Caldwell Investment Management Ltd.

Independent Investment Managers

"The future ain't what it used to be."

- Yogi Berra

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In 2008, the Federal Reserve implemented what Chairperson Yellen refers to as "unconventional monetary policies". The goal of these policies is to counter act the negative forces unleashed by the global financial crisis, eliminate deflationary pressures, and help reduce economic slack. With the slow recovery of the U.S. economy the Federal Reserve began to reverse the unconventional policies. In January of 2014, the Federal Reserve began to taper its purchases of assets, slowing the rate at which its balance sheet grew. Today, with the unemployment rate close to 5%, and with inflation, (as measured by the trimmed mean PCE) close to 1.7%, the Federal Reserve is close to introducing the next phases of its normalization process, increasing interest rates. In normal times, the Federal Reserve would increase interest rates to slow economic growth reducing the inflationary pressures. Given where the economy is within the business cycle, investors typically follow a playbook that determines the optimal asset allocation mix. As the market repositions to take into account the Federal Reserve rising short term interest rates. We are finding that many investors are implementing a strategy that does not take into account the nuance of rising interest rates to reverse the unconventional monetary policies is not the same as rising interest rates to slow the economy down. Investors need to develop a new chapter of their playbook. No, this time is not different, we just haven't seen this since 1937. To wit, the playbook, many investors use, was written with any recent history in mind.

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Unconventional monetary policy components

The following are a generalization of the steps implemented by the Federal Reserve.

1) Set fed funds rate to zero.
2) Expand Federal Reserve's balance sheet. Purchase financial instruments.
3) Reinvest capital when purchase assets mature.

Increasing interest rates, without damaging economic growth will be no easy task. Many suggest that the Federal Reserve is making a mistake starting the interest rate normalization process, with an economy as weak as it is. The rationale for this view is based on the recession in 1937, which is seen as being caused by the Federal Reserve prematurely raising interest rates. In addition, the diverging monetary policies of global central bankers, will also create strong cross currents in the global economy which will add to market volatility.

The normalization process will have three distinct phases:

1) Stop expanding the size of the Federal Reserve's Balance Sheet.
2) Increase overnight interest rates to its normal long term average.
3) Decrease size of balance sheet.

Phase one is complete. Phase two is about to begin. With global monetary policy starting to diverge, the continued strength in the US dollar against major currencies must also be planned for. Finally, as long as the Federal Reserve is keeping its size of its balance sheet stable, and reinvesting the maturing assets, it is implicitly purchasing risky assets in the open market, keeping monetary conditions accommodative.

What is the normal rate of interest?

Should we expect the Fed Funds rate to go back to its historical average of close to 4.5%? Former Federal Reserve Chairman Bernanke is quoted as saying that he does not expect the Federal funds rate, the Fed's main benchmark interest rate, to rise back to its long-term average of around 4% in [his] lifetime. So yes, it is true, the Federal Reserve is starting to normalize interest rates, however, the normal level of interests rates associated with an economy that is viewed to be in a period of secular stagnation, will be lower than its historical average. How much lower remains to be seen. To wit, investors must realize that within an historical context, interest rates

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will be lower for longer, and build their portfolios accordingly. With lower energy prices stimulating economic growth, we could be entering into a period where economic growth in the United States surprises to the upside. This could lead to a trajectory of interest rates hikes steeper than investors are currently discounting, increasing volatility into the market.

As the financial markets enter the phase of interest normalization, there will be two key questions that investors will need to answer: At what interest rate level is interest rate normalization achieved? We are assuming a level between 0 and 4.5%, its mid-point is a good starting point. Second: How quickly will the market discount future rate move and the actual rate trajectory chosen by the Federal Reserve? With the inflation rate being discounted in the market, significantly lower than leading economic indicators are forecasting, with health care inflation picking up, the effects of El Niño are creating conditions for stronger economic growth. There is a good possibility that the trajectory is steeper than the market is ready for today.

Being able to accurately identify where the economy is in it evolutionary process and determining the rate of its evolution helps investors identify sectors in the market that will most likely outperform in the coming months. In normal times, the rising of interest rates by the central bank sends a clear and strong signal that inflationary pressures are building, and there is a strong desire by policy makers to slow the economy down. However, this is not the case today.

Through deconstructing the Fed's methods, we have developed a new chapter in the playbook and are using it to position our clients' portfolios.

A brief review of the relationship between the business cycle and optimal asset allocation finds that there are four phases in the business cycle:

1) **Early Cycle:** Low interest rates, monetary and fiscal policy to stimulate demand, rising tide lifts all boats. Economic growth starts to gain momentum. Credit conditions are loose. Margins start to expand and the yield curve is steep. High beta stocks outperform.
2) **Mid Cycle:** Economy evolves into a new growth phase, low interests, job growth, private sectors organic growth propels economy into a phase of sustainable economic growth. New sectors of economic growth are identified. Stock selection matters.
3) **Late Cycle:** Economic growth starts to generate scarcity in economy causing inflationary pressures to build to the point where the central bank starts to raise interest rates. Yield inverts. Market breath narrows.

4) **Slowdown/Recession:** Economy contracts, interest rates peak, interest rates decline. Investors play defense.

During the normalization process we are now in, stock selection will be key – and more important than sector weightings. Managers with high active share will outperform. Companies that have adapted quickly to the global environment, with good growth characteristics, expanding margins and strong management teams will outperform. It will not be good enough to just choose the right sectors and invest in an ETF. The global economy is going through a rapid dynamic adjustment phase and the best companies in many sectors will be gaining market share. Avoiding stocks with slow growth, low margins, high historical valuation, and low dividend yield is the rule investors must follow. In this new phase it's all about stock selection, not sector allocation.

1) Rising short-term rates will benefit those companies that are positioned to have a steepening yield curve.
2) Every company is now a technology company. Those that fail to adapt will lose market share.
3) With the emerging market growth substantially slowing on and with the structural adjustment taking place in China, companies that benefit from consumer and service growth in China should attract capital.
4) The U.S. economy is less dependent on global trade than other major economies and has exited its adjustment phase and will be strong enough to generate job and wage growth.
5) While inflation, caused by stabilizing commodity prices may be muted, increases in wages, as well as health care inflation in the United States, is set to take center stage.

Following the above five axioms should help investors navigate this new phase the global economy is entering into.

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