Quarterly Market Outlook & Strategy Letter

Fourth Quarter of 2014

January 2015

Executive Summary

- The final quarter of 2014 was marked by increased volatility in financial markets, and growing disparity in their relative performance. US stocks continued to deliver solid returns, capping another year of double-digit gains. US real estate and most bond sectors also posted good results. However, overseas markets lagged well behind those in the US, as a consequence of continued sluggishness in foreign economies, compounded by a surge in the US dollar.

- These trends in relative performance are not new, but they accelerated at the end of last year, producing a cumulative disparity between the US and foreign equity markets that is now quite large. Given integrated global trade and capital markets, either growing American prosperity will eventually become more widespread, or the US will succumb to the pressures of weaker global growth. We have been leaning toward the increased prosperity scenario, but think there will likely be adjustments all around. US stocks are not cheap, and investors are uneasy after six years of rapid appreciation. Leverage is high, the breadth of market gains is narrowing, and volatility spikes are becoming more common. The US debt markets are sending some early warning signs of slower growth.

- The transmission of global economic activity occurs through changes in the relative prices of internationally-traded goods and financial assets—especially interest rates, exchange rates and commodity prices. All of these relative prices have experienced large swings over the past year, which will set in motion a rebalancing of global demand. The first and most dramatic relative price change has been the falling cost of oil. Most economists expect that the drop in oil prices will be supportive of the US recovery. It will probably be even more supportive of overseas economies (oil exporters aside), especially those in the developing world. Since the US has now become a major oil exporter, the fall in the price of crude is no longer an unmitigated blessing.

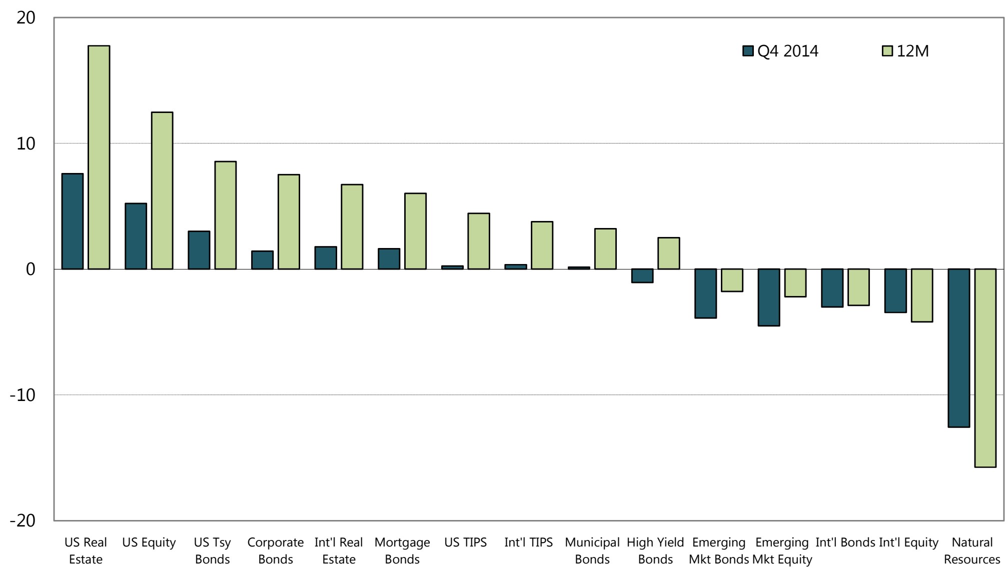
- The second major change in relative prices has been in the global structure of interest rates. Global debt markets anticipate more restrictive monetary policy in the United States than in other countries—which will produce a shift in relative growth rates. One of the main channels through which that rebalancing will occur is via a stronger US dollar—the third relative price change. Since mid-year, the greenback has appreciated by 15 percent, a very rapid rise by historical standards. The US trade balance is about to get a double-whammy from the combination of lower oil prices and a stronger dollar. The currency has moved far beyond its customary relationship with interest rates, and appears to be having a Wile Coyote moment—just as the country's external balance is set to weaken.

