From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Cross Currents

There are times in markets when black becomes white and white black. We are apparently going through such a rotation, and we are trying to decide if it is temporary and counter trend, or reflecting the beginning of new trends.

Recent relative winners:

- Emerging markets, especially Latin America
- Longer duration bonds, utilities, MLPs and REITS

Recent losers:

- Developed world stocks, especially Japan
- Mid and small caps, NASDAQ momentum stocks in Technology and Biotech

The weakness in smaller cap stocks and technology, combined with the strength in bonds would typically indicate economic weakness; yet the data has been stable to stronger. Meanwhile emerging markets have firmed as commodity prices have stabilized, also arguing for improved global growth prospects. Furthermore another reliable indicator of economic weakness, the yield difference between corporate and Treasury bonds, has been stable. Thus, we believe the decline in bond yields is temporary.

We believe the euro, currently at $1.39/euro, is unlikely to strengthen much further against the US dollar after recently peaking at $1.40, and that there is downside risk towards $1.30.

An argument has been made that investors are reacting to better economic news by worrying that better data brings the Fed closer to raising interest rates and fearing that it will mistakenly raise rates too soon. We think this makes some sense as an explanation, but while we do see rates rising in 2015, we believe the Yellen Fed will want to see clear signs of persistent economic strength. Japan's weakness is also policy related. The consumption tax was raised on April 1st and investors are clearly worried about the sustainability of the economic and earnings recovery. We are currently overweight Japan, but we have a risk management plan in place.

We have hedged some of our euro exposure. The European Central Bank (ECB) is slowly, but surely, becoming more proactive in preventing deflation and sustaining recovery in the Eurozone. In contrast, the US Federal Reserve is likely to be the first among major developed market central banks to raise interest rates as the US economy exhibits relative strength.

As a result, we recently lowered our euro-currency exposure and raised weightings in European small caps, given the increased likelihood of euro weakness and targeted stimulus from the ECB.

Recently, ECB President Mario Draghi said the central bank is: "Unanimous in its commitment to using... unconventional instruments within its mandate in order to cope effectively with risks of a too prolonged period of low inflation." Last Friday, the ECB backed up its assertion to use 'unconventional measures' by jointly publishing a paper with the Bank of England that lays the groundwork for central bank purchases of asset-backed securities.

Unlike quantitative easing (QE) in the US, where the Fed is purchasing Treasuries and government agency mortgage-backed securities, 'private QE' in Europe is being designed to get credit to small businesses flowing again. While sovereign credit spreads have come down significantly since Draghi pledged to do "whatever it takes" to prevent the Eurozone from breaking apart, borrowing costs for small businesses, which are the engine of the European economy, remain restrictive. With the sovereign debt crisis mostly behind it, in our view, we think the ECB's attention will increasingly be towards jump-starting growth through small business lending. As a result, we recently lowered our euro-currency exposure and raised weightings in European small caps, given the increased likelihood of euro weakness and targeted stimulus from the ECB.

THE WEEKLY CHART: EURO CLOSE TO RESISTANCE AT 1.40

Past performance is no guarantee of future results. Source: Thomson Reuters Datastream

Heading into the 2008 to 2009 Global Financial Crisis, the euro reached a record high versus the US dollar, but it has been in a downtrend since the Great Recession and its own sovereign debt crisis, which drove most of Europe back into recession two years ago. The euro has rallied substantially since its 2012 lows as the Eurozone became less likely to break up given ECB support, but relatively tight monetary policy compared to the US has helped keep the euro rally going. With the ECB becoming incrementally more accommodative and the Fed less so, we believe the euro is likely to have peaked, and we expect its downtrend to resume.