September 2015

Dominoes

A few things come to mind when we think of 'dominoes'[1]. First, it makes us hungry as we think of Domino's, the pizza delivery business. Second we think of the popular game. Third we think of the 'domino effect'.

Pizza

Domino's Pizza Inc., is an American restaurant chain founded in 1960 in Michigan. It has since grown to become the world's second largest chain (behind Pizza Hut) with over 10,000 stores in 70 countries. The Domino's story began when Tom Monaghan and his brother James purchased DomiNick's, a small pizza parlour in Ypsilanti, Michigan. The deal was secured by a $500 down payment, and the brothers borrowed $900 to pay for the rest. The brothers planned to split the work hours evenly, but James didn't want to quit his job as a full-time postman, and within eight months, James traded his half of the business to Tom for the VW Beetle they used for pizza deliveries. By 1965, Tom had purchased two additional pizzerias; he now had a total of three locations in the same county. Monaghan wanted the stores to share the same branding, but the original owner forbade him from using the DomiNick's name. One day an employee returned from a pizza delivery and suggested the name Domino's. Monaghan immediately loved the idea and officially renamed the business Domino's Pizza, Inc. in 1965. The company's logo (Domino's) with three dots represents the first three stores in 1965. Monaghan planned to add a new dot with the addition of every new store, but this idea quickly became impractical as Domino's experienced rapid growth.

Game

The game is played with rectangular 'domino' tiles. The domino gaming pieces make up a domino set, sometimes called a deck or pack. The traditional Sino-European domino set consists of 28 dominoes, colloquially nicknamed bones, cards, tiles, tickets, stones, or spinners. Each domino is a rectangular tile with a line dividing its face into two square ends. Each end is marked with a number of spots (also called pips, nips, or dobs) or is blank. The backs of the dominoes in a set are indistinguishable, either blank or having some common design. A domino set is a generic gaming device, similar to playing cards or dice, in that a variety of games can be played with a set. The earliest mention of dominoes is from the Song dynasty in China, and they first appeared in Europe (Italy) during the 18th century. Although it is unknown how Chinese dominoes developed into the modern game, it is speculated that Italian missionaries in China may have brought the game to Europe. The name 'domino' itself is from the resemblance to a kind of hood worn during the Venice carnival.

Domino effect (and politics)

The domino theory was prominent from the 1950s to the 1980s that speculated that if one country in a region came under the influence of communism, then the surrounding countries would follow in a 'domino' effect. The domino theory was used by successive US administrations during the Cold War to justify the need for American intervention around the world. Though he never directly used the term 'domino theory', President Eisenhower put the theory into words during an April 7, 1954 news conference, when referring to growing communism in Indochina.

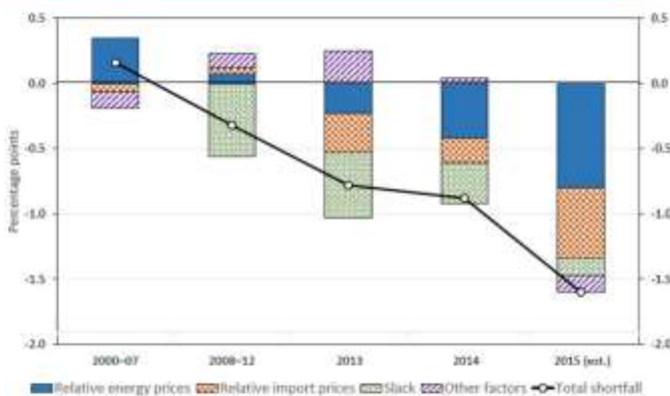
Finally, you have broader considerations that might follow what you would call the 'toppling domino' principle. You have a row of dominoes set up, you knock over the first one, and with almost complete certainty you know that the last one will topple in quick succession. So you have the beginning of a disintegrative process with the most profound 'knock on' influences; a chain reaction with a cumulative effect started by one event but setting off a chain of similar events. A largely mechanical process that typically refers to a linked sequence of events where the time between successive events is relatively small, today it can be used literally (an observed series of actual physical collisions) or metaphorically (causal linkages within systems such as global finance or politics).

