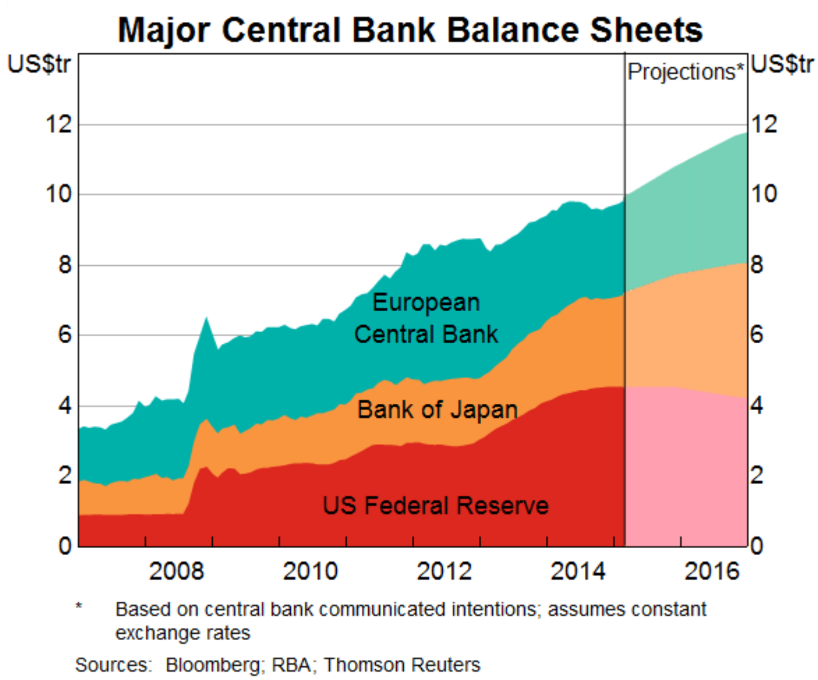
COMMENTARY

April 24, 2015

Dear clients and colleagues,

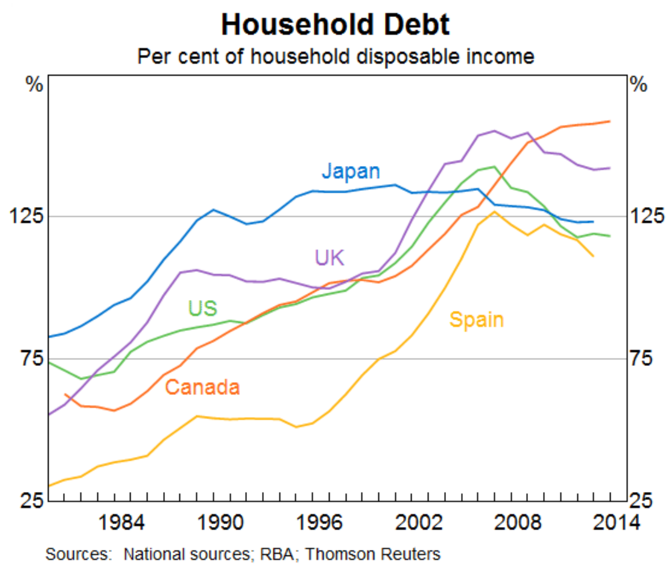
Central banks around the World are continuing to add to their unprecedented stimulus programs. Last Sunday, China's central bank launched a new wave of stimulus to counter the country's slowest growth in six years. It lowered the amount of cash large banks must keep on reserve by 1% to 18.5%, 17.5% for smaller banks and 16.5% for the China Agricultural Development Bank. This is the lowest the reserve requirement has been since December 2008, during the midst of the financial crisis. Since the beginning of 2015, over 24 central banks have lowered interest rates. These include Australia, Canada, Israel, India, and Sweden, all with the hopes of driving down their currencies and boosting growth.

The situation we are facing today is unprecedented. The amount of money being created is staggering (see figure below). Interest rates are negative across much of Europe. Long-term government bond yields in most of the advanced economies are the lowest seen in history.



Yet, growth is sub-par at best and inflation, a normal result in past cycles, is nowhere to be seen, except for asset price inflation such as the stock market and real estate.

