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"By The Way"

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A popular song of 1967 began with the lyrics; "It's a strange, strange world we live in Master Jack". While not written with me in mind, the words do echo, some fifty years later, my view on the current market environment. The worst start to a year by the S&P 500 has been followed by one of the longest and strongest buying stampedes in history. There was no discernable change in fundamentals that would have caused such a reversal, but rather a 180% shift in investor attitudes toward risk. In my opinion, this reversal was in large part driven by a change in the intentions of the Federal Reserve toward the raising of regulated interest rates. The Fed had indicated late last year that it intended to increase rates through a four step process in 2016. In investors' minds the effect of such a policy would be to strengthen the U.S. dollar which would in turn lower U.S. trade and GDP growth, and have repercussions on economies around the world. The result was the significant decline in world stock markets that we experienced. We now have Fed members making statements that seem to indicate only one, if any, rate increase will take place this year. In addition, the European Central Bank, and the Japanese Central Bank and the People's Bank of China all continue to provide increasing liquidity as well. If we weren't convinced before, we certainly should be now; global central bankers do not want asset values to decline in any meaningful way for fear such a decline would impact on the economy in general.

One element of the "strange world we live in" is the widespread existence of negative interest rates. At the end of March, 38% of developed countries' bonds were trading at negative yields, and negative rates are the official policy of the Swiss and Japanese Central Banks. These are two motivating factors for this historically unusual situation; the desire for safety has driven investors to accept a small negative return in order to avoid a potentially much larger loss, and central bankers are doing all in their power to discourage saving and promote spending to bolster the economy. Using the metaphor of the carrot and the stick, the stick has been the weapon of choice to this point. The success of such a policy has been difficult to ascertain, other than sales of home safes in Japan are exploding as people hoard cash rather than invest at a negative return. But a new more "carrot-like" policy is being adopted by the European Central Bank which I believe has a better

chance of encouraging banks to make loans and companies to invest and spend. The current policy punishes banks by charging them to hold excess reserves at the ECB in the hope that to avoid that charge they will instead lend out those funds. Under a new initiative the ECB will lend money to the banks at a negative interest rate (in effect paying them, not charging them to borrow), as long as the bank in turn loans out the money to a worthwhile client.

The internal strength of the S&P 500 is so impressive that arguments citing high valuations, slow economic growth, and suspect corporate fundamentals are being totally overwhelmed. For example, the S&P Advance/Decline line has made a new high; the broad-based Value Line stock index is out-performing which means a majority of stocks are participating; and the 50 day moving average has crossed above the 200 day. And for those with a contrarian bent, the latest Barron's "Big Money Poll" showed that only 38% of the portfolio managers in the survey are bullish. That's the lowest in its over 20-year history and down from 55% last fall.

Of course markets never go straight up, and there are signs currently that the market is overbought and the slower summer season is near which will likely lead to some weakness. Nonetheless, as long as central bankers continue to create massive amounts of new liquidity, investors should use weakness to add to equity holdings. Keep an eye on the Fed though; and be wary of strength in the US dollar which might warn of a renewed intention to raise rates, and would force us to become more negative.

And finally, the quest for yield has produced its own "strange world" situations; take for example the recent issuance of bonds by Argentina. It was oversubscribed by a factor of four times, as investors clamored for the average yield of 7.14%. This is a country that has defaulted on its debt three times in the last 23 years, and about a quarter of the issue will be used to pay off the hold-outs from the most recent default. Isn't this why Mr. Madoff is in Jail

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