KLCM Advisors, Inc.

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A Not So Sleepy Summer

After the market volatility experienced in the first quarter of 2016, many were hoping for a slow season and summer ‘break’ for investors. During the summer trading volumes typically decline, market moves can be less pronounced and investor interest tends to wane. Vacations, barbecues, golf and other outdoor activities provide opportunities for all of us to relax and recharge.

Not this year.

The most recent disturbance occurred as a result of ‘Brexit’. Of course we are referring to the June 23 referendum vote, where UK voters decided to leave the European coalition of member nations (EU). Up until the decision, markets had been sanguine with the thought that Britain would remain in the EU. The outcome changed the mood to frenetic. Global equities lost anywhere from 5% to 14% in a two day period before recovering a great majority of the losses by quarter end. The dollar rallied against British sterling and other currencies, along with the US 10 year note, which is now yielding less than 1.4%.

The longer term risks related to the vote are structural in nature. The fears associated with Eurozone confidence, along with EU exit risk by other European countries will linger. The exit vote weakened the perceived strength of the EU itself and has created an appetite for other nations to hold their own referendums on membership. It has also sparked concern over European banks, especially the Italian banks that need capital infusions.

Looking forward, the Democratic and Republican presidential nominees will officially be determined this summer. We believe that this will start to draw more attention; especially as we move towards the July conventions. The caucuses (or should we call them circuses) will likely create another catalyst for near-term market volatility; another reason for investors to keep a close eye on the markets.

You can also add Q2 earnings to the perspective instability elixir. Report cards for the quarter start in July, and we are expecting another set of generally weak year-over-year sales and earnings figures. Although there is a view (not universally shared) that company prospects will improve for the second half of 2016, we suspect that the market will be unforgiving to those who do not communicate positively about their outlook.

These episodes of increased volatility are occurring in the midst of global central banking initiatives that have distorted markets for some time. Since the recession of 2008 and 2009, central bankers in many areas of the world have been taking action in an attempt to stimulate growth. Traditionally, this would entail lowering interest rates to spur credit creation and the virtuous circle of economic growth. Yet with rates already at zero in many areas and growth still frustratingly slow, they have turned to a new and in many ways unconventional set of ‘tools’.

A handful of central banks, most notably the Bank of Japan (BOJ) and the European Central Bank (ECB), have been experimenting with new ideas to spur economic activity; the most controversial being negative interest rates. Just as individuals keep some funds in a checking or savings account, banks keep their "excess reserves" (funds that the bank could otherwise lend out) at their central bank. The BOJ and the ECB, amongst others, are now charging banks within their system to hold these funds. The idea is that by charging banks interest to hold their excess cash it should incentivize them to loan the money out instead; put differently, earn a return on their funds rather than pay the central bank to simply hold it. If the banks lend more money, economic activity should benefit. So far, the results have been mixed, at best. The extreme measure of moving to negative interest rates seems to have caused more concern than confidence on the part of consumers and businesses.

Since central banks provide a benchmark for borrowing costs, negative rates have spread to a range of fixed-income securities. In a report released in late June, Fitch (a credit rating agency) highlights that following the UK's EU referendum, there is a total of $11.7 trillion dollars of sovereign debt with negative yields as of June 27th, up $1.3 trillion from the end of May. It appears that worries over global growth, in addition to Brexit fears, have continued to spur demand for sovereign paper. The unconventional monetary policies outlined above, along with large-scale bond-buying programs have helped drive the increases in negative-yielding debt. Oddly enough, the biggest component of the June increase was in long dated bonds, with German 10 year yields turning negative during this period of time.

Negative interest rates also have a profound impact on currency markets. Interest rates and currency exchange rates are highly correlated. As rates move into negative levels, the underlying currency usually weakens. The low rates may improve near-term trade for a region; however capital flight from the lower interest rate markets to more favorable returns in positive interest rate currencies is inevitable over time.

All the recent central banking efforts and negative interest rates should be viewed with a healthy dose of skepticism. The policies have yet to spur economic activity, as evidenced by the anemic global GDP growth of the last several years. The persistently low rates also encourage dubious behavior from investors; look no further than recent real estate/REIT and private equity activities for evidence. Another shocking derivative impact of these policies can be seen in the year to date performance of the S&P 500 utility sector, a place where many investors go for yield. It is up almost 20% year to date 2016. Could this chase for yield be a bubble in the making?

We remain apprehensive about all of the distortions brought on by overly accommodative monetary policy, a contentious election season, the difficult fiscal decisions that lay ahead, the outlook for Europe, etc. As a result, we believe that it is important to be measured and have an increased margin of safety built into all of our decisions. We will continue to position portfolios for longer-term upside while having cash available to use when the market affords opportunities. The macro environment, along with being in the late stages of an economic cycle, mandates caution.

Enjoy the summer!