March 2nd, 2015

Should investors fear interest rate hikes?

After a volatile January in which U.S. equities lost 3%, stocks did a 180 (and then some) in February with both the S&P 500 and Dow Jones Industrial Average gaining 5.5%, the MSCI AC World Index rallied 5.4%, but it was the Tech heavy Nasdaq that registered the biggest monthly gain at 7%. At a sector level it was Consumer Discretionary (+3.7%), Materials (+3.5%) and Healthcare (+3.2%) leading the charge through the first two months of 2015 with the Utilities (-7%), Financials (-4%), and Energy (-3%) sectors being the biggest laggards so far this year. Gains in international equity markets have been even stronger than the U.S. with Europe (+6.1%) coming in as the best performing region in February on the back of receding Greek concerns and macro data improving off a low base including GDP growth, Consumer Confidence, and PMIs. Japan (+6.0%) also performed well as its equity market climbed to 15 year highs and through February is up 8.5% for the year.

This begs the question of whether recent gains are reflecting economic health, or are global equities mainly piggybacking on policy easing? The current ebullience (in particular for U.S. equities) seems at odds with the backdrop of moderate economic growth, floundering corporate earnings, rich (relative to historical average) valuations, and the approaching monetary tightening cycle in the U.S. However, these headwinds are clashing with the constructive tailwinds of lower oil prices, a labor market that is approaching full employment, global disinflation, brightening fundamentals in major developed markets outside the U.S., stimulative monetary policy action from other central banks, stock buybacks and ultra-low interest rates around the globe.

This wall of worry has been present and persisted in various degrees of severity throughout this bull market which is now approaching its six year anniversary. Those who have bet against stocks – on the notion that this perpetual wall of worry would have at some point become too insurmountable to overcome – have left a lot of gains on the table. The following chart from BofA Merrill Lynch Global Research illustrates how this current bull market stacks up against other bull markets dating back to 1932 (data for the current bull market is through year end 2014).

History of US Equity bull markets				
Start	End	Rally	Duration (months)	Prior Bear Market
6/1/1932	3/5/1937	323%	57	-86%
4/29/1942	5/29/1946	153%	49	-54%
6/14/1949	8/2/1956	265%	86	-30%
10/22/1957	12/12/1961	86%	50	-22%
6/27/1962	2/9/1966	79%	44	-28%
10/7/1966	11/29/1968	48%	25	-22%
5/26/1970	1/11/1973	74%	32	-36%
10/3/1974	11/28/1980	126%	73	-48%
8/12/1982	8/25/1987	229%	60	-27%
12/4/1987	7/16/1990	65%	31	-34%
10/11/1990	3/24/2000	417%	113	-20%
10/9/2002	10/9/2007	101%	60	-49%
3/9/2009	12/31/2014	204%	69	-57%
Average		167%	58	-39%

Source: BofA Merrill Lynch Global Investment Strategy, S&P Dow Jones Indices, Bloomberg

This bull market (which continued through February) is now in its 72nd month and has appreciated by 215%, surpassing both the average length (58 months) of prior bull markets and handily outpacing the average percentage gain (167%).

Just like valuations can push beyond historical levels and stay richly extended for significant periods of time (i.e. Tech bubble), so too can this bull market cycle defy the reversion to the mean crowd by continuing beyond the average levels of prior bull markets. However, the wall of worry that this market has shrugged off so readily in the past is likely to be much more of a challenge going forward (in my opinion).

Stepping aside from the day-to-day economic data, the latest geopolitical event, or the most recent corporate fundamental developments, I want to highlight two themes that are in the midst of transition which will likely create some indigestion for capital markets over the next six months: 1) liftoff for the Fed's rate hiking cycle and 2) a material slowing in corporate earnings. I don't believe either of these events spell impending doom for the current bull market, but I do believe the current setup on these two fronts creates the most significant hurdle inhibiting near-term gains and likely will bring with them heightened volatility in asset prices.

