Dear Partners,

We are pleased to provide the following update on financial markets, economic trends, and geopolitical hotspots for the second quarter of 2015. As always, we welcome your questions and feedback regarding this commentary, or any other aspect of our business.

Downshift in Global Growth Expectations

Following a weak first quarter which saw a surprise contraction in US GDP growth and negative inflation readings in several major developed economies, global growth expectations were re-calibrated during the second quarter. Both the IMF and the World Bank trimmed their forecasts for global GDP growth, citing slower than expected growth in the US and a broad-based slowdown in emerging markets. The actions of policymakers in major world economies during Q2 also reflected softening conditions. Chinese officials lowered bank reserve requirements and relaxed controls on local government borrowing in an effort to spur growth. The Japanese central bank voted to expand the country’s monetary base (i.e. print more money) to the tune of $650 billion throughout the next 12 months in an effort to reach the country’s 2% inflation target. In the US, the Federal Reserve elected not to increase interest rates at either the March or June Federal Open Market Committee (FOMC) meetings, citing below-target inflation, a widening trade gap, and continued “underutilization of labor resources”.

Figure 1: World Bank 2015 GDP Forecasts

US Monetary Policy: Preparing for Liftoff

As of the time of this writing, the consensus view is that the Federal Reserve will “initiate liftoff” at its mid-September meeting by announcing its first interest rate increase since June 2006. Such a move would be defensible in our opinion. Labor market indicators have shown a pattern of steady improvement over several years [Figure 2]. Meanwhile core inflation, despite being below the Fed’s 2% target for 38 consecutive months, has settled into a relatively stable range of 1.2 to 1.5% since early 2013. Fed officials must also be cognizant of the lag effects of policy decisions and the length of time required to normalize interest rates. For instance, if the Fed increases rates by 25 basis points at successive meetings, the timetable for achieving a “neutral” fed funds rate—that which neither stimulates nor restrains economic growth—could be as long as 4 years. A survey released following the June Fed meeting indicated that 15 of 17 FOMC members expect one or more interest rate hikes this year, and several Fed officials have made public statements to that effect in recent weeks.

![Figure 2: Federal Reserve Labor Market Conditions Index](image)

Despite the logic supporting a September rate hike, we would not be surprised to see the Fed delay liftoff until December, or even early 2016. Since the late 1980’s, policy risk with respect to the Fed has been decidedly skewed towards over-accommodation and the creation of asset bubbles. The so-called “Greenspan-Bernanke doctrine”, which entails prioritizing near-term inflation and employment targets over the long-term risks of keeping rates too low for too long, has thus far been carried forward in earnest by the current FOMC under the leadership of Janet Yellen. For this reason, even the slightest hint of downside movement in inflation or employment measures from current levels would likely bring about an immediate shift in the Fed’s policy stance and lower the odds of a near-term rate increase.
Europe: Positive Momentum, Negative Headlines

Notwithstanding the broader downshift in global growth, Europe has shown signs of positive momentum. Q1 marked the sixth consecutive quarter of positive year-over-year GDP growth for the Eurozone following a double dip recession that spanned five years. Measures of industrial production have ticked up, the Conference Board’s index of leading economic indicators for the Eurozone increased for the seventh consecutive month in May, and the IMF and World Bank recently increased their 2015 and 2016 GDP forecasts for the Euro Area.

The most visible threat to economic momentum in Europe is the Greek debt crisis and uncertainty regarding Greece’s future as a member of the Eurozone. By failing to make a payment of €1.6 billion on its 2010 bailout package, Greece recently became the first country to fall into arrears with the International Monetary Fund (IMF) since Zimbabwe in 2001, and the first developed country ever to do so. Greece faces several additional near-term debt maturities, including €450 million owed to the IMF, over €3 billion to the ECB, and another €3 billion to Greek Treasury bill holders, all in the month of July. Meanwhile, Greece’s leaders have vociferously rejected the fiscal austerity measures proposed by creditors as a condition for additional financial support, and the Greek populous has, to the surprise of many, upheld this position by voting to reject the creditor terms in a July 5th referendum, thereby providing a clear mandate for the Greek leadership to continue its policies of brinksmanship in an effort to extract better terms from creditors.

