BOSTON PORTFOLIO ADVISERS

Second Quarter 2016 Outlook and Commentary

Early in the first quarter and for the second time in just over six months, global stock markets fell precipitously only to rebound sharply and recover almost all of the lost ground. Last summer the S&P 500 Index plunged by 13% in five trading days before climbing almost all the way back in September. By comparison, January's decline was more leisurely, with the index shedding a bit under 13% over three weeks, then rebounding sharply from mid-February to the end of March, at which point it was up a scant 0.8% on the year.

A positive interpretation of the recent market rebound might be: the price of oil found a bottom in late January and economic data from China has stabilized. Market fears that global economic growth would crater were overdone and investors now realize that for the foreseeable future we are in a low growth, low interest rate world and that's good for stocks. We believe all of that to be true. But it also misses something more fundamental that might explain the severity of recent stock market volatility.

For much of the post-financial crisis period, the ultra-low interest rate policies of the U.S. Federal Reserve (supported for the most part by other central banks) have acted as a security blanket for capital markets. How much can go wrong when the Fed is going full throttle? But eighteen months ago the Fed announced the end of quantitative easing (QE), signaling the very early stages of a rate hike cycle. Since that time investors may have begun focusing on a couple of ways in which the world looks very different than it did before the financial crisis.

<u>The end of the G7/G8</u>

The G7 dates back to 1975 when the world's six largest developed economies began to meet regularly in order to coordinate economic policy and foster international financial stability. The size of the group (and name) has changed a few times with Canada joining the club in 1976 and Russia in 1998 (before getting booted recently as a result of aggression in Crimea and the Ukraine). In 1999, a larger group of nineteen countries (plus the European Union) was formed in recognition of the growing significance of emerging market economies such as China, India and Brazil. The G8 retained its preeminent role until 2009 when government leaders announced that the G20 would take over as the primary forum for coordinating economic policy.

In the immediate aftermath of the financial crisis, it was clear that the world needed all the monetary and fiscal stimulus authorities could muster. Policy response varied from region to region but everyone was steering in the same direction. The U.S. Federal Reserve led the way on the monetary front with its zero-interest rate policy while a massive infrastructure program in China provided the bulk of the fiscal stimulus. After eighteen months of relatively uniform response, efforts began to get disjointed in 2010 when Europe (and the U.K.) initiated austerity measures as the result of a burgeoning government debt crisis. The U.S. followed suit a year later when President Obama agreed to hold down federal spending through "sequestration" in exchange for Congressional Republican support for a debt ceiling increase. The European Central Bank further muddied the waters in the spring of 2011; while the U.S. Fed was continuing to push interest rates lower, the ECB began to lift rates only to reverse course six months later.

For several years investors were largely shielded from this lack of policy coordination. As long as the Fed was keeping interest rates near zero and China's economy was booming all seemed right with the world. By 2014 though, the Fed had begun to wind down QE and China's economy was beginning to soften. Disjointed management of the global economy became a major issue last August when the Chinese stock market bubble burst and authorities in Beijing reacted clumsily. The fact that leaders of the world's second largest economy didn't seem to know what they were doing was bad enough. Making matters worse, having had very limited interaction with Chinese counterparts, policy makers in the U.S., Europe and Japan were, to a large degree, flying blind.

The influence of governments and central banks on the global economy is indirect and rather imperfect. Even so, capital markets like to think there is a hand on the tiller. For several decades the G7/G8 played a critical role in harmonizing economic policies. The G20 is too large and unwieldy a group to serve that function. Perhaps over time the U.S. and China, as the two leading economic powers, can muddle their way into shared leadership. But no one knows exactly what that would look like and that's certainly not where we are now. Capital markets crave stability; observing weakened mechanisms for smooth policy coordination has undoubtedly been unsettling.

The possible collapse of the U.S.-Saudi alliance

Speaking of shared leadership, for the last thirty plus years the U.S. and Saudi Arabia engaged in an arrangement designed to ensure relative stability in the price of oil. The role of the U.S. has been to guarantee the free flow of Persian Gulf oil through the Strait of Hormuz. The U.S. also supplies enough advanced weaponry to make Saudi Arabia the dominant military power in the region. In return it has been understood since at least the mid-1980s that the Saudis would use their leading market share in oil production to keep prices from getting too low or too high. The two oil crises of the 1970s caused energy prices to skyrocket, prompting western countries to lessen their dependence on oil through conservation and the development of coal, natural gas and nuclear power to generate electricity. Saudi rulers, frightened at the prospect that the West would wean itself from Middle East oil, began a long term effort, through OPEC, to keep the price of oil within a range that would be palatable to producers and consumers alike.

