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Review

The S&P 500 index was volatile this quarter. Investors were bewildered by the decline in oil prices, the strengthening US dollar, and uncertainty about when the Federal Reserve might raise interest rates. Many economists believe the Fed will increase interest rates by mid-year, helping to push the US dollar up relative to other currencies. The US job market has continued slow but steady expansion, and the housing market has continued to improve; both positive influences on US stock prices. On the other hand, low oil prices and a strong US dollar have hurt companies in certain industry sectors.

Most forecasts of the US economy remain positive and, in fact, are improving. The forecasts call for improved GDP growth, continued slow improvement in the labor market, and low inflation. While a strong economy will certainly help US stock markets, we expect questions about the timing of interest rate increases, the strength of different economies around the world, currency issues, and geopolitical tensions will result in continued volatility in US stock markets.

Outlook

Normally we focus on the numbers in our Outlook section, like forecasts for inflation or unemployment. This quarter, however, we focus on a proposal from the Obama Administration, designed to reduce conflicts of interest, and assure transparency of hidden fees when brokers and financial advisors manage retirement accounts. Similar ideas have been proposed in the past, but large brokerage firms and investment banks have successfully lobbied against new fiduciary rules. The Department of Labor is expected to submit new rules for consideration sometime in the next few months.[1]

We look forward to the successful implementation of these new rules, and hope the public receives better information about the fiduciary responsibilities (or lack thereof) of brokers, financial planners, and investment advisors.

At present, Registered Investment Advisors, like Waycross, have a legal obligation to act as fiduciaries, which means we are obligated to put our client's interests first. The same is not true for other types of advisors in our industry. Brokers receive compensation when they sell products like annuities or certain mutual funds. This can create an incentive for them to continue to promote these products, even when doing so does not further their client's goals. Investors often do not know the difference between advice from a fiduciary versus a sales pitch from a broker. The Obama Administration is searching for a way to eliminate these problems, focusing first on guidelines for people managing retirement accounts, such as IRAs.

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As a fiduciary, Waycross does not sell any products, or receive any compensation other than our direct management fee. We do a significant amount of research and analysis in-house, but frequently consult research from other organizations, as well. Our objective is to select the most appropriate investments for our clients, based on their needs and goals. We are not tied to any particular investment, and we are always happy to explain the differences in how brokers, advisors, and financial planners are compensated.

For those of you who traveled outside the United States this year, you may have noticed that you can generally buy a lot more euros, pesos, or yen for your US dollar. The Canadian and Australian dollars have also dropped significantly relative to the US dollar. This happened for a number of reasons: relatively weak foreign economies, relatively low interest rates abroad, and lower commodity prices.

Figure 1: Relative Performance of Indices[2]

In Focus

Over the past several years, the United States Federal Reserve Bank ("the Fed") has engaged in a process called "quantitative easing", which stopped in October of 2014. Quantitative easing is accomplished by the Fed purchasing government bonds, driving down shorter-term interest rates, while simultaneously putting more dollars into the financial system. Pushing interest rates down is intended to allow cheaper financing for things like housing construction, home and auto purchases, and equipment purchases by corporations, thus stimulating the economy. But driving down interest rates also has the effect of pushing down the value of the dollar relative to other currencies.

Recently, other major national economies have started to get into the quantitative easing game. Japan has been at it for years, but went into overdrive in the past year, in a deliberate attempt to drive down the value of the yen relative to the dollar (at which they have been quite successful). Europe is also starting a quantitative easing program. They have deliberately avoided quantitative easing since the "great recession," despite stagnant economies with staggering levels of unemployment, especially in Southern Europe. In stark contrast, the US ended its quantitative easing program in 2014, and the current discussion is when the Fed will start to raise interest rates. The result has been the US dollar rising in value relative to most other major currencies.

The implications of large currency moves are significant for investors holding US equities, especially in the short term. Many of the largest US companies operate on a global scale, deriving a significant portion of their revenue from foreign sales. However, US companies report earnings in US dollars. The dollar values of foreign earnings drop when the values of foreign currencies drop relative to the US dollar. This can result in a negative impact on stock prices.

For other companies with foreign operations, currency risk may be a wash if they purchase input components, including labor, in countries with devaluing currencies, while selling a significant amount in the US market, in US dollars. For example, many Apple components are manufactured in Europe and Asia. Apple takes a hit on revenues after conversion into US dollars from foreign sales, but their input costs also go down in US dollars, so US margins should increase. The effects of strong currency moves will be unique to each company, and anticipating the exact impact of currency fluctuations for each company is a considerable challenge for the investor.

One way to mitigate currency risk is to search for companies with operations largely in the US, as they are not directly exposed to currency fluctuations. For example, Southwest Airlines uses planes manufactured in the US (Boeing), operates largely in the domestic airspace (customers pay in US dollars), pays employees in US dollars, and buys fuel in US dollars. Compare this to the business model of American, Delta, or United airlines, all of who have a significant international business. Other examples in the current Waycross portfolio of holdings where currency risk should be minimal include Kroger, CVS Health, and United Rentals.

The rise in the value of the US dollar relative to other currencies has added one more variable that can impact stock prices. For the time being, we are paying close attention to its possible impact when we consider stocks to purchase.

1. Mason, Jeff and Lynch, Sarah N. "Obama takes aim at brokers' fees on U.S. retirement accounts." *Reuters.com*. Published: February 23, 2015.
2. XE Currency Charts. "EUR per 1 USD". *Xe.com*. Accessed: 4/1/2015.