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Client Newsletter – Quarter Ending March 31, 2015

Global economy slows

In this past quarter volatility increased in markets throughout the globe. The Chinese economy, second largest in the world, saw its growth slow even as its equity market doubled. Germany, France, Italy and the U.K. also slowed. Even the U.S. economy, long the strongest in the world has slowed, having been battered by ferocious winter storms and a West Coast port strike. The response in the ex U.S. countries has been to cheapen their currency in an effort to grow exports and grow their economies. Interest rates have been slashed. Europe has embarked on its own version of Quantitative Easing to promote its economies. This strategy has yet to work. Meanwhile, the U.S. Federal Reserve has played with raising interest rates in the U.S., but so far has not had the courage to do so. Talk of raising rates has had the effect of increasing anticipation that interest rates will rise, and the U.S. Dollar has strengthened. Although equities in many countries have increased, the increase relative to U.S. investments has been diminished by the stronger dollar. The dollar has increased 18% against a basket of currencies in the past year and up 30% year on year to the Euro.

Japan has seen the Nikkei index increase to its highest level since 1989, but at 19,652 the index is still only half of the value achieved at its peak. Germany, the linchpin of the ECU, has seen inflation drop to almost nothing, raising fears of deflation. German GDP in the first quarter is expected to grow in the 0.4% to 0.6% range, down from 0.7% in the 4th quarter of 2014. The Russian economy, stung by falling oil prices and sanctions, has suffered greatly, yet their equity market has jumped more than 20% this year. The strengthening dollar reduced that gain in dollars terms.

Europe continues to be plagued by Russian President Putin's ambitions and the conflict in Ukraine, with other conflicts threatened. Greece continues to totter on the verge of debt default. The Greek government is caught between campaign promises and debt obligations that they cannot meet. The chance that they will exit the Euro has increased dramatically, although Mario Draghi, head of the European Central Bank says there is no provision for exiting the Euro. If Greece does leave the ECU, what happens to Spain, Portugal and Italy? Germany certainly does not want the breakup of the Euro, which would cause the German currency to leap, and perhaps plunge Germany into recession. Counties leaving the Euro could destabilize Europe and become easy picking for Russian adventurousness.

China is threatening stability in the South China Sea.

The Middle East continues to disintegrate, and in spite of our Iranian initiative, we seem powerless to affect peaceful outcomes

In spite of all these negatives, and in spite of port strikes and extreme weather, the U.S. economy trudges on. Our growth is not robust, as profits are falling, but there is growth. Our ISM index (a measure of economic growth) is up to 51.5%. Anything over 50% is growing. Unemployment is down. Job openings are up strongly. Average hourly earnings have bottomed and could be looking at an increase. People are more willing to quit jobs to take another job, a sign of optimism.

Another sign of optimism is household formation (new families), which has recently leapt. More families means housing construction will increase, and that means more jobs, because it takes a lot of workers to build a house. But plaguing the U.S. market is, what is the Fed going to do about interest rates? They get oh so close to raising rates and then get white knuckles and pull back. At some point they have to raise rates, because bubbles are appearing. Still they lack the conviction, because the economy is still tepid. If they raise too soon, they could push the U.S. back into recession. We can't take another recession so soon. Furthermore, the Presidency is occupied by a Democrat who would like his successor to be a Democrat-to protect his own legacy if nothing else. If the economy is in recession, the voters will be inclined to "throw the rascals out."

It takes a cast iron stomach to invest in these turbulent times, but being invested is the right thing to do. We will pick our way through these times, and survive. We will look back in a few years and congratulate ourselves on staying the course. Be prepared for volatility and some nail biters. We have not had a ten percent correction in almost four years; however, I don't think this is the year, and I think the second half of this year will be stronger. Next year is unlikely to be a down year because it is a Presidential election year.

So, 2017 is likely our next down year.

If you have questions or comments please call or email me. Make sure your personal email is on the letter.

Best,

William D. Rutherford

Rutherford Investment Management