HUTCHINSON
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INVESTMENT PERSPECTIVES

Currency Wars

The Federal Reserve Bank was a leader in responding to the 2008-2009 financial crisis by lowering short-term interest rates (the federal funds rate) to zero and providing unprecedented liquidity through quantitative easing (QE) in order to prevent an even deeper downturn and stabilize the economy.[1] These moves created a domino effect by which other countries have followed suit and not since the Great Depression have central banks across the globe taken such drastic steps to stimulate growth for their economies. With interest rates in some regions below zero we truly are in unchartered territory. One consequence of these easy monetary policies is the corresponding impact on currencies. Some economists and strategist have even gone so far as to characterize the process of driving down the value of currencies to generate growth as a "currency war." Key questions: will central banks' efforts to boost economic growth be successful; if so, what does the path to "normal" look like; and, will this path lead to heightened volatility and dislocations in the markets?

What Is A Currency War?

The term "war" typically has military and/or political connotations associated with it so what is meant by a "currency war"? To provide some historical perspective, prior to August 1971 the United States dollar was "fixed" as a currency because it traded on the gold standard. The gold standard was a commitment by participating countries to fix the prices of their domestic currencies based upon a specified amount of gold and money then could be freely converted into gold at a fixed price.[2] The implications were that in order to create a unit of currency, a central bank would need to acquire the corresponding amount of gold. Then the fixed exchange system allowed governments to sell gold to the United States Treasury at a specified price of $35 per ounce. Since 1971, however, the dollar has "floated" in value and the myriad of factors that influence its value include but are not limited to the supply and demand for the currency, the outlook for economic growth, inflation expectations, interest rates, market sentiment, and the general confidence in the country.

In a floating currency environment monetary policy makers wield considerable power and influence because they set short-term interest rates and control the money supply. A currency war can be started when a central bank employs strategies that drive down the value of its currency with the aim of stimulating economic growth. How does this happen? As an example, a weaker currency for Country A translates into the exports of goods and services of that country being relatively

[1] In quantitative easing, the US Federal Reserve or other central banks provides additional monetary stimulus by purchasing debt securities (bonds). These purchases often drive bond prices higher and their corresponding yields lower as the central banks expand their own balance sheet.

[2] The Encyclopedia of Economics and Liberty

cheaper for Country B. On the flipside, imports of goods and services for Country A become more expensive. In other words, in theory a weaker currency can provide stimulus due to increased exports, reduced imports and improved economic growth (because exports are additive to GDP). However, the benefits of this type of economic strategy to Country A can come at the expense of Country B and/or other country(ies). The negatively impacted country(ies) can respond by employing monetary strategies to weaken its own currency(ies) which can potentially spark other countries to respond in similar manner. In summary, a "currency war" scenario is one in which countries compete against each other to weaken their domestic currencies with the aim of generating economic growth.

<u>The Federal Reserve: First Mover</u>

Our Federal Reserve first announced its quantitative easing program back in the fall of 2008. The Fed was primarily interested in preventing deflation, which can be defined as a general and widespread decline in prices. Central banks fear deflation because if prices are expected to be lower in the future, consumers will delay spending and forgo consumption which will further lead to a downward spiral in prices. Deflation is particularly cumbersome for those with debt because the future value of those dollars is higher than today making the repayment of that debt even more expensive. A critical objective of the Fed's efforts was to lower long-term interest rates to stimulate spending and give indebted borrowers a chance to refinance at reasonable rates and prevent a further increase in debt defaults. This strategy has worked and driven the 10-year Treasury yield, a key benchmark for mortgage lending, from 4% down to below 2%. This decline has allowed thousands of mortgage owners to refinance at lower interest rates and put cash back in their pockets through lower interest payments. Unfortunately, lower interest rates have benefitted debtors at the expense of savers who receive little interest on their savings.

