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AR SCHMEIDLER & CO
INVESTMENT ADVISORS

# THE OUTLOOK

***The team at ARS is introducing Outlook Notes for our clients. Outlook Notes will be published as events dictate, and will be a supplement to The Outlook which we publish about four times a year. We hope you find this shorter communication tool valuable and would appreciate your comments.***

## Quick Take on the Franc, the Euro and the Greek Election

In the past two weeks, two big economic changes and one big political change occurred in Europe. On January 15th, the Swiss National Bank (SNB) surprised the markets by freeing its currency, the franc, from its link to the euro causing the franc to instantly increase in value and setting the stage for Switzerland's export-driven economy to go into recession. This recent change was in anticipation that the European Central Bank (ECB) would expand its quantitative easing (QE) program to ward off deflation and recession in the Eurozone. The ECB, on January 22nd, did exactly that announcing monthly purchases of 60 billion euros through September 2016 or until the ECB sees a sustained adjustment in the inflation rate to its target of below but close to 2%. Then on January 25, 2015, the people of Greece elected the anti-austerity party setting up a fight between Greece and its creditors. The SNB policy action is emblematic of the currency wars which are a consequence of insufficient global demand resulting from the lack of appropriate fiscal policy. The ECB policy action is illustrative of the challenge facing governing institutions in the Eurozone as they attempt to address the growing imbalances, structural deflation and insufficient fiscal policy support. The very important Greek election is the direct result of seven years of a shrinking economy which has led to record high levels of unemployment, particularly for youths. Shrinking economies have also resulted in lower living standards and increased resentment throughout the European community. This is a tipping point for Europe's governing bodies in determining the outlook for the Eurozone.

These changes serve as a reminder of the interconnectivity and interdependency that exists not only within Europe but also within the global economy. Monetary policy has been the primary tool used to stimulate global growth and stave off deflationary forces brought about by excess debt, overcapacity and insufficient demand. With interest rates at record lows and still falling in many developed nations, central banks are running out of tools for policy implementation and it is time for political leadership to finally use fiscal policy and face up to the need for proper structural reforms to generate economic growth. Our two most recent Outlooks addressed the disequilibrium in foreign exchange rates, interest rates, oil prices and inflation rates which are creating distortions in the global markets. The key takeaways for investors from the SNB and ECB policy actions and the Greek election are:

1. **Increased volatility** should be expected

2. **Interest rates** should remain below historical norms for some time

3. **Structural deflation** should be the primary concern of central banks and governments in most developed countries and is being underestimated or perhaps confused with cyclical deflation by many government leaders and market participants

4. **Fiscal policy** needs to be more focused on addressing the structural deflation challenge, as monetary policy alone is insufficient

5. **The transmission mechanism** for the European economy has been broken due to lack of aggregate demand, demand for loans stemming from high unemployment and an unwillingness of banks to lend

6. **Of the developed nations,** the growing U.S. economy remains best suited to deal with today's challenges (refer to the January 9, 2015 Outlook for details)

## Swiss Franc Currency Actions – Then and Now

*"The current massive overvaluation of the Swiss franc poses an acute threat to the Swiss economy and carries the risk of a deflationary development. If the economic outlook and deflationary risks so require, the SNB will take further measures."*

*- Excerpt from the SNB press release, September 6, 2011*

*"Recently, divergences between the monetary policies of the major currency areas have increased significantly – a trend that is likely to become even more pronounced. The euro has depreciated considerably against the US dollar and this, in turn, has caused the Swiss franc to weaken against the US dollar."*

*- Excerpt from the SNB press release, January 15, 2015*

Back in 2011, the SNB acted to defend its currency as it viewed the franc as significantly overvalued and posed the risk of deflation. The Swiss were attempting to "achieve a substantial and sustained weakening of the currency". An expensive franc was hurting the Swiss economy which relies on exports for 70% of its GDP, so the SNB introduced a policy to fix (peg) the exchange rate at 1.20 per euro. The Swiss acted to remove the peg as a large scale QE program by the ECB would have made it even more difficult for the SNB to maintain its peg. The removal of the currency peg roiled the currency markets and led to a large decline in the Swiss stock market. Back in 2011 when the financial markets were in turmoil, safe-haven currencies like the Swiss franc were attracting significant inflows which made the currency more expensive. As with most currency interventions, this policy helped the Swiss economy for a time as it made the franc less expensive and the economy more competitive. However, the need to print francs in order to purchase euros caused the balance sheet of the SNB to expand to a size almost equal to its GDP. This became unsustainable for economic and political reasons. Broadly speaking when currencies are fixed to inherently weaker currencies, they ultimately set themselves up for recession and deflation.