- Weaker foreign currencies will stimulate exports and corporate earnings abroad which, together with lower commodity prices and easier monetary policy, will support overseas equity markets. Once the dust has settled, it is very common for foreign equities to surge in the wake of a meaningful currency adjustment. We continued to hold our foreign equity investments, in anticipation of better times ahead.

Market Overview

The final quarter of 2014 was marked by increased volatility in financial markets, and growing disparity in their relative performance (Figure 1). US stocks continued to deliver solid returns, capping another year of double-digit gains. US real estate and most bond sectors also posted good results, as long-term Treasury bonds rallied. However, overseas markets lagged well behind those in the US, as a consequence of continued sluggishness in foreign economies, compounded by a surge in the US dollar. Those two forces, along with excess supply in global resource markets, caused a sharp fall in the prices of some commodities (especially oil) which in turn propelled weakness in the emerging equity and debt markets.

Figure 1. Benchmark Asset Class Returns

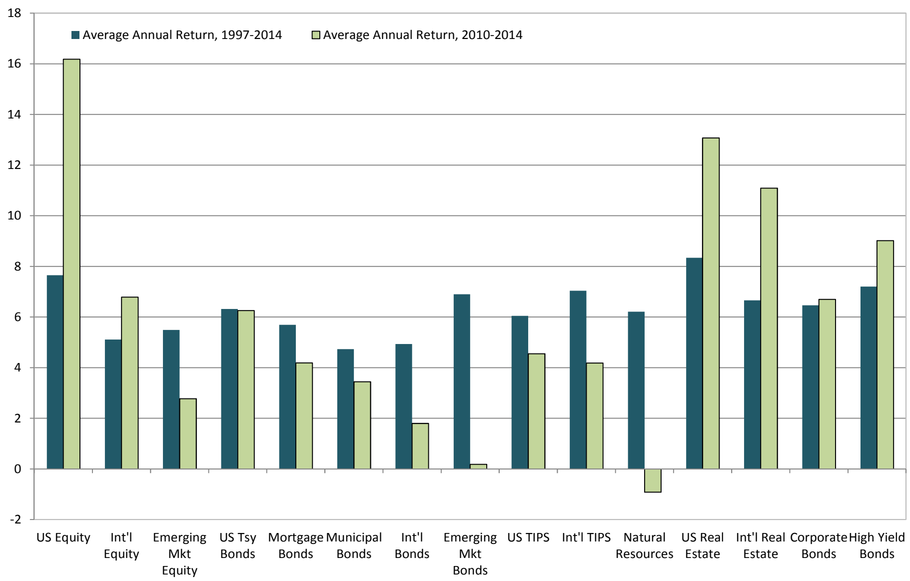


Source: Bloomberg

These trends in relative performance are not new, but they accelerated at the end of last year, producing a cumulative disparity between the US and foreign equity markets that is now quite striking (Figure 2). No nation is an island, however. Given integrated global trade and capital markets, one of two outcomes is likely: either growing American prosperity will eventually become more widespread, or the US will succumb to the pressures of weaker global growth. Whether other countries and markets manage to "catch up" with the US, or whether the US "catches down" with the rest of the world, is the central investment question for 2015. We have been leaning toward the "catch up" scenario, but think there will likely be adjustments all around, marked by considerable uncertainty and turbulence along the way.

The transmission of global economic activity occurs through changes in the relative prices of internationally-traded goods and financial assets—especially interest rates, exchange rates and commodity prices. All of these relative prices have experienced large swings over the past year, which will set in motion a rebalancing of global demand. What we don't know is whether these changes will help the rest of the world—by more and sooner—than they hurt the US. Hence, the uncertainty and volatility.

Figure 2. Asset Class Returns in Historical Perspective



The first and most dramatic relative price change has been the falling cost of oil. Since last June, a barrel of crude oil has declined from $107 to $46 dollars, a 57% drop. It goes without saying that a price move of that magnitude and speed is exceptional by historical standards, and will have large repercussions for the global economy. Most economists expect that the fall in oil prices—which has already translated into a large drop in gasoline prices at the pump—will be supportive of the US recovery. It will probably be even more supportive of overseas economies (oil exporters aside), especially those in the developing world, which rely more heavily on energy in their manufacturing processes. Energy also looms larger in consumer spending in poorer countries. The influences are direct (reflecting the larger share of heating and transportation in household budgets) and indirect (via its influence on the price of food, which also absorbs a lot of consumer spending). About three-quarters of the larger emerging market economies stand to gain from lower oil prices, and to a greater degree than the mature economies.

