued yuan does boost China's exports, but it also boosts domestic inflation by making it more expensive for Chinese consumers to buy imported goods. Similarly a strong dollar hurts revenues and earnings of U.S. multinationals, but simultaneously helps keep consumer prices in check despite easy monetary policy and low unemployment.

There are numerous factors which help determine the exchange rate between currencies: the relative economic performance of the two countries, the supply and demand for the two currencies, relative inflation rates, interest rate differentials and ease of capital flows, to name but a few. These variables are constantly in flux. Determining the "correct" value is an impossible task. This is true for most things in a complicated economy. It is essentially impossible to decide what the "correct" hourly wage should be for a school teacher, or a lawyer. Fortunately, though, relative wage costs are self-regulating, to a large degree. If the hourly wage for a lawyer gets "too large," it will attract more college students to shun teaching to apply to law schools, eventually producing a surplus of lawyers and a shortage of teachers. Wages for the former will then stagnate, while salaries for the latter should rise to attract new teachers. In a similar manner, a currency which is too strong will over the long term generate a feedback loop that will correct the mispricing. A strong currency will result in export weakness, causing the trade deficit to widen even further, eventually weakening the currency.

As investors, this dynamic creates a conundrum. In the near term, domestically focused companies will have stronger earnings momentum because of the lack of a currency headwind. The list of companies which have managed to meet or exceed estimates is extremely narrow, and both institutional and retail investors have continued to plow money into the favored few. But the best values are to be found amongst those companies with large overseas sales, whose stocks have been punished because a strong dollar has weakened sales and caused margins to compress. When the cyclical reversal comes, which it must eventually, the stocks with currently depressed valuations will be the same ones to receive an earnings boost from a declining dollar. As Warren Buffet has said, "In business the rear view mirror is always clearer than the windshield."