NOW'S A
GOOD TIME
TO GET SOME
GOOD ADVICE

ROSHAMBO

It's easy to be distracted by day-to-day market movements, but the performance in any given week, month or even quarter may actually be inconsequential within the context of long, secular, structural trends that usually take years if not decades to play out. It is far more important to understand key long-term thematic forces and to build a strategy that takes advantage of them. For 2015 and beyond, asset allocation weightings are being driven by the strong U.S. Dollar.

Strong Dollar

The global currency war began a year ago May. Since then the U.S. currency has risen some 27%, the steepest advance since the early 80's. The Euro, then near 1.50 to the U.S. $ is now 1.08 and the U.S. $ to the Japanese yen, then around 100 is now 120. Near term, we believe the U.S. $ is consolidating its massive launch, but in our view the rise in the dollar has more to go over the long term.

Currency depreciations result as countries try to boost economic growth at the expense of other countries. The U.S. started the process after 2008 with our zero interest rate policy and various QE's. Other countries are now taking similar action. Few remember the Midwest "rust bowl" that developed from 1980 into the dollar peak in 1985 when US manufacturing suffered at the hands of a strong dollar. How long will it be before the U.S. moves to mitigate the negative effects on our economy? It is not a question of if, but when?

The investment implications of currency changes can be both positive and negative. A sampling of U.S. dollar strength positives are: falling oil and commodity prices, cheaper cost of goods for U.S. consumers, falling costs for international travel and increasing foreign investment. Some of the negatives are: a worsening trade deficit, reduced revenue and earnings for U.S. multinational companies, deflation and reduced US competitiveness.

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How does a strong dollar influence investment behavior and therefore your portfolio? The most significant changes are: increased weightings in international investments (particularly hedged), and decreased weightings in resource issues. Since most commodities are priced in U.S. dollars (e.g., oil, gold, copper), a strong U.S. $ means lower commodity prices for U.S. investors.

Historically, U.S. equities have mostly risen in the twelve months following a strong dollar advance, but certain industries do best; namely, those that are less influenced by foreign income sources. Examples include companies in health care, consumer discretionary, financials, utilities, telecommunication services and real estate sectors. Small and mid-cap companies usually outperform large multi-national companies since their earnings are mostly in dollars. Recent Q1 results for multinationals have all reflected the negative earnings impact of the strong dollar.

International Over Domestic

When you look historically, a secular trend in equities is characterized by broad participation globally. This was not happening over the last six years. The assets of choice were U.S. bonds, US stocks and U.S. REITS.

In our letter of January, we pointed to a necessary broadening of participation from the rest of the world if the U.S. rally was to maintain traction. And indeed the broadening has begun. **Table 1** shows the results through mid- April.

Table 1: *Asset class returns 12/31/14 -4/17/15*

ASSET CLASS	RETURN
INTL' STOCKS: MSCI EAFE ETF	8.4%
RESOURCE: N. AMER. NATURAL RES. ETF	4.0%
US BONDS: CORE AGGREGATE ETF	1.4%
US STOCKS: SPDR S&P 500 ETF	1.2%
US STOCKS: SPDR S&P 500 ETF	0.9%

For the first time since the 2007 peak in global stocks, more than 50% of world markets have surpassed their all-time highs. Even in the U.S., the strongest of the global markets, the NYSE and Nasdaq Composites are just surpassing prices reached at the respective peaks in 2007 and 2000.

why a global rally now?

Internationally, the rest of the world is adopting a U.S. style quantitative easing recently underway in Japan, China and Europe. Japan shows no signs of changing strategy, China is still cutting rates and in Europe, the printing has only just begun. Asset prices are going up in value as the printed money has to go somewhere even though the economic throughput may be minimal. As evidence, year-to-date, EAFE (Europe, Australia and Far East) has outperformed the S&P 500 by the most since 1Q98.

A further support for U.S. $ appreciation comes from the interest rate differentials. For example, in Germany, France and Switzerland where sovereign bonds are yielding negative returns, there is an incentive for foreigners to buy U.S. Treasury bonds, a yield of 1.9% feels rich compared to nothing or less. International markets outperformed the U.S. from 2000 to 2007, have underperformed since then and with the aid of a strong dollar, international assets are set to outperform the U.S. over the next few years.

Paper Over Rock

The strong dollar is also influencing another major asset allocation decision which we dub **PAPER OVER ROCK**. With financial assets like stocks and bonds (paper) and tangible assets like gold, oil and commodities (rock) there tend to be long periods of alternating outperformance. Real estate is a hybrid and can do well or poorly in either environment depending on the underlying fundamentals. A secular shift is underway that favors paper over rock. In **Exhibit 1**, you can see how this relationship has played out over the last few decades and how the trend is developing today. In this example, we examine the relationship between Gold (rock) and the S&P500 (paper).

Exhibit 1: *Gold divided by the S&P500*

As the rising trend shows, commodities were star performers during the high-inflation 1970's while equities and bonds languished. Then, from 1982 -2000, commodities were under pressure. While there were significant rallies, they lasted months and not years. For a buy and hold investor, 10-year annualized commodity returns ranged between -5 and +5%. During the same period, 10–year average returns for equities, ranged between +15% to +20% until their peak in 2000. From 2000 until 2012, it flipped again. Commodities were star performers, where every sell-off was a buying opportunity on the way to 15 to 20% average returns per year. Again, the returns in equities were harder to come by, averaging just 5% per year and even dipping to a 10-year **negative** return in the depths of the 2008/2009 bear market. It now appears that the 2012 peak in Gold and the coincident bottom in US stocks was the beginning of another secular switch that could last for many more years.

it's not just about gold ...