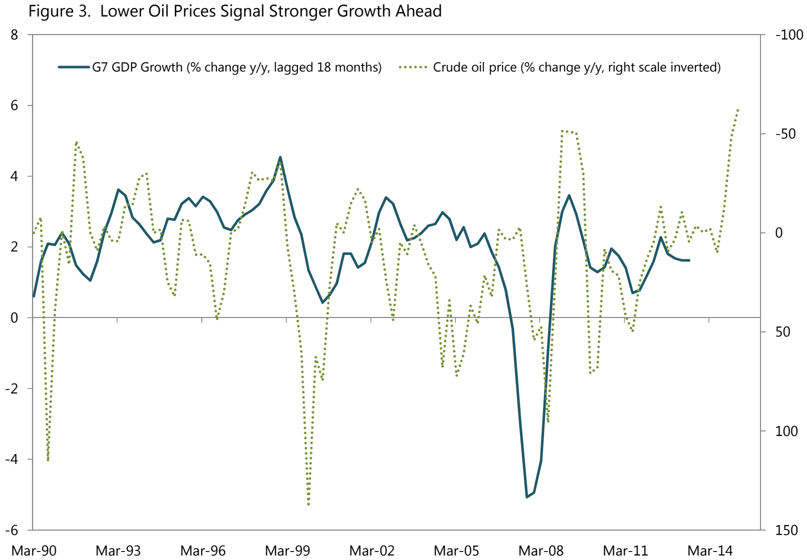
Economists are debating whether the sudden fall in oil prices reflects mainly excess supply, or is a harbinger of weakening global demand. Some point to the declines in other commodity markets as a worrying sign. However, that's exactly what *should* happen, given that oil is used intensively in the production of other commodities (i.e., energy for the extraction of minerals, fertilizer for food crops, and transportation of everything). In competitive markets (which commodities are) a drop in the price of a key input such as energy should lead to lower output prices as well. Broad-based declines in commodity prices are also the result of appreciation of the US dollar, which may not reflect weak global growth.

While softening demand, especially in China, has undoubtedly played a role, recent oil market dynamics probably owe more to changing perceptions of global supply. The key contributor to that change was, of course, OPEC's decision in late November to *not* coordinate a reduction in output by its members. Analysts suggest that this is an attempt by OPEC to undercut US shale producers who operate at a much higher cost. If so, the effort was successful, as many US drillers are rapidly scaling back their expansion plans. Such cutbacks should not derail the US recovery, given the modest share of energy in total output; the shale oil boom has contributed perhaps 0.2% and 0.5% to US GDP growth in recent years. However, there will be a negative impact on capital spending in the energy sector, with spillovers to ancillary manufacturing activity in those industries that provide equipment and services to it. The energy-rich states of Alaska, Wyoming, Louisiana, Oklahoma, Texas, and North Dakota could very well fall into recession. And of course, lower oil prices will translate into weaker earnings for all energy-related businesses and lower stock prices in this sector of the market. Since the US has now become a major oil exporter, the fall in the price of crude is no longer the unmitigated blessing it was in the 1980s and 1990s.

The decline in oil prices is already feeding into lower consumer prices, which is altering expectations of global monetary policy. With inflation already close to zero in most of the mature economies, the drop in commodity prices is causing global central banks to worry about whether they will be able to fulfill their mandate of price stability. The central banks of Japan and Europe are redoubling their efforts to provide financial stimulus to their struggling economies. In late October, the Bank of Japan announced a massive expansion in its asset-purchase program, which now incorporates not only government bonds, but also real estate and equities. We have been anticipating a similar (though less dramatic) quantitative-easing announcement from the European Central Bank, which should be coming shortly.