Our immediate focus is the risk of financial contagion resulting from debt defaults, bank failures, and additional capital flight from Greece. At the moment, these risks appear to be contained. Since Greece’s initial bailout in 2010, the country’s debt has changed hands, and much of it is now held by “official creditors” such as the European Central Bank (ECB), the International Monetary Fund (IMF), and Euro Area governments. Estimates suggest that 80% of Greece’s approximately €300 billion in outstanding government debt is held by government or quasi-governmental institutions. Of the 20% held by private investors, less than 10% is held by banks and insurers and approximately 2% is held by institutional asset managers. While the second and third order effects are nearly impossible to predict, the potential for direct losses in the financial sector due to non-repayment of Greek sovereign debt appears to be limited.

While we’re not in the business of predicting policy outcomes in the short term, the Fed’s demonstrated bias towards over-accommodation, combined with the sheer length of time required to achieve a neutral policy rate, offers assurance that credit availability will not be a headwind for the US economy for the foreseeable future, and that the normalization of interest rate policy should be viewed as a multi-year process as opposed to a near-term event.
The risk of financial contagion is also curtailed by the European Central Bank’s €1.2 trillion stimulus program, launched earlier this year. The purpose of the program is to reduce borrowing costs throughout the Eurozone by purchasing €60 billion of sovereign bonds and asset-backed securities each month until September of 2016. As we stated in our Q1 letter, the total issuance of European sovereign bonds throughout this period is expected to be approximately €270 billion, which suggests that demand for bond purchases will likely exceed new sovereign issuance by a factor of four over the timeframe of the ECB’s asset purchase program. While the yields of debt issued by peripheral European countries will undoubtedly increase on negative news regarding Greece, we would be extremely surprised to see credit spreads or absolute yields approach the levels seen at the peak of the European financial crisis in 2010 and 2011. Figure 4 shows the yield spreads of Italian, Spanish, and Portuguese 10 year government bonds over German 10 year government bonds. In November of 2011 these spread reached extreme levels just before Eurozone finance ministers approved a Greek bailout. More recently, the spreads have remained low, and are nearly a full standard deviation below their respective five year averages. This reflects either (i) very little investor concern regarding near-term contagion effects from Greece or (ii) the effectiveness of the ECB’s asset purchase program in suppressing bond yields. Regardless, in the absence of a spike in borrowing rates across the periphery, shocks to fixed capital investment and business confidence are less likely and the economic fallout of the Greek crisis is manageable for Europe.
Investment Returns

Against the backdrop of softening global growth and uncertainty emanating from Greece, global equities essentially treded water in Q2, with non-US developed and emerging markets edging out the US on small gains. Commodities rebounded during the quarter, thanks to an uptick in the agriculture sector. Yield-oriented assets, namely long-dated Treasuries and REITs, were among the worst performers, reflecting investor concern over the potential for rising interest rates in the US.

![Figure 5: Total Returns of Major Asset Classes](Q2 2015 and Calendar Year-to-Date)

- Global Equities: 0.5, 3.0
- US Large Cap: 0.1, 0.8
- Non-US Developed: 0.8, 0.8
- Emerging Markets: 0.1
- Nat. Res. Equities: -2.5
- Commodities: -1.6
- REITs: -5.2
- Long Treasuries: -9.1

Source: Morningstar. Data referenced include MSCI All Country World Index (Global Equities), Russell 1000 (US Large Cap), MSCI EAFE (Non-US Developed), MSCI Emerging Markets (Emerging Markets), S&P Global Natural Resources (Natural Resources Equities), Bloomberg Commodity Index (Bloomberg), Dow Jones US Real Estate Index (REITs), Barclays US Treasury Long (Long Treasuries).