Oil has dropped 50% since June 2014 and is likely to drop even more in the long term. One reason is that all commodities are priced in the U.S. $, but a reason specific to the drop in oil is technology. Extracting oil from shale formations has become just like any other manufacturing process.

Through trial and error, shale producers have figured out ways to reduce costs over time. And U.S. shale is not the only game in town; there are copious shale oil reserves from China to Poland. Then there is alternative energy. Solar installed capacity has doubled every two years for the past 12 years as the cost to install has fallen. Vehicle propulsion technologies may change radically over the next ten-to-twenty years – consider that the transport sector accounts for more than half of global oil consumption! What does it mean for your portfolio? You can expect a lower core exposure to the traditional commodity-based equities or commodity-producing countries. Still there will be opportunistic times to own these names or countries when prices have fallen too far too fast and the risk/reward is favorable. You can also expect to see more alternative resource stocks: green energy, agriculture and water.

Low Interest Rates

Bond yields have been coming down for 34 years! As strong as U.S. equities have been for the last few years, there are still sizable investment flows into bonds even after nearly seven years of short-term, near-zero interest rates. In the face of such low rates in the U.S. and low to even negative rates in the rest of the world, investors are still willing to invest in a 30-year Treasury that yields 2.5%, but after inflation and taxes, your real rate of return is close to zero; and the return gets worse if interest or inflation rates go up. Bonds still have a place in portfolios for diversification, current income and risk control. However, the largest allocation should be in short and intermediate maturities. The long bond can be an excellent trade from time to time as well as a defensive hedge if the equity markets were to start to tumble. But long bonds are not "buy and hold" instruments for the foreseeable future.

Still, while the secular downtrend of 34 years could be coming to an end, there is also no evidence that yields are about to take off any time soon. Recent economic weakness, according to The Economic Surprise index, shown in **Exhibit 2,** (a measure of economic surprises across housing, manufacturing, employment, lending and consumer sentiment) has been declining all year.

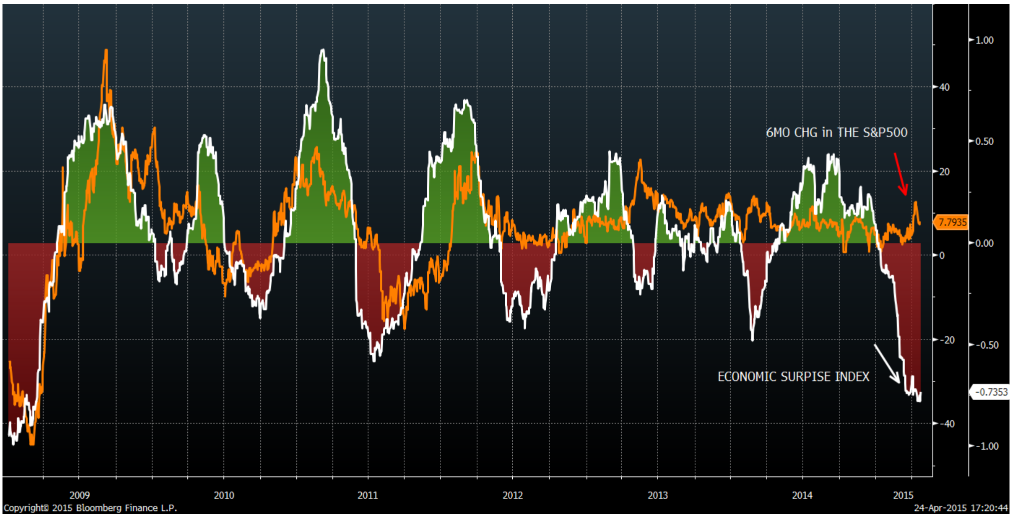

Exhibit 2: *U.S. Economic Surprise Index*

This weakness may be another reason rates have remained so low, even without additional QE. Eventually, the spread between stock market strength and economic weakness needs to narrow. From these depressed economic levels, we think the gap will narrow in favor of economic strength, which could temporarily pressure bond prices. However, absent continued low short-term rates, it will be difficult for the US economy to maintain even trend-like growth, so rates could remain low even if the Fed begins to raise them.

The relationship between central bank infusions and current asset values is indisputable. Normal valuation metrics are hard to calibrate against near zero interest rates. A possible untethering from reality could have already set in as investors reach for return by overpaying for assets. Therefore, continued economic weakness, an unexpected spike in rates or a surprise negative consequence of central bank policy could certainly "panic" the markets. Since 1930, there have only been three other times when US stocks rose this long without a 20% correction. So if the strong rebound in global markets and the near-linear rally in the U.S. were to break, it could lead to a 1987-style drop. In percentage terms, it could be 20% or greater, but it would likely be swift, scary and short, offering a place to add to equity holdings at better valuations.

From a long-term strategic perspective you should expect a heavier weighting in global equities and an under weighting in resource and bonds over the coming years. Declines in equity markets, even sharp ones, will be an opportunity to add to holdings, particularly international equities.

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