Inflation is higher in most of the emerging economies, but the drop in oil prices is nevertheless giving many of them scope to cut interest rates and support growth. The Reserve Bank of India recently followed in the footsteps of China, Poland and Chile by trimming its benchmark interest rate, which caused the country's equity market and currency to soar. Others countries, such as Korea, will undoubtedly follow suit. Lower oil prices and the resulting turn toward easier monetary policy has created a stronger underpinning for global growth, which could accelerate toward 3% in 2015 (Figure 3). Much of that stimulus will be felt where it is most needed, in overseas economies.

Figure 3. Lower Oil Prices Signal Stronger Growth Ahead

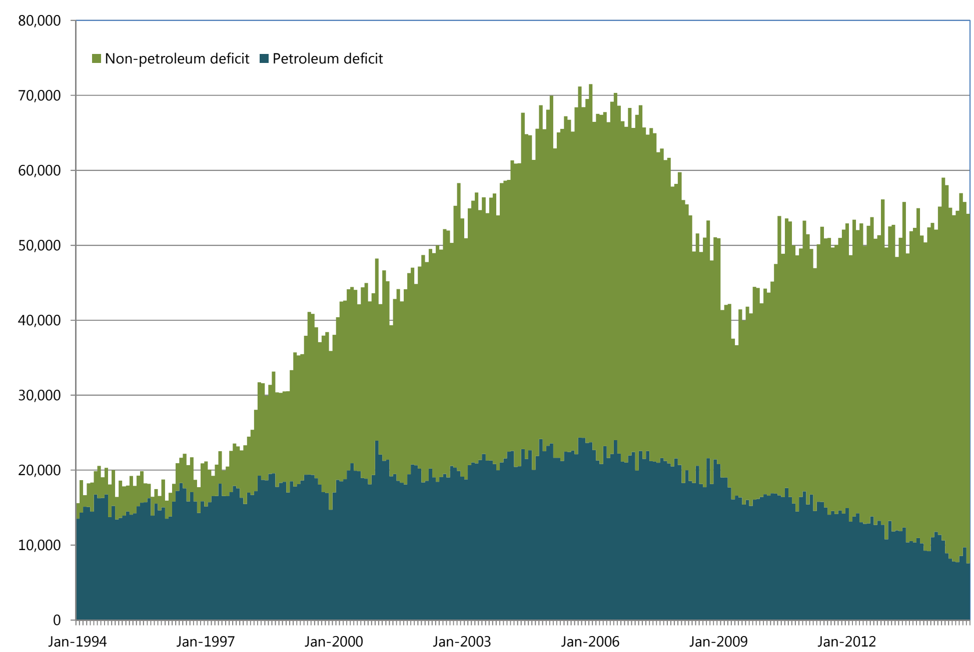


The second major change in relative prices has been in the global structure of interest rates. Over the past year, interest rates in foreign developed economies have fallen to very low levels, even as the Federal Reserve has been preparing to tighten US monetary policy. The result has been a widening US vs. foreign interest rate differential, and a relative flattening of the US yield curve (the spread between short-term and long-term interest rates). In other words, global debt markets anticipate more restrictive monetary policy in the United States than in other countries—and a resulting shift in relative growth.

One of the main channels through which that rebalancing will occur is via a stronger US dollar. Since mid-2014, the greenback has appreciated by 15 percent. That is a very rapid rise by historical standards, and mirrors the drop in the commodity markets. Indeed, the US currency *always* moves inversely (though by a lesser degree) to commodity prices, which are denominated in dollars. The stronger dollar makes US exports abroad more expensive (hence less competitive), even as it reduces the cost of goods imported into the United States. The result is lower inflation and a larger trade deficit, which detracts from US growth. By contrast, foreign economies benefit from higher imported inflation and rising trade surpluses, which contribute to stronger growth abroad.

The US trade balance is about to get a double-whammy from the combination of lower oil prices and a stronger dollar. The deficit has shrunk markedly over the past five years, supporting an otherwise sluggish recovery. However, the improvement was due *entirely* to a shrinking petroleum deficit. The non-petroleum deficit actually widened, and will widen further in response to stronger US consumption (which leans heavily toward imports) and weaker export growth (Figure 4).