Last week Chair Yellen testified in front of both houses of congress in her semi-annual testimony where the investment community interpreted the whole of her comments as dovish in regards to the future path of interest rates. The markets reacted by sending equity prices and the dollar higher while Treasury yields moved lower (bond prices, which move inversely to yields, went higher).

Since Yellen became Chair of the Fed her comments have focused more on the full employment side of the Fed's dual mandate with less attention paid to price stability (aka inflation). However, with the unemployment rate nearing what many Fed officials view as full employment, the focus has shifted to an inflation rate that is running below the Fed's 2% target. Chair Yellen used this to downplay any changes that may occur to the Fed's forward guidance at upcoming policy meetings – namely dropping the term "patience". To wit:

> "*If economic conditions continue to improve, as the Committee anticipates, the Committee will at some point begin considering an increase in the target range for the federal funds rate on a meeting-by-meeting basis. Before then, the Committee will change its forward guidance. However, it is important to emphasize that a modification of the forward guidance should not be read as indicating that the Committee will necessarily increase the target range in a couple of meetings. Instead the modification should be understood as reflecting the Committee's judgment that conditions have improved to the point it will soon be the case that a change in the target range could be warranted at any meeting…*

"Provided that labor market conditions continue to improve and further improvement is expected, the Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when, on the basis of incoming data, the Committee is reasonably confident that inflation will move back over the medium term toward our 2 percent objective."

This is in contrast to previous comments made by Chair Yellen where she indicated that dropping the term "patience" implied a rate increase would come two meetings later – now, she suggests that dropping the reference does not have any pre-set timetable. This provides Chair Yellen and her FOMC colleagues some cover for a more flexible path with future policy adjustments.

It appears as though there is better than even odds that the FOMC drops "patience" at their March meeting, but according to Yellen, such a change merely means "conditions have improved to the point where it will soon be the case that a change in the target range could be warranted at any meeting." This in effect establishes an additional stage of policy guidance for the Fed and alleviates pressure from market forces which would have likely priced in that a rate hike was imminent within a couple months once "patience" was dropped – given this was the case in the lead up to the initial volley in the 2004 rate hiking cycle.

So with the stage set for the Fed to come off the zero-policy-rate-floor which has buttressed asset prices for +6 years, should investors fear the Fed? For the equity markets, the historical archives say no – as the peak in stocks on average does not occur until three years following the initial hike with the shortest increment of a market peak coming in the late 1960's at a year and a half. Furthermore, in terms of the duration and magnitude of the rate hiking cycle, it's not until late in the cycle that the stock market begins to peak. Since 1960 the average increase in the Fed funds rate is 350 basis points from the lows (the smallest run-up that induced a bear market was 130 basis points) before the economy begins to peter out as a result of a liquidity squeeze and the stock market rolls over.

On a long-term basis, equity investors have little to fear with the onset of what is likely to be a prolonged and deliberate rate hiking cycle. The typical short-term reaction in stocks following the initial volley is for equities to sell-off and spend some time consolidating as the weak hands get rung out with this change of direction.

However, this just may be one of those instances where the “it’s different this time” crowd may have a valid justification for using such phrase. Going back to the 1950s, never have we been five years into a bull market before the Fed began raising rates – the historical records show that the range is usually one to three years.

