Ashdon Investment Management

Q1 2015 ECONOMIC COMMENTARY

April 2015

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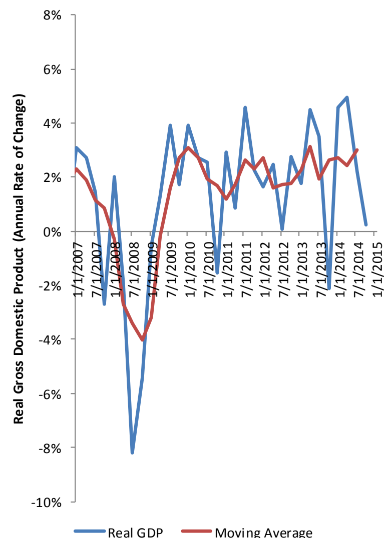
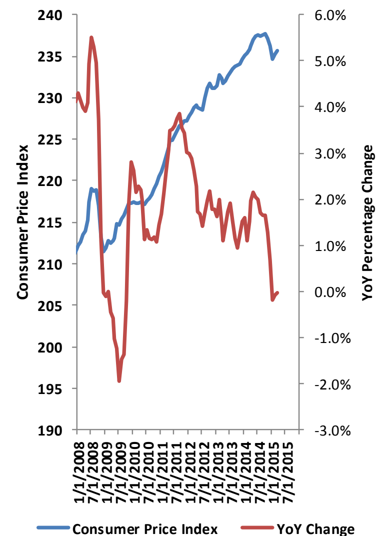
First Quarter 2015 Economic Commentary

After rebounding in the last half of 2014, Gross Domestic Product (GDP) for Q1 2015 grew very modestly at 0.25% (quarterly change at an annual rate). The cause of the deceleration was primarily a decline in exports driven by persistent dollar strength in 2014: the dollar appreciated by more than 20% versus other currencies making US goods more expensive and therefore less attractive to foreign buyers. Weather was another contributor to the softness over the quarter. As we stated last quarter, it is important to keep in mind that quarter to quarter volatility can obscure the more important underlying trend. Below is an update to the chart of change (percent change from a year ago) in GDP, showing that the overall economy continues to grow at a moderate rate.



The inflation index in the US ticked up slightly through the first quarter. Even so, the year-over-year change in prices is still very low – near zero. Low inflation has been part of the economic landscape globally since the last recession. This has confounded many economists and commentators. Many thought the FOMC policies, designed to stimulate inflation, would be successful. However, the low growth environment has not been accompanied by rapidly increasing aggregate demand – a key ingredient for inflation. Things may be changing.



There has been much written about the FOMC's next policy changes. Writers have been clear that the utility of the innovative "QE" methods has been exhausted. A gradual rise in the "overnight" interest rate – the traditional tool of policy makers – is expected by most economists. We agree. What is unknown is how asset markets will react. The bond market was notably volatile during the first quarter. The causes of the volatility lie in the technical details of bond trading. But the price movements may be in response to changing expectations in inflation and therefore rates. We do not have a clear view of the transmission mechanism to drive inflation globally, but there are numerous candidates (for example, Chinese economic diversification, ECB success in stimulating EU and therefore global demand and growth, spending in Japan to stabilize the country's global status). We are watching changes in German long bonds and JGB's to see how they are responding.

At present, our expectation is that this state of economic affairs will persist into the future for many quarters. Last quarter, we stated that it was conceivable that the low growth economy might persist for many years. This is still an acceptable scenario, but other short term scenarios are coming into view. The resolution of the large imbalance put in place by monetary policy may occur very slowly and smoothly as we expect. However, it may also evolve with episodes of short-term rapid changes. This evolving view makes us even more committed to holding "dry powder" in the form of high quality fixed income investments or other cash equivalents. Risks of many kinds (political events, policy errors, etc) seem to be rising as asset prices climb ever higher in a highly correlated way. Investors should mitigate these risks by owning quality investments in highly competitive companies with dominant brands of services or products.

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