Figure 4. United States: Monthly Balance of External Trade
(in millions of seasonally-adjusted 2009 US dollars)

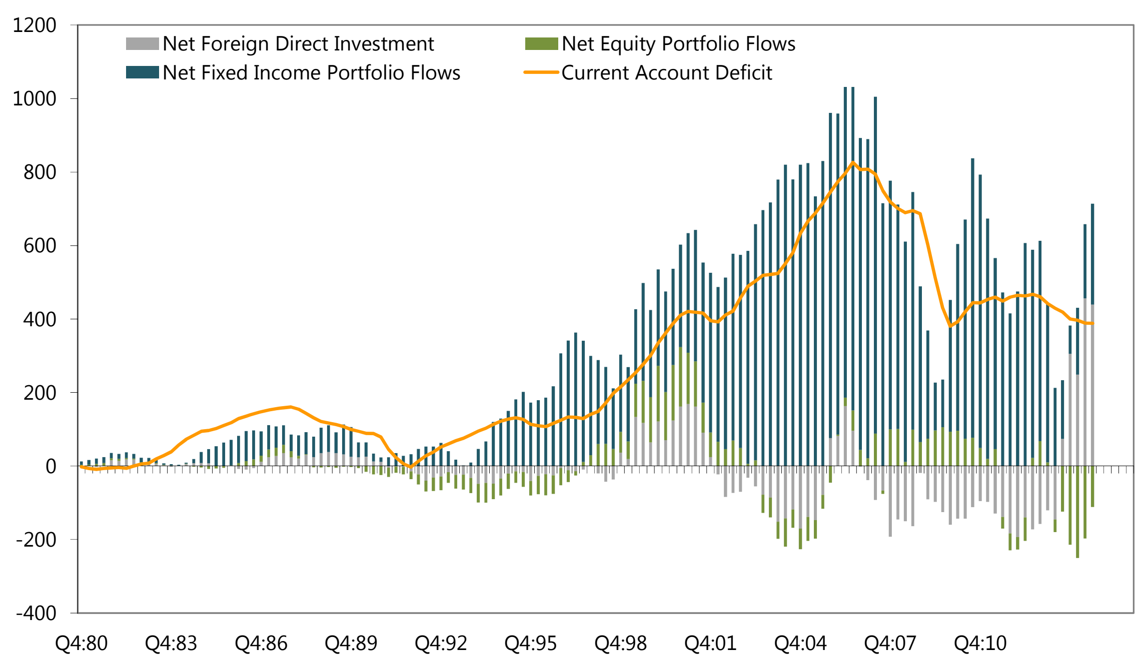


The collapse in oil prices, *if sustained*, will cause the petroleum deficit to return to its old level. This won't happen immediately, as domestic producers will pump as much oil and gas as they can (regardless of price) to repay the substantial debts they incurred for exploration and development. However, most US shale oil drilling is not economical at current prices; as supply lines are exhausted, output will decline and demand will shift back to overseas producers. As a result, both the petroleum and non-petroleum deficits will rise, pushing the overall US trade deficit back toward 2007 levels.

In contrast with US producers, the Saudi government used the oil windfall to pay down the country's debt, increasing its resiliency in the face of lower oil prices. The Saudis can keep pumping for longer than US producers can remain solvent—and it is likely that they will do so. Barring a geopolitical crisis in the Middle East, low oil prices are here to stay for a while.

The collapse in the energy market will weigh on the US balance of payments in other ways as well. Over the past few years, foreign direct investment into the United States has surged, and a significant part of the surge can undoubtedly be traced to investments in the energy sector (Figure 5). Without these capital inflows—which may not be sustained—the US dollar probably would not have strengthened to the extent it did, given that portfolio equity and debt inflows to the US remain subdued. In sum, the rise in the US dollar and collapse in the oil market will set in motion a deterioration in the US trade and capital account balances that will dampen growth in the United States, relative to the rest of the world.

Figure 5. United States: Net Capital Flows
US$ Billion, 4-Quarter Sum



The US dollar is already in a precarious position. As Figures 6 and 7 show, the currency has moved far beyond its customary relationship with interest rates. Indeed, the greenback appears to be having a bit of a Wile Coyote moment, having moved well over its skis just as the country's external balance is set to deteriorate.