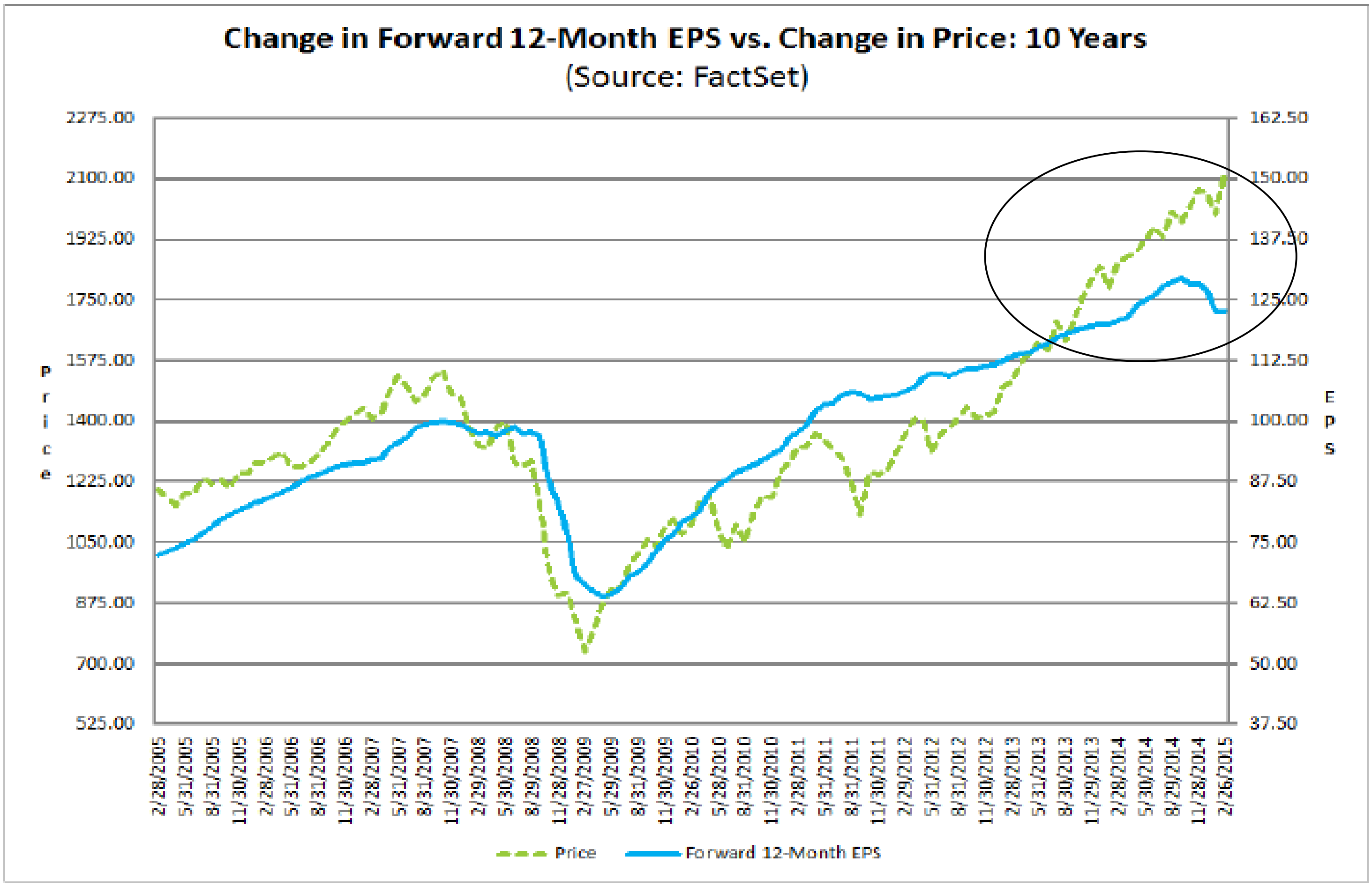
Another supportive argument for the “this time is different crowd” is the fact that global capital markets have never experienced a time where central banks around the world have been as involved as they are today by pushing global yields to all-time lows in many regions. An example of this was on full display last Thursday when the yield on the seven year German bund traded into negative territory which followed a $3.7billion five year German note auction the day before that fetched an average negative yield of 0.04%. As if that isn't striking enough, Portugal – a sub-investment grade credit (a nice way of saying its debt carries a junk credit rating) – has 10-year debt trading at a record low sub 2% yield – that's lower than U.S. 10-year paper.

Anyone buying plain-vanilla sovereign debt today can only be doing so on the premise that yields are heading lower and they intend to make money from the capital appreciation that would accompany such a move. Because the coupon payment, at current levels, just doesn't justify the risk – especially compared to the S&P 500 where nearly half its components pay a dividend yield above the 10-year Treasury and a payout ratio that sits near century lows, leaving ample room for growth over time relative to a locked-in fixed 2.0% coupon on a newly issued 10-year T-note.