In a speech to the National Economists Club in 2002, Fed Governor Ben Bernanke theorized that monetary policy could still be effective, even after short term nominal interest rates had been reduced to zero or what some call "the zero bound."[3] His hypothesis was that deflation is a more severe economic outcome than inflation, and it should be prevented at almost any cost. This is an important point because it not only serves to codify the thought process of the Federal Reserve Board but also explains the unprecedented steps taken since the financial crisis to attempt to revive the economy. It is helpful to note that as a doctoral student Bernanke had extensively studied the Great Depression along with the mistakes that were made by the government and central bank to exacerbate it.

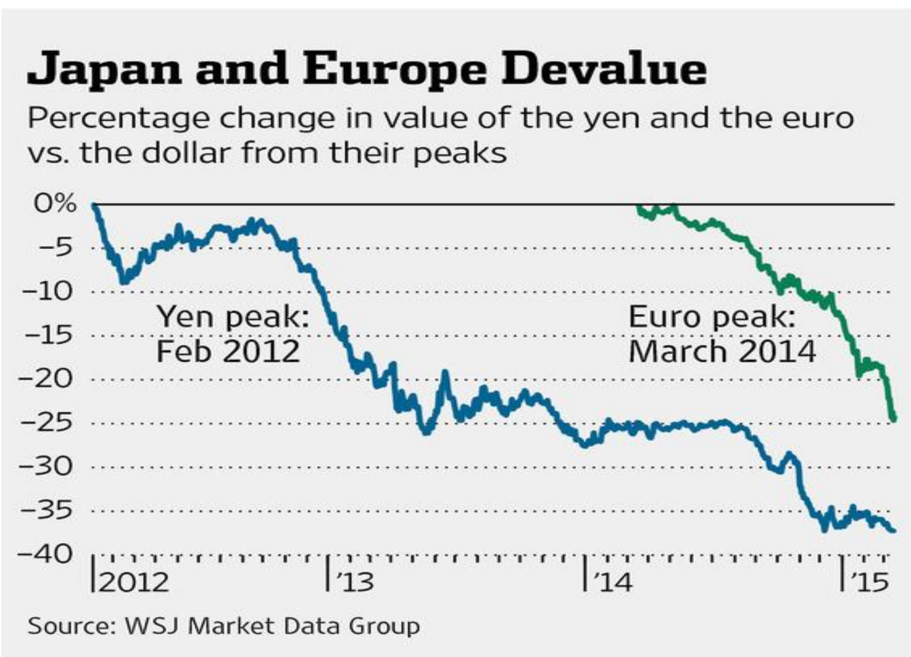
Traditionally, when an economy is slowing down, central banks have the ability to reduce interest rates in order to stimulate spending in the economy. However, when interest rates reach zero there is no more room to further reduce rates. Bernanke laid the foundation for "quantitative easing" in his 2002 speech by speculating that monetary policy can still be effective because central banks can essentially just print more currency and then use that currency to purchase bonds. By doing so, it would increase the amount of currency in supply, stimulate the economy and (hopefully) create inflation. The irony is that we have experienced little to no inflation; however, we have seen stock prices rise during a six year bull market due to low borrowing costs and a world awash with liquidity. The net effect of quantitative easing was a decline in bond yields across various

[3] Bernanke, Ben S. "Deflation: Making Sure 'It' Doesn't Happen Here" National Economists Club, November 21, 2002.

maturities and a corresponding decline in the value of the dollar. Subsequent to the US ending its QE program, other countries have begun theirs and the dollar has strengthened relative to those currencies.