Figure 6. US vs. Global 2-Year Yield and the US$

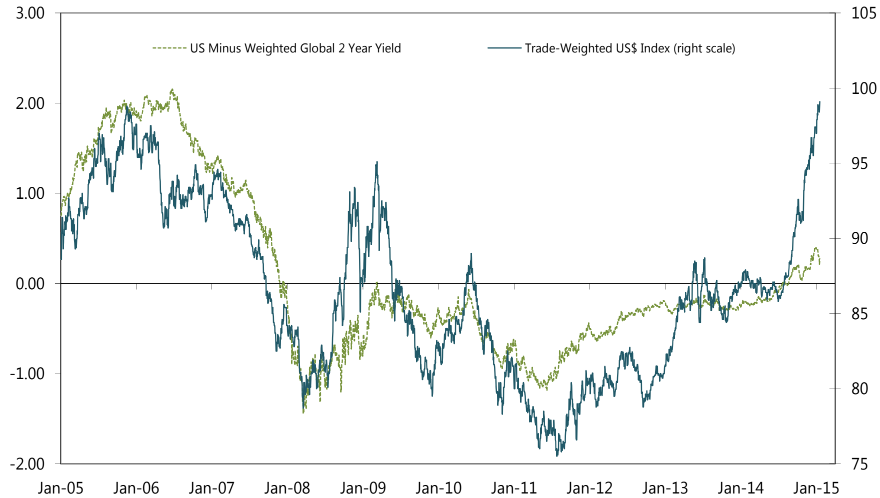
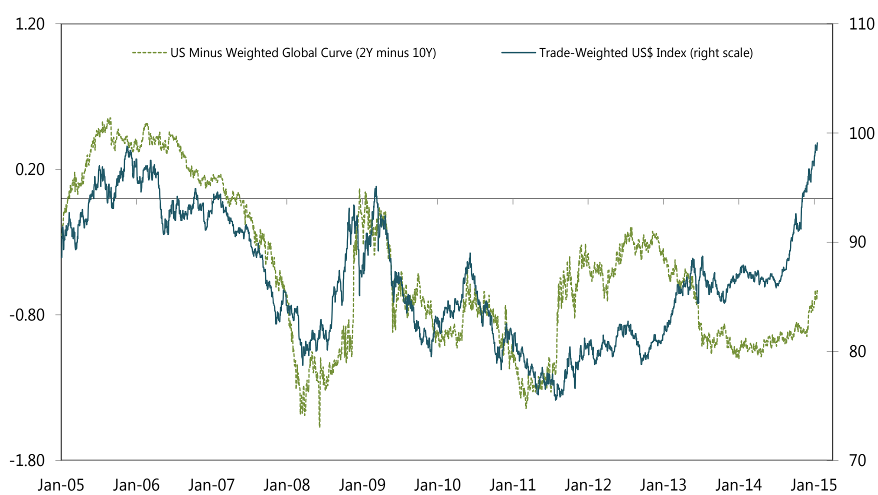
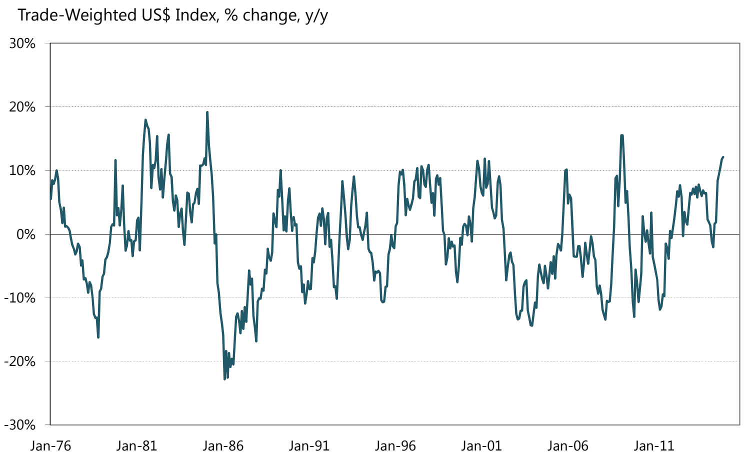


