

COUNTERPOINT

The Quarterly Commentary of Jurika, Mills & Keifer LLC



Mills

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CENTRAL
BANKERS GONE
WILD!

CURRENT
INVESTMENT
STRATEGY

Spring Break:

It's Spring Break throughout many parts of the U.S., and beaches and resorts are packed with families and college students looking for sun, fun, and escape after a long and cold winter.

It is also Spring Break among the ranks of the developed world's Central Banks and, after a long winter of economic stagnation in Europe, Mario Draghi has finally joined the cast of *Central Bankers Gone Wild*, punch bowl in hand, and ready to let loose like never before.

This particular party is a bold initiative to use both

Summary:

- Mario Draghi arrives late to the monetary bash, ready to party. Meanwhile, Janet Yellen eyes the exit.
- Former dynamic duo of U.S. stocks and bonds start to underperform rest of world. Diversification starts to work again.
- Global economy getting slowly better relative to low expectations.
- Europe, in particular, looks interesting, benefitting from restored confidence, declining Euro, oil prices and interest rates.
- U.S. stocks are fully priced. Non U.S. stocks look more attractive. Expect volatility.
- Bonds remain unattractive.
- We continue to balance investments targeted at areas of long-term global growth with a strong core of defensive strategies, and a stable foundational base of bonds and cash.

conventional and extraordinary monetary policy to stimulate otherwise moribund, debt-laden and deflation-prone economies.

Their objective has been to create an environment of renewed confidence, low interest rates, and easy money, resulting in a resurgence in investment and economic growth, rising asset prices and higher levels of employment.

It started with the U.S. Federal Reserve in 2008 with the first of several rounds of “quantitative easing,” (*aka QE*) in response to the global financial crisis. The Federal Reserve was followed by the Bank of England in 2009, and the Bank of Japan in 2013. In January of this year, Mario Draghi, on behalf of the European Central Bank, finally put his money where his mouth was and announced a major program of quantitative easing for the Eurozone.

Ben Bernanke once famously quipped “**The problem with QE (*Quantitative Easing*) is that it works in practice but it doesn’t work in theory.**”

Thus far, in practice extraordinary monetary policy appears to have been mostly successful at achieving its primary objectives, although not without some significant side effects. In the U.S., it has led to a resurgence in economic growth, employment and prosperity, as well as strong equity and bond markets. In Japan, since they announced their massive program as a part of a broader set of reforms, the Japanese economy has started to rise from the dead, and the Japanese stock market has appreciated by more than 20%. Now, at long last, Europe has capitulated and the European Central Bank under Mario Draghi’s leadership has gone all-in, with a bold program on the part of the ECB to buy trillions of euros in bonds. The impact has already been dramatic. The Euro has declined by almost 25% in value against the dollar, and interest rates around the Eurozone have fallen significantly. Italian and Portuguese bonds now yield less than

U.S. Treasury bonds and German and Swiss ten year bonds actually offer a negative interest rate. You pay them to lend them your money. Such a deal!

For the moment, the party is in full swing and seems to be having the desired effect of reigniting economic growth and risk-taking, and offsetting the pernicious effects of deflation.

But what happens when the monetary party comes to an end as all parties eventually do? This is a question that is keen in the minds of many investors, especially as Janet Yellen and the Federal Reserve have announced their intentions to pack up their punch bowl and go home sometime this year.

As extraordinary monetary policy has shown its usefulness to stimulate growth and combat deflation, it has also led to artificial pricing of assets and risk. This is most evident in the global credit markets, where bonds have become the fixed income equivalent of dot-com stocks. Perhaps we have been at this too long, but the promise of a negative return on investment in a government bond does not seem like a good deal to us. You could at least put your money in your mattress and earn nothing.

And yet investors in Europe seem willing to do this. A U.S. ten year bond yielding a meager 2% looks like a good deal on a relative basis, and a high quality stock that sports a 3% dividend and the potential to appreciate looks like a bargain.

In a world starved for yield and attractive, safe returns, there is a huge incentive to accept ever greater risks to achieve ever lower returns.

So investors have flocked to junk bonds, real estate, stocks, emails from Nigerian Princes and any other potential investment that promises a higher potential return, almost regardless of the inherent risk of the investments.

And because there is an abundance of cheap capital - at least for those who qualify - there has been a tendency for investors to make decisions that they would not make if interest rates and the pricing of risk were at more normal levels. This type of behavior rarely ends well.

When the party ends, the hope is that economies will have enough momentum that they can move forward under their own power, and withstand the gradual increase in interest rates that inevitably follows. It remains to be seen if this will be the case in the U.S., Japan and Europe.

Ideally, monetary stimulus is meant to be a supplement and compliment to fiscal stimulus - rather than a substitute for it.

But aggressive fiscal stimulus has been largely absent in the U.S. over the past five years, leaving the Federal Reserve to do almost all the heavy lifting.

In Japan, their aggressive monetary policy was supposed to be matched by large-scale fiscal spending and deregulation. But thus far, fiscal stimulus has been lackluster and the government even passed an ill-fated sales tax increase that they subsequently had to repeal because it was hindering economic growth.

In Europe, until last year, governments were more focused on *austerity* than stimulus, causing economic growth in Europe to contract and making the ECB's job all the more difficult. Europe is now moving away from this agenda towards a more growth-oriented fiscal mindset, especially in the wake of public opinion that is sick of austerity, deflation and high levels of unemployment.

