THE OUTLOOK

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The Implications of "Whatever it Takes" Global Monetary Policy

The challenge for investors is to understand the current economic environment which differs from any in the past. **The global economy is undergoing an adjustment process that, unlike others, is not easily self-correcting as the growing debt burdens and the deflationary impact of excess capacity and technological advances are not being offset by an adequate level of demand for goods and services.** These deflationary forces have led to an environment characterized by increasingly negative interest rates set by central banks in Europe and Japan as the "whatever it takes" monetary policies of both nations have shifted from highly accommodative to aggressive. This is the backdrop for today's market volatility, and investors should be prepared to move quickly to invest when volatile markets present compelling valuations.

"It is hardly unusual for financial markets, particularly those dealing in currencies and equities, to trend well away from economic fundamentals. After all, such excesses in the other direction were a major part of what built up bubbles and led to subsequent crashes in the EU and US crises. The current divergence in views is worthy of deeper scrutiny, however, since it is driven in substantial part by distrust of the credibility and capability of economic policy to respond to bad economic news."

Adam Posen, Peterson Institute, March 2016

The actions of market participants have been so episodic that they are distorting both the positive and negative views of the U.S., China, Europe and Japan. As the standout economy, the United States demonstrates many positive attributes including improving employment, a turnaround in labor participation rates, better housing numbers, lower energy costs, an improving consumer and a relatively better economic standing than other nations as evidenced by modest GDP growth and a positive interest rate structure. Unlike in the past when a gradual rise in interest rates was viewed as a sign of an improving economy by the markets, the discussion by the Federal Reserve earlier this year of a less accommodative monetary policy was viewed negatively. While the United States cannot carry the global economy on its own, we do not believe that it is headed for a recession, and it should continue to do relatively well. China, the world's second largest economy, is undergoing a significant long-term economic transition. Investors may be underestimating China's ability to effectively manage this change and to have the financial resources to do so. While China has several short-term challenges in transitioning from export-driven to domestically-driven growth, the government has a longer time horizon than most market participants. Just recently, China targeted excess capacity in the steel industry by announcing planned shutdowns and 1.8 million layoffs over the next 5 years. Excess capacity is one of the biggest issues for China and the global economy, and China's actions indicate that the government is committed to addressing its problems. The industrial sector of the economy, which drove China's double-digit growth, is not working as it once did. The service sector is now starting to take the leadership role as evidenced by the increase in travel and its growing middle class. As a result, the Chinese consumer arguably represents one of the most compelling investment opportunities for the next decade.

ZIRP to NIRP – The Latest Effort by Central Banks

The volatility experienced in the market this year is the unavoidable result of a deflation-prone environment lacking sufficient demand accompanied by large amounts of outstanding debt. As exporting nations try to gain economic advantage by devaluing their currencies to the detriment of other nations, capital is flowing to the strongest currencies which is perpetuating and reinforcing the stresses in the global system. **In response to deflationary concerns, central banks have shifted from the most accommodative monetary policies (Zero Interest Rate Policy or ZIRP) in history to the most aggressive ones as evidenced by the recent announcements from the Bank of Japan (BOJ) and European Central Bank (ECB) to introduce or expand the use of a Negative Interest Rate Policy or NIRP.** NIRP involves the lowering of interest rates on government bonds to below zero in an attempt to more aggressively stimulate demand by forcing money into the system through bank lending. It is designed to have investments made with borrowed money in order to generate growth. In the first seven days following the announcement by the Bank of Japan in late January, more than $1 trillion of government debt moved from positive to negative yields, and today it is estimated that more than $7 trillion of global government debt outstanding has a negative yield. That means that those who purchase these debt securities are guaranteed a loss if held to maturity. Ironically investors could make money if the bonds are sold at even lower yields (higher prices) and would buy these bonds if they believed that central banks would be forced to push negative rates even lower.

In a negative interest rate environment, banks are charged to hold money with a central bank. The goal is to stimulate economic growth by encouraging banks to lend more aggressively, corporations to borrow and invest, and consumers to borrow and spend. For investors, the negative yields on government bonds force many income-oriented investors to seek alternative investment strategies to achieve their income goals. Pension plans with long-term obligations, insurance companies and retirees living on a fixed income are among the most negatively impacted by this program. On the other hand, it is providing governments the opportunity to make investments by borrowing at the lowest interest rates in history.

"Given continued high structural unemployment and low potential output growth in the euro area, the ongoing cyclical recovery should be supported by effective structural policies. In particular, actions to raise productivity and improve the business environment, including the provision of an adequate public infrastructure, are vital to increase investment and boost job creation. The swift and effective implementation of structural reforms, in an environment of accommodative monetary policy, will not only lead to higher sustainable economic growth in the euro area but will also make the euro area more resilient to global shocks.

Mario Draghi, President of ECB, March 10, 2016

As discussed above, the effectiveness of the NIRP initiative is dependent on bank's willingness to lend more, corporations to invest more and consumers spending at higher levels to create greater demand for goods and services. NIRP must also be done in conjunction with structural reforms and productive fiscal stimulus programs by governments. Monetary policy alone can only do so much to stimulate growth, and it is reaching its limits. It is not a replacement for structural reforms that are needed in so many nations to achieve sustainable growth. In 2015, McKinsey estimated that $57 trillion of infrastructure investment is needed globally. Well-defined infrastructure projects can be stimulative not just for the near term, but also for the long term as they create jobs, improve productivity, stimulate demand and increase needed government revenues. Governments around the world must take advantage of low interest rates to finance these critical investments, and those nations that do not will likely remain in the low growth mode and put themselves in an increasingly uncompetitive position. **In an even more competitive global economy, those nations that make these investments will enhance their competitive standing. Major nations that address structural reforms and embark on fiscal stimulus initiatives would bolster demand which would be a huge positive for the global economy.**

Investment Implications

"The Committee expects that economic conditions will evolve in a manner that will warrant only gradual increases in the federal funds rate; the federal funds rate is likely to remain, for some time, below levels that are expected to prevail in the longer run."

Federal Reserve March 16, 2016 Press Release

Under current conditions, the environment of negative to low interest rates, low inflation rates, and slow growth will persist for an extended period in our view. This was further supported by the Federal Reserve's recent announcement to abandon its less accommodative interest rate policy as stated in December and January. The key areas for emphasis in client portfolios are on owning high-quality growth and high quality-dividend growth companies. Cash positons are meant to take advantage of opportunities when presented by volatile markets. What matters for successful stock selection is often far less complicated than market participants make them out to be. While not easy, it comes down to clearly understanding some salient characteristics.

- What is going to drive the business going forward?
- Is management of high quality?
- Is the business getting better or worse?
- Are margins, earnings and free cash flows improving or getting worse?
- Is the business gaining or losing market share?
- What is the risk and reward to purchasing at the current price?
- In terms of portfolio construction, is it purposely adding a similar exposure to other companies already owned or is it providing exposure to a new area?

Our focus remains on selecting companies benefitting from positive trends in mobility and cloud computing, rising defense spending, healthcare, U.S. consumer spending and the shift to a more service-oriented global economy led by China. We continue to target companies that are gaining market share, maintaining or improving profit margins, increasing free cash flow, restructuring to gain more efficiency, increasing pricing power and/or growing dividends. Companies that are able to more aggressively invest in the future growth of their businesses will be more highly rewarded as there is a growing view that many corporations have only been able to financially engineer their performance improvements through share buybacks. **Given the distinct nature of the current economic environment, investors should be careful not to let short-term emotions divert them from making sound, longer-term investment decisions. Investors should be buyers during times of market weakness.**