Developed Markets Equities

Europe and Japan, which comprise over 85% of the non-US developed equity universe by market capitalization, have both outperformed the US thus far in calendar year 2015. Referring to Figure 6 on the following page, Europe’s outperformance seems well-supported by relative valuations, positive earnings surprises, and earnings growth. However, the opposite is true of Japan, which lacks the attractive fundamental characteristics of Europe. Investors have bid up the shares of Japanese companies based on upwardly-revised earnings forecasts, many of which are based on the anticipated positive effects of cheaper oil and a depreciating currency. To the latter point, the yen has fallen 20% against the dollar throughout the past year, and more than 40% since 2011, thereby increasing the competitiveness of Japan’s export-oriented national champions such as Toyota, Mitsubishi, Sony, and Canon.
As a general matter, our preference is to overweight regions and sectors which offer relative value, stable or improving fundamentals, and multiple catalysts for value creation. On this basis, Europe strikes us as a more interesting opportunity set than Japan. While Japanese stocks may continue to perform well, we are reluctant to overweight them solely on the basis of near-term price momentum, exchange rate movements, and commodity price swings.

**China**

In our Q1 2015 update, we commented that an 80% rally in Chinese equities throughout the prior year had been supported by government-led stimulus and an influx of retail investors, many of whom had purchased stocks using margin debt. We also expressed broader concerns about the implications of a hard landing in China for the global economy. In Q2, Chinese stocks climbed an additional 35% from April 1 to June 12. The rally was accompanied by a series of provocative and upbeat statements by government-controlled media. For instance, shortly after the Shanghai composite eclipsed the 4,000 mark in early April, the state-run People’s Daily declared that it was “just the beginning of the bull market”. Another state-run publication, the China Securities Journal, published an article titled “Go! Buy Hong Kong Stocks!” on April 9th. As of the time of this writing, the Shanghai Composite index is 27% below its mid-June peak—the largest 3 week drop in nearly 20 years—and is poised to drop further. According to Bloomberg, trading has been halted in 745 stocks which comprise more than 20% of listed firms on mainland China’s exchanges, and the aggregate market capitalization of Chinese stocks has declined by more than $3 trillion since mid-June—equivalent to more than 10 times the total value of Greece’s sovereign debt.

At the risk of sounding cynical, this strikes us as a textbook example of China’s Communist party using ostensibly capitalist institutions to pursue its goals. One of China’s near-term needs is to recapitalize heavily-indebted, often state owned companies—a task made much easier and more lucrative by higher stock prices. Concurrent with the recent rally, GF Securities, China’s fourth largest investment firm, raised $3.6 billion in its Hong Kong IPO on April 10th (the day following the previously mentioned state-sponsored “Go! Buy Hong Kong Stocks!” article), GF Securities was Asia’s largest of IPO of 2015, and the second largest globally. Two other Chinese financial firms, Orient Securities and Haitong Securities, have
collectively raised more than $10 billion from equity offerings since the start of 2014. A similar pattern of using elevated stock prices to extract cash from market participants is portrayed in a 2011 exposé on the Chinese financial system titled *Red Capitalism; The Fragile Foundation of China’s Extraordinary Rise*. Below are excerpts from the book referencing IPO and dividend activity of China’s largest state-owned banks during the 2004-08 bull market.

“The data [below] show actual cash dividends paid out by the Big 3 banks over the period 2004-08, during which each was incorporated and then listed in Hong Kong and Shanghai. The figure also shows the funds raised by these banks from domestic and international equity investors in their IPOs. The money paid out in dividends, equivalent to US$42 billion, matches exactly the money raised in the markets. What does this mean? It means international and domestic investors put cash into the listed Chinese banks simply to pre-fund the dividends paid out by the banks largely to the MOF [Ministry of Finance] and Central SAFE [State Administration of Foreign Exchange]. These dividends represented a transfer of real third party cash from the banks directly into the state’s coffers”.