While the project of keeping oil prices stable has not been perfectly successful, for several decades U.S. interests and Saudi interests were closely aligned. Alignment of economic interests encouraged the U.S. to turn a blind eye to some egregious behavior, including the Saudi royal family's long history of funding Wahhabism, an extreme branch of Sunni Islam many believe to have inspired Al Qaeda.

Seven years ago President Obama came into office committed to making overtures to Iran, Saudi Arabia's chief rival in the region. After years of false starts, those overtures eventually led to negotiations over the Iranian nuclear program. Saudi rulers fought bitterly against the pact but perhaps emboldened by dramatically lessened reliance on Saudi oil thanks to the shale revolution, Obama concluded a nuclear deal with Iran last summer. Seeing the writing on the wall with respect to the nuclear agreement and fearing Iran's growing influence, the Saudis intervened a year ago in Yemen against the Teheran-backed Houthi rebels. Although the U.S. military continues to provide significant support for the campaign, in private the administration worked strenuously but unsuccessfully to head it off.

With the long-term foundation of the alliance in question, perhaps it shouldn't be surprising that Saudi Arabia sat on its hands as the price of oil cratered in January. The regime may have seen an opportunity to deal a crippling blow to U.S. shale producers who, with relatively high operating costs, lost money pumping oil at recent prices. Gone are the days when investors can look to Riyadh to serve their interests. While the price of oil doesn't have as big an impact on the global economy as it did in the 1970s—world economic output is much less "energy-intensive" than it used to be—it's still important. Deep fissures in the U.S.-Saudi alliance serve as another reminder to capital markets of the profound changes taking place in the foundations of the global economy.

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The U.S. Federal Reserve announced the end of QE in October of 2014. Progress since then toward a normalized Fed Funds rate has been glacial. One thing holding the Fed back is that the ECB and the Bank of Japan are moving in the opposite direction as they fight persistent fears of deflation (fears that were exacerbated by the collapse in oil prices). Outside the U.S., more than seven trillion dollars of government bonds feature ***negative*** interest rates. It's hard to imagine that a spike in interest rates is just around the corner (although we've been guilty at times of imagining just that). But even if rates rise very slowly, the process has begun. And the fact that the Fed is moving so cautiously and tentatively could itself be a cause for concern, forcing capital markets to wonder if central banks can navigate a smooth path toward normalization.

From the early 1980s until just before the financial crisis, investors could count on several elements of global economic leadership. The G7/G8 ensured that policy was coordinated among all of the key economic powers. The U.S.-Saudi alliance guaranteed that oil prices would generally stay within an acceptable range. And central banks had the ability to steer interest rates as appropriate in order to smooth out the rough edges of the business cycle. Of course none of this worked perfectly—policy conflicts arose, oil prices spiked and central banks faltered. But investors had a sense that crises could be managed and that they knew, more or less, who would manage the crises and how they would manage them. That sense of the ability to navigate crises isn't there in the way it was for 35 years and that's bound to make capital markets jumpier when the inevitable challenges arise, whether it's a collapse in oil prices, the bursting of the Chinese stock market bubble, the possibility of the U.K. exiting the European Union, growing disenchantment among U.S. voters with the pursuit of free trade, or a threat currently unforeseen.

None of this means that global stock markets are headed south or that we are on the verge of a global recession. The market has been fearful of an economic downturn since last summer and from our vantage point it still seems unlikely. As alluded to earlier, we seem to be in the kind of low growth, low interest rate environment that tends to be favorable for stocks. And, the global economy has gone through periods of major transition before. In fact, transitions and volatility tend to create significant opportunity. For example, emerging markets stocks now have a negative five-year total return while developed foreign countries are flat for the previous five-year period. There are a myriad of reasons including low interest rates, the price of oil and the strength of the dollar, but five-year trends tend to reverse sooner rather than later. It is likely that if we look to the next five-year period, today's laggards will be tomorrow's leaders. And with bonds not yet yielding much, we need to look to stocks to generate the majority of our returns going forward. Still, even if the coming quarters and years provide solid returns, you'd probably be well advised to anticipate additional bumps along the way.

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Boston, MA

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