Quantitative Easing: Follow the Leader

Now that the United States has ended quantitative easing, other countries are viewing quantitative easing as a way to devalue their currencies, ward off deflation and stimulate their economies. In the European Union, President of the European Central Bank Mario Draghi has committed to a QE program that will provide €60 billion per month. In Japan, Prime Minister Shinzo Abe has also launched a quantitative easing program of ¥4-5 trillion per month. Often dubbed Abenomics, the program aims to overcome years of deflation in Japan's economy. Since the start of their respective programs, relative to the dollar, the euro has declined 25% and the yen has declined 35%, as shown on the chart below.[4] In addition to the European Union and Japan, the quantity and magnitude of the easy money policies that have been initiated by other central banks across the globe have been significant. In fact, there have been over 500 easing moves by central banks over the past three years including recent ones by the central banks in Canada, India, Russia, Australia, Denmark, Sweden, Switzerland and Singapore.[5] With seemingly few viable options central bankers appears willing to use devalued currencies as a tool to make their exports more attractive to counteract persistently sub-par economic growth.



A recent research report from the Bank Credit Analyst (BCA) points out that in a world of slow domestic economic growth, there is typically more resistance to competition from foreign goods and labor.[6] A persistent retreat from globalization could negatively impact productivity, profits and overall growth. At an extreme, protectionism could materialize if growth remains subpar.

[4] "Japan's Devaluation Warning for Europe." The Wall Street Journal, March 16, 2015.
[5] Forsyth , Randall W. "Currency Wars: Central Banks Play a Dangerous Game." Barron's, February 15, 2015.
[6] "The Debt Supercycle R.I.P. Now What?" The Bank Credit Analyst, January 2015.

US Economy: "Safe Port in the Storm"

The US economy is growing again and we believe has reached self sustaining economic growth. Confidence is returning to business owners who are hiring and consumers who are shopping for new products, cars and homes. Since the US is a consumer based economy, it is critical that we have jobs and confidence to drive economic growth. Many other countries just starting quantitative easing programs are far behind the US in terms of sustainable economic growth, most notably Japan and the European Union and surrounding countries. The US is now the "safe port in the storm" as shown by our rising dollar, even in the midst of historically low interest rates. In 2014, US GDP grew 2.4%, its fastest pace in four years, while outpacing the other major developed countries.

Stock Prices and Valuation

For the past six years through March 31st, the S&P 500 Index has risen 193.52% on a cumulative basis or 19.66% on an annualized basis. The magnitude of these returns gives us pause as we remain vigilant against the natural human tendency to extrapolate trends into the coming years. At the risk of stating the obvious it is also natural for market corrections to occur periodically. The easy monetary policies by the Federal Reserve that we discussed have provided a positive support for stock prices the past several years but future gains will be harder to achieve, particularly given the likelihood of higher interest rates. Valuation is a related concern: the S&P 500 Index began this New Year with a price-to-earnings (P/E) multiple of 18 times trailing 12-month earnings; this multiple represents a valuation higher than about 74% of the time since 1945 according to market strategist Jim Paulsen of Wells Capital Management. Even more significant, the median New York Stock Exchange (NYSE) stock is currently at a post war record high P/E multiple, price-to-cash flow (P/CF) multiple, and price-to-book (P/BV) multiple.[7] It appears to us as though many investors are not aware of just how expensive the median stock is trading today.

As outlined, the past several years have been marked by an unprecedented period of easy monetary policies. In the US, while the economic recovery from the Great Recession of 2008-2009 has been modest relative to historical ones, the economy and markets have continued to outshine much of the rest of the world. By contrast, other developed countries are at different stages of economic recovery. In a desperate quest to achieve sustainable levels of growth, central banks of numerous countries have turned to devaluation of their currencies and engaged in what some have described as "currency wars" in order to gain a relative advantage. While we do not profess to have any particular insights on what the future might hold as these countries navigate the path to "normal" growth we would not be surprised to see a period of heightened market volatility. Further, given outsized market returns, full valuation levels, and the prospect for higher interest rates our investment posture is biased towards exercising caution and patience. Regardless of how the coming months and years play out we plan to adhere to our value-oriented investment approach which has stood the test of time since the firm was founded almost twenty years ago.

[7] Paulsen, James W. PhD. "Economic and Market Perspective" Wells Capital Management, January 8, 2015.