Why is the economy not doing better? The answer is household deleveraging.



We cannot make a forecast on how things will play out just yet. However, we believe that the Federal Reserve made a mistake by lowering rates to zero. We would argue that the difference between stopping at a rate of 2.5% to 3% and going down to 0% is negligible. Interest rates at zero have done nothing to stimulate the economy, but this rate environment has created a number of negative consequences.

First, it has penalized savers, retirees, pension funds, and so on. The impact is estimated to be over $350 billion per year in the U.S. alone.

Secondly, low rates have encouraged the wrong kind of behavior from corporations, such as taking on debt to buy-back shares or increase dividends. In the meantime, little has been spent on long term growth initiatives. One could argue though, that if money had been spent on adding capacity, this would have exacerbated overcapacity issues and resulted in further deflationary pressure.

The move by the Fed forced other central banks around the World to follow suit and lower rates, igniting currency wars and increasing volatility.

In summary, the Fed overstepped its mandate and essentially enabled the government to further delay urgently needed structural reforms.

Two future scenarios are possible. First, the Fed slowly raises rates and brings the situation to a more normal long term course, providing a framework for the rest of the World to raise rates as well. The second option is the Fed does nothing and we wait for the next financial crisis, which could be of a scope and magnitude that has not been seen since the 1930s.

On another subject, you may know by now through reading our comments that we are true believers in the increasingly important role alternative energy will play in the near future. An important shift occurred in 2013 when the World added 143 GW of renewable electricity capacity, as compared to 141 GW from new plants that burn fossil fuels (including nuclear).

2014 was another record year in terms of new installations of solar, wind, biomass, geothermal, and other sources of alternative energy, driven by continuing reductions in prices. Solar and wind are now on par or cheaper than traditional grid electricity in many areas of the World, even without subsidies.

For the skeptics who reject wind and solar as being reliable energy sources, the solar eclipse in Europe a few weeks ago proved that smarter grids can manage the peaks and troughs. The next major revolution will be storing energy with battery packs, a goal being pursued by Tesla's Elon Musk, or through creating hydrogen, a vision pursued by others such as Toyota.

Coming back to solar energy, according to Deutsche Bank, solar is now competitive without subsidies in 14 U.S. states. Within 12 to 18 months, this number will rise to 47 States. Costs associated with solar systems have fallen at a compounded 15% per annum for the past 8 years. Costs should fall another 40% over the next 4 years.

But the real incentive is political. Just this week, President Obama cited climate change as Earth's biggest threat. China has finally changed its mind as well. The change is not due to climate concerns, but rather the quality of air, which is one of the greater risks threatening social peace and the hold of the Communist party. This political signal was accompanied by an even more important fact. In 2014, Chinese coal consumption actually fell.

The rise of alternative energy will have enormous consequences on society and several industries. Regarding the fossil fuel industry, first coal, then oil and nuclear, and eventually natural gas, will see supply and demand and also pricing curves shift to much lower levels.

Geopolitically, alternative energy will have important consequences on countries in the Middle East and in Russia. Already, we are reading that the real motivation behind Saudi Arabia keeping oil prices low is to delay the inevitable decline in demand.

Electricity utility companies will also face significant challenges as the model for distributed electricity will give way to a much more on-site and flexible model.

Often, investors fail to consider how fast changes can happen. In order to assess just how fast, one has to see when the tipping point occurs. After that, change moves rapidly. We believe we are past the tipping point for alternative energy.

So, how do we invest in this sector?

Many of our companies have significant exposure to the alternative energy sector.

Examples of holdings with exposure include: Ormat (ORA US, www.ormat.com), a World leader in geothermal energy, both as a producer and equipment supplier; Atlantic Tele-Network (ATNI US, www.atni.com), an emerging solar energy producer; Nabtesco (6268 JP, www.nabtesco.com/en/), a maker of gears for solar farms and robotics applications; Disco (6146 JP, www.disco.co.jp/eg/), a maker of saws, grinders, and polishers for the solar wafer and panel industry; and PMC Sierra (PMCS US, www.pmc-sierra.com/), a maker of semiconductors used in inverters.

Have a good week.

The Global Alpha Team