But across the developed world, central banks have had to offset the absence of good fiscal policy with extra doses of monetary medicine. And, economies, markets and investors have become accustomed, if not addicted to artificially cheap money and the

hope, if not belief that things will be like this for an *extended period of time*.

This may indeed be the case, but at some point the party will wind down of its own accord or prove unsustainable, and artificially depressed interest rates and volatility levels will start to rise. We think this will be a gradual process and that interest rates will tend to stay depressed for longer than most people expect. But we also know that markets rarely behave as people want them to behave or think they should, and the potential exists for a more sudden and dramatic increase in rates.

In either case, there are many investments that are being made today, especially in the bond market, that make no sense to us and will likely end in losses, if not tears. We therefore think that it is important to look through the current party-like atmosphere and make sure that investment decisions can stand the test of time, based on a realistic assessment of risk and a realistic cost of capital.

Quarterly Review and Strategy:

On the surface, the first quarter of 2015 marked an unremarkable start to the year, especially in the wake of several years of strong performance. The bell weather S&P 500 was roughly flat for the quarter, and even the US bond market produced meager returns.

Beneath the surface however, a number of important things happened that are likely to have a meaningful bearing on how economies and global financial markets move from here. These include a dramatic fall in the price of oil and increase in the value of the U.S. dollar relative to most other currencies.

We are also starting to see a divergence from the prior trend of the U.S. stock and bond markets being the only game in town. So far this year, non-US equity and bond markets are outperforming the

US, volatility is on the rise, and diversification is adding value. We expect that there is more of this to come.

In the U.S., the first quarter saw some slowing in economic growth, which has caused concern among investors. Overall, we think the U.S. economy is in fine shape and that a lot of the recent softness in economic data can be attributed to nasty winter weather as well as the port strike. We expect to see a resurgence in growth in the coming quarters.

In Europe, we are seeing “green shoots” of economic growth across the Eurozone and have grown increasingly optimistic about its prospects for four reasons.

First, the ECB has restored confidence that the Eurozone will hold together. The ECB is prepared to do whatever it takes to encourage new growth and risk taking, even if it means loading up the Central Banks’ balance sheet with toxic bonds.

Second, because of its actions, the ECB has caused a significant decline in the Euro relative to the dollar and other currencies. This makes European exported goods much more competitive in the global market and exports represent a much larger percentage of European GDP than they do here in the U.S. This also makes Europe a much more attractive tourist destination. It’s a great time to buy that Greek Island you’ve always dreamed of owning.

Third, the sharp drop in oil prices, which are a major input cost for the European economy, has provided an additional boost to consumer spending and profit margins.

Finally, the change in mindset from austerity towards more stimulative economic policy means economic policy and fiscal policy are no longer fighting each other, but rather rowing in the same direction.

This is not to say that we expect Europe to be a booming beacon of economic prosperity, efficiency and entrepreneurial zeal. But many of these factors that were headwinds for Europe are now tailwinds, and that is definitely a positive change and is being reflected in European equity markets which were up strongly in the first quarter.

The Emerging equity markets also delivered positive performance in the quarter, although when talking about “Emerging Markets” it is important not to take a monolithic view. There are huge differences between countries and regions.

We continue to think of the growth of the developing world as an exciting inevitability, which already accounts for more than half of total global economic growth and will only increase over time.

But not all countries are the same and will participate in this growth the same way, and we are primarily focused on the growth of the Asian consumer, including India, and away from resource dependent economies like Brazil.

Investment Strategy:

As always, we take a long-term view of portfolio positioning and asset allocation.

We seek to identify and invest in areas of long-term growth and opportunity, and avoid areas of risk and challenge. We invest as if we were required to lock our clients’ portfolios in a vault for five years without being able to touch them.

This helps to clarify our thinking about what we believe with conviction about the long term, while tuning out all the near-term noise, sound and fury that rarely signifies anything over time.

We always want to be very intentional about where we allocate client capital and take our risks, and always emphasize balance and diversification in



portfolio construction. Whatever we, or anyone may think about the future, the probabilities are that it will turn out differently than conventional expectation. This is one reason why diversification is so important.

Looking at the world with this perspective, and considering valuation relative to economic fundamentals and future opportunity, we think that the U.S. economy is in good shape relative to much of the rest of the world. But much of this is in the price. The U.S. stock market is fully valued, although there are pockets of value and large divergences between stocks that are in favor and out of favor.

Expensive markets can easily get more expensive, but the risk relative to the potential reward is less compelling now. We have therefore increased our allocation to long/short strategies that benefit from disparities in valuation, help defend portfolios during market declines, and can become more aggressive when markets are cheaper.

We continue to have a long-term favorable outlook towards areas of innovation such as technology, life-sciences and healthcare and have our clients' capital committed to these areas.

Relative to the U.S., Europe and Asia look considerably more compelling and we have been increasing our allocations to these regions over the past six months.

We think that bonds offer poor long-term value as investments, especially if and when interest rates start to rise. We do maintain a modest allocation to bond investments to serve as a foundational base for client portfolios. These are primarily invested in short-term and conservative "total return" bond funds.

As always, we welcome your questions and comments.

Jurika, Mills & Keifer, LLC
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Our firm is built on a core set of values and investment principles that have been central to our identity and success for over 30 years.

Our objective is to preserve and build the purchasing power of our clients' capital over time through forward-looking investment management and effective financial planning.

We think for ourselves and are often willing to challenge conventional wisdom and practice.

Our offices are in San Francisco, California. We welcome your inquiries.

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