Regardless of the motives of the Chinese government, the confluence of high valuations, heavy-handed state intervention, and rampant speculation on the part of retail investors leaves us skeptical regarding Chinese equities, and our client portfolios are currently positioned accordingly. While underexposure to China has hurt our relative performance at times, we feel that our pessimism is warranted. This is not to say that Chinese equities couldn’t deserve an overweight if valuations were attractive enough, however that is not the case today.
**Major Risks**

The world is currently awash in “expert opinions” regarding the near-term fate of Greece and the resulting implications for financial markets. Rather than trying to handicap the probability of any particular scenario, the focus of our work is weighing the impact of worst case outcomes against market fundamentals and valuation-based return opportunities. Our base case is that a default by Greece, or even an exit from the Eurozone, would not unilaterally derail the global economic recovery, nor warrant a de-risking of an investment program with a long-term investment horizon. While a broad selloff in risk assets and a flight to safety in the short term would not be surprising, the limited scale of the Greek economy (equivalent to approximately 0.3% of global GDP) and the absence of financial transmission mechanisms to private markets suggests that the fallout from any number of unfavorable scenarios should be manageable. Our foremost concern regarding Greece is the further impoverishment and suffering of the Greek people and the risk of political polarization and an overall decline in economic cooperation throughout Europe. In summary, political contagion in Europe is a greater risk than financial contagion.

Looking beyond Greece, two major downside risks are a hard landing in China and an unanticipated inflationary spike. While the latter is highly improbable, a large uptick in inflation would be extremely impactful because equity and bond valuations currently reflect very low inflation expectations and would be subject to a negative adjustment. We also have concerns regarding liquidity in the corporate fixed income market. According to a recent report published by Citigroup, the size of the US corporate bond market has increased by approximately $3.7 trillion over the past decade. During this time, the share held by retail mutual funds has more than doubled. Meanwhile, dealer inventories have declined by approximately 76% due to regulatory initiatives such as Dodd Frank which have impelled banks to put far less capital at risk than they did before the global financial crisis. Given a larger bond market and fewer types of investors who are able to provide liquidity in the event of market stress, the resulting lack of liquidity could exaggerate the effects of a selloff when the FOMC begins lifting interest rates.

**Looking Ahead**

The previously mentioned downshift in global growth expectations and persistently weak inflation in major developed economies suggests that economic growth, while stable and positive, is far from robust. Meanwhile, we expect global central banks to provide accommodation “on demand” in response to occasional bouts of market volatility. Against this backdrop, we expect interesting opportunities to surface as market participants contend with various macroeconomic and geopolitical risks, and short term episodes of fear and panic yield long-term opportunities for patient investors.

---

**Gene Lohmeyer, CFA**  
Chief Investment Officer

**Sean Cook**  
President

www.cedarrowepartners.com
Disclaimer

David Cook and Associates (DBA “Cedar Rowe Partners”) is an investment advisor headquartered in Atlanta, GA and registered with the Securities and Exchange Commission. Registration does not constitute an endorsement, and does not imply any level of qualification, training, or skill.

This message is provided for informational purposes only and is intended for the sole use and benefit of the recipient. The contents of this message, to include text, images, logos, icons, and other materials, are considered valuable intellectual property and proprietary to Cedar Rowe Partners. No portion of this communication may be transmitted, broadcast, transferred, reproduced, or utilized in any manner without explicit written consent from Cedar Rowe Partners. Any and all unauthorized use or reproduction shall be deemed a willful infringement upon the intellectual property rights of Cedar Rowe Partners.

While Cedar Rowe Partners uses reasonable best efforts to provide accurate information, Cedar Rowe Partners makes no representations or warranties regarding the accuracy or completeness of any information contained. Nothing contained or referenced in this document constitutes tax, legal, or investment advice. Recipients in need of tax or legal assistance should seek such assistance from a qualified professional services organization. This communication reflects the opinion of its author as of the time of publication, and will not necessarily be updated as views or information change.

This communication does not constitute an offer or solicitation to provide any investment advisory service or to sell or purchase any security. Cedar Rowe’s publications reference historical performance data. Such data do not guarantee or imply future performance. To varying degrees, the investments and investment strategies referenced in Cedar Rowe publications entail risk of financial loss.