Domino effect (and financial markets)

The third quarter turned out to be quite a volatile month for investors in the financial markets. Some market participants blame the Chinese central bank's (PBoC) decision to unpeg the Chinese Yuan and manage a free float, that triggered a sell-off in assets and a broad-based spike in capital (and debt) market volatility. Arguably that first PBoC domino also toppled the chance of a September Fed rate hike.

[1] Source: Kapstream, Wikipedia, Domino's Pizza Inc.

In September's Fed decision to keep rates at zero, Yellen acknowledged that although there were good arguments to begin hiking rates, increasing global uncertainty combined with continuing low inflation and only modest improvement in the jobs market argued for keeping rate hikes on hold for the time being. It appears that most policymakers agreed with this view. At the moment there are 4 policymakers (17 in total) who believe 2016 will be the timing for the first Fed rate hike, up from 2 policymakers in the June projection. Greater uncertainty resulting from both a weaker global growth outlook and financial market volatility allowed policymakers to delay the timing of the first hike, at least so far. In keeping rates on hold, Yellen balanced continuing marginal improvements in labour markets versus global developments, particularly stock market volatility, which overall was expected to place additional downward pressure on near-term inflation.



Source: Janet Yellen, Chair, US Federal Open Market Committee

The Fed has referred to the chart included to explain what factors have caused inflation to remain below their 2.0% target. As can be noted, declines in commodity prices have reduced inflation by about 0.75% in 2015 while "import prices" (otherwise known as dollar strength) have reduced inflation by another 0.50%. The Fed has noted that historical "slack" or the quantity of labour and capital that could be deployed but isn't, has fallen over the years as the unemployment rate fell toward 5%.

As slack becomes less of a drag on inflation and commodity prices eventually stabilise, the Fed believes inflation rates will move back toward 2%, hence talk of rate hikes. Whilst, additional US dollar appreciation and declines in energy prices, would drag inflation down, the Fed views these moves as transitory.

We remain in the minority in believing labour slack will continue as the underemployment rate (U6 – a measure of underemployment) remains at 10.3%, well above the 5.1% unemployment rate (U3). We believe nearer-term rate hikes would also lead to US dollar appreciation, allowing "import prices" to be a continuing drag on inflation. With slower global growth, particularly in Asia, we believe a currency war will continue as Asian economies move from domestic-led internal demand back to what has worked in the past – export led growth.

Despite our contrasting views on the timing of the Fed's first rate hike, there has been a downward trend in policymaker estimates of the longer-run funds target rate. With US 2-year Treasuries currently yielding 0.65% and 5-year Treasuries yielding 1.37%, we are neutral to the market's view that there won't be many rate hikes over the coming years.

And the Fed has supported this view as projections for the longer-run unemployment rate—essentially a proxy for the Fed's estimate of the natural unemployment rate or NAIRU—edged lower. The median estimate for the longer-run unemployment rate edged down to 4.9% from 5.0% in June and projections by individual participants show estimates for the natural rate as low as 4.7%.

In this environment of near record low rates, we still believe bonds are fairly priced, balancing longer-term low growth and inflation against eventual Fed rate hikes.

Overall we believe the theme of low global central bank rates and more liquidity will continue, compelling investors to hold risk assets. We foresee a continuing currency war as global central banks position for export growth amidst deteriorating domestic environments. The US will remain the only developed market not playing the currency game as prior structural and banking reform promote greater growth prospects.

Against this backdrop, we continue to maintain a conservative stance, holding interest rate duration at 0.80 years, retaining our liquidity bucket of cash and government-related securities at 22% and continuing to sell some of our more volatile corporate holdings. The Fund currently yields 3.7% and we expect to continue to remain more cautious in the coming months as interest-rate volatility remains high.

Reference in the Fed messaging that US interest rate policy decisions must factor in the influence (on the continuing domestic recovery) of an uncertain global economic climate and heightened global market volatility, proved something of a revelation against the rather more inward-looking stance of previous FOMC statements. It is hard to recall a clearer acknowledgment of the stark interdependence of global markets and economies, and the interconnectedness evident in the ‘domino’- like chain of policymaker decision-making.

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