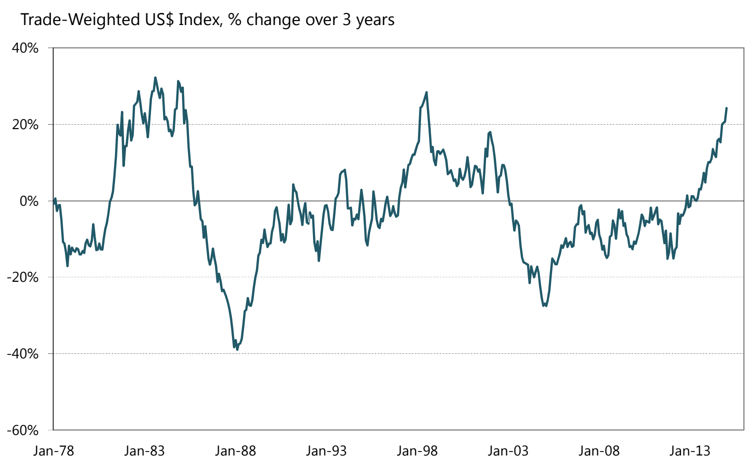
Figure 7. US vs. Global Yield Curve and the US$

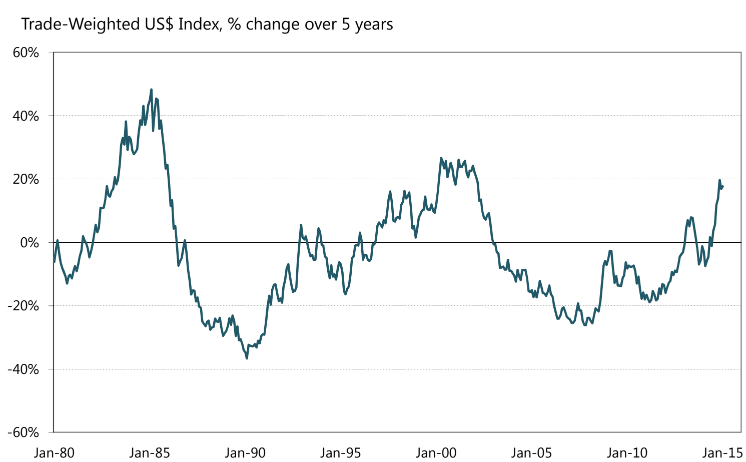


Sharp swings in the US dollar, which serves as the world's reserve currency and the currency of denomination for much global trade, are anathema to policymakers. Perhaps for this reason, movements in the dollar tend to be bounded by a range of +/- 10%. The currency is at or near the top of his historical range, on 1-year, 3-year and 5-year horizons (Figure 8). While that does not mean that a reversal is inevitable or imminent, it does suggest that the rubber band has stretched very far, and that a period of consolidation or correction is likely.

Figure 8. Wile Coyote







In the meantime, weaker foreign currencies will stimulate exports and corporate earnings abroad which, together with lower commodity prices and easier monetary policy, will support overseas equity markets. Indeed, once the dust has settled, it is very common for foreign equities to surge in the wake of a meaningful currency adjustment, given the improvement in competitiveness and the relatively larger share that overseas trade represents in GDP and corporate earnings. Although there are negative translation effects for US investors from a decline in foreign currency values, over time that is often more than offset by improved equity performance—since movements in stock markets can be orders of magnitude greater than currency changes.

Over the past month, the US dollar's (modest) interest rate advantage has begun to shrink, as US rates have started to decline toward levels overseas. The shift reflects changing expectations of US inflation and monetary policy, suggesting that markets are already anticipating the disinflationary (if not contractionary) effects of falling oil prices and a stronger dollar. Ever since the "Taper Tantrum" of mid-2013, investors have been laser-focused on the extent and pace of US tightening. They needn't be. The Fed gracefully navigated an end to its extraordinary bond-buying program last year. And although modest rate increases are planned for 2015, it's quite likely that these will come little and late. The US job market, though improving, is still not drawing discouraged workers back into the labor force. Wages remain stagnant, and the housing market is still fragile. Even when it seemed likely that the Fed would hike more, and sooner, than most experts now expect, long-term interest rates nevertheless declined. That's because inflation has been falling, and investors judge the US economy to be insufficiently strong to support a meaningful tightening of liquidity.