## The ECB and the Greek Election – One Step Forward and Two Steps Back

*"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough… And I think the key strategy point here is that if we want to get out of this crisis, we have to repair this financial fragmentation."*

*- Speech by Mario Draghi, President of the European Central Bank, July 2012*

*"This assessment is underpinned by a further fall in market-based measures of inflation expectations over all horizons and the fact that most indicators of actual or expected inflation stand at, or close to, their historical lows. At the same time, economic slack in the euro area remains sizeable and money and credit developments continue to be subdued … As a consequence, the prevailing degree of monetary accommodation was insufficient to adequately address heightened risks of too prolonged a period of low inflation."*

*- Remarks by Mario Draghi, President of the European Central Bank, January 22, 2015*

The European region is once again at a crossroads. At the time of the creation of the euro as a common currency, there was little, if any, recognition of the possibility of member nations having to deal with structural deflation, high unemployment, high debt levels and virtually zero interest rates as the member nations were experiencing structural inflation and growth. In fact the developed world, until the financial crisis in 2008, had been characterized by credit-fueled growth which fostered inflation which became structural over many years. The financial crisis effectively marked the end of the structural inflationary period as the use of credit to foster demand has shrunk to a fraction of what it was in pre-crisis times. Europe has entered into a structural deflationary environment. Because current economic forces present in the European economy were not contemplated at the euro's inception, the ECB has had to rely on unconventional measures to stimulate the economy. Today there are some positives for Europe as it is benefitting from lower oil prices which support real disposable income and corporate profits, and the region should also see domestic demand increase due to the expanded monetary measures being put in place. However, these positives are being offset by fiscal tightening resulting from austerity policies. In his remarks following the most recent QE announcement, Mr. Draghi stated that "the euro area recovery is likely to continue to be dampened by high unemployment, sizeable unutilized capacity, and the necessary balance sheet adjustments in the public and private sectors."

Mr. Draghi once again highlighted the need to repair the financial fragmentation that exists in Europe. There are two critical and related factors weighing on the European economy that make the solution to this structurally deflationary environment much more difficult. The first is the multi-country framework for the coordination and implementation of fiscal and monetary policy. Unlike in the one-country framework such as the U.S. where the central bank implements monetary policy and the treasury executes fiscal policy, the ECB has to rely on the 19 member nations to execute fiscal policy. The second is the requirement for austerity and structural reform on highly-indebted member nations. Given the divergences between the strong and weak economies in Europe, it is extremely hard to employ a one-size-fits-all fiscal policy as the the requirement to reduce deficits in the weaker countries has fostered an environment for anti-European political groups to gain support. Greek voters elected a new government this past Sunday with the anti-austerity opposition party Syriza winning and moving quickly to form a coalition government. The Greek election is an outright rejection of the core policy as devised by the country's biggest international lenders - the European Union (EU), International Monetary Fund (IMF) and European Central Bank (ECB) also referred to as the Troika. Greece sets up another challenge for European leaders as the new Prime Minister Alexis Tsipras wants to renegotiate Greece's debt while remaining a member of the EU. These negotiations will be closely watched by other anti-austerity parties including members of Spain's anti-establishment party, Podemos, which is currently leading in the polls ahead of elections later this year. Germany has already stated that it expects the new Greek government to live up to its existing commitments to creditors. This is hardly the recipe for an end to political friction and financial fragmentation.

## What this Means for Investors

Against a backdrop of a highly accommodative central bank policy in Europe, investors should expect to see increased dissatisfaction from both sides of the austerity debate as well as additional changes in party leadership in governments across Europe. Parties representing the far left and far right will be gaining traction as Mr. Draghi's concerns of financial fragmentation play out in the coming months with the Greek debt negotiations framing the debate as to how structural reform is addressed. While the long-term outlook remains uncertain, investors should not be surprised to see European financial assets appreciate in the near term based on the QE program of the ECB. As stated in our Outlook, we expect the current low growth, low inflation and low interest rate environment in the developed world to persist for a considerable period of time, perhaps through the end of the decade. The aforementioned risks to the European economies, other global risks and rising deflationary pressures may well make the Federal Reserve hesitant to raise interest rates this year. We would use the higher than normal cash positions in client accounts to take advantage of price distortions created by increased market volatility to buy or add to quality businesses that have the ability to maintain and raise profit margins. Based on our Outlook, we continue to expect the U.S. to be a primary beneficiary, but certainly not immune to the global challenges.