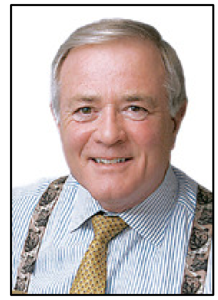
DJC
THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON


William Rutherford

In the U.S., uncertainty drives volatility

Published April 13, 2015

The Federal Reserve has been teetering on the brink of raising interest rates for the first time since the financial crisis. Officials have hinted at raising rates, but qualified any increase with such words as "patient" and "data driven." On March 18, they removed the word "patient" from their statement, but said that it would be a few meetings before they raised rates and that they would examine the data before doing so.

For the first time, the Fed indicated that it would also review foreign markets and economies. For a while it appeared that a rate rise was imminent – maybe even this summer. The interest rate futures market seemed to indicate that the rate increase could come in the fall. Some Fed speakers argued energetically for a prompt rate increase. But in the meantime, the data kept getting in the way of an increase.

World economies seem to be slowing. To be sure, Germany is doing "OK" in Europe, but most of Europe and the UK seem to be experiencing slow to no growth. In addition, deflation threatens. While the German equity market was strong, much of that gain has been eroded by the declining euro.

China has been experiencing slower growth. Earnings are under pressure, bank loans are souring and the property market is suffering, but the government is making monumental efforts to shore up the economy. In addition, China has allowed the yuan to weaken to help its export markets. The Chinese equity markets have been showing strength.

The Japanese equity market has reached its highest point in 15 years, but still at a level only half of its all-time high. Japan too joined the list of countries devaluing currencies to gain a better position in the world export markets.

The U.S. stands alone in its strengthening currency, to its short-term detriment. A combination of factors supports the stronger dollar. The first is that the U.S. is experiencing the strongest growth among developed economies. Not that the U.S. recovery is strong, but it is stronger; that is a testament to how weak the world economies are.

Money is simply flowing to the U.S. for safety and a bit more yield. Yield is also fueling the strong dollar, because expectations are that the Federal Reserve will eventually raise rates. Other central banks are simply not in a position to raise rates, and most are cutting. The stronger dollar means slower export sales and downward pressure on oil prices, which hurts the oil producing countries and the U.S. oil producing states, but has an overall positive effect on the economy.

As economies slow, job growth slows. The U.S. added only 126,000 jobs last month, seasonally adjusted. Estimates had been as high as 250,000 new jobs being created. Job growth is not creating enough new jobs to keep unemployment from rising. However, new jobless claims fell for the month of March and, when taken with the low job creation numbers, suggest that the unemployed are dropping out of the workforce.

The U.S. manufacturing index had its lowest reading in nearly two years as factories cut jobs. Oil-related companies have laid off tens of thousands of workers. A dock workers' strike added to the economic woes. Led by a drop in energy prices, S&P earnings are expected to fall for the first times since 2009. In the face of these headwinds, can the Fed raise rates? Can a pig's ear be a silk purse?

Can the Fed raise rates in a weakening economy and a market with high valuations without serious consequences? What are the possible effects on investment returns? One measure of valuation, based on data compiled by Yale University economist Robert Shiller, shows that the market price of the S&P is about 27 times its average earnings over the past 10, years, adjusted for inflation. The long-term average, based on data going back to 1871, is that adjusted earnings were about 16 times earnings, suggesting that by historical norms the market is overvalued. When the average was 27 times earnings, over the following 10 years, the total returns of the market, counting dividends, averaged about 2.5 percent, according to Shiller.

Shiller goes on to say, over time, the return on stocks after inflation has come very close to the sum of two numbers: Dividend yield plus the inflation-adjusted growth rate in dividends. The current dividend yield for the S&P is 2 percent. For more than a century, the growth rate of dividend yield has been about 1.5 percent after inflation. So, adding these two numbers one gets an expected equity growth of 3.5 percent.

The government's core measure of inflation is running about 1.7 percent annually. So, if you have your portfolio solely in equities that return 3.5 percent, minus inflation of 1.7 percent, you might gain 1.8 percent. Using similar measures, a portfolio that is half bonds and half equities would return even less. Of course, all of these "returns" are before taxes or trading costs. By historical standards, these returns are puny.

In the near term, things may not be so dark. We are in the second quarter of the third year of a presidential cycle. While past performance is no indication of future success, it is interesting to note that in April of the second quarter of the third year of the presidential cycle, the market is up 100 percent of the time. April is historically the second best month of the year, after December. Most of the gains take place in the second half of the month. So, this April may have positive returns too.

Prepare yourself mentally for more market volatility. Hold on tight. Talk to your investment adviser if you have one. If you don't have one, you should get one. Invest for the long term and be appropriately diversified.

William Rutherford is the founder and portfolio manager of Portland-based Rutherford Investment Management. Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com. *Information herein is from sources believed to be reliable, but accuracy and completeness cannot be guaranteed. Investment involves risk and may result in losses.*