Although a stronger US dollar and weaker oil prices may take some of the steam out of the US recovery, as described below, chances are pretty good that these relative prices shifts will not derail it. However, there will be a significant impact on corporate earnings—starting this quarter and gaining steam in Q2. The initial impact will be mostly negative, since the drop in oil prices will cause a sharp decline in earnings of the energy sector (representing about 10% of the S&P 500). Moreover, S&P 500 companies now source 40% of their revenues from abroad, and will begin to feel the loss of competitiveness. Stocks are not cheap, and investors are uneasy after six years of rapid appreciation—there hasn't been a seventh consecutive year of US stock market gains since 1871! Leverage (margin debt on the NYSE) is high, momentum trading is increasingly popular (as evidenced by the rising correlation between hedge fund returns and the broader stock market), the breadth of market gains is narrowing, and volatility spikes are becoming more frequent. The US debt markets are sending some early warning signs of slower growth, via a flattening of the yield spread and rising credit spreads.

These developments certainly warrant caution, and we will be using the recent market gains to rebalance our clients' US equity and real estate exposures back to target. We will be increasing portfolios' cash positions to a corresponding degree, as a cushion against potential market volatility. However, we believe that longer-term US economic and corporate fundamentals remain sound, and that the oil price shock will help far more individuals and businesses than it hurts.

The US stock and bond markets have been on a juggernaut over the past several years, far outpacing their overseas counterparts. Investors are beginning to wonder whether maintaining a global portfolio makes any sense in an era of apparent US economic supremacy. We think it does. The last era of US ascendance ended with the technology bubble and subsequent market crash—which was followed by a decade of superior performance by overseas economies and markets.

A well-diversified portfolio produces excellent results, on average, over the long run. Unfortunately, in any given year, the diversified strategy almost always seems less attractive than one that is focused on the current winners. Yet concentrated strategies, or those based on rapid tactical adjustments (also known as market timing), have a poor track record. Leaving aside the difficulty of predicting winners, it is prohibitively expensive, from a tax standpoint, to reallocate one's portfolio frequently, as that entails realizing short-term capital gains. Therefore, it is important to think ahead, and incorporate into the portfolio investments that are likely to perform well in the *future*. And the most reliable (albeit imperfect) indicator of future returns is an investment's current valuation.

As the rebalancing of the global economy proceeds, the relative performance of foreign investments should improve. As they say, the best cure for high prices (whether of oil, currencies or financial assets) is high prices. Everything that goes around comes around in the self-equilibrating global financial system.

KPF Global Portfolio Strategy

As noted above, we are rebalancing (reducing) our clients' US equity and real estate exposures back to target, after the strong run they've had over the past several years. For clients with a more conservative risk profile, we will be adjusting those targets downward. Having trimmed clients' US small cap stock investments two years ago, we will be tilting toward these as a way of insulating the portfolio against the effects of a strengthening US dollar. Within the large cap space, we continue to rely on our proprietary low-volatility US equity income strategy, which has delivered outstanding results since inception in early 2012. We are holding our international equity positions, in anticipation of better times ahead, and increasing our activity in the "opportunistic investments" component of the portfolio. At present, that includes long exposure to Japanese equity (on a hedged basis) as well as a small investment in China's local (A share) equity market. Within the real assets category, as we trim US real estate, we are rebalancing (buying) natural resource investments via our preferred fund, whose manager performed relatively well in a very difficult environment—the fund was positioned for weaker commodity prices.

In fixed income, we continue to avoid inflation-protected bonds, in favor of municipal debt, mortgage bonds, corporate and high yield bonds, and (on a smaller scale) emerging market debt. We are lengthening duration on our clients' high-yield bond investments and adding a bit of credit risk.
The net effect of these various adjustments will be to increase our clients' cash positions modestly, to 5-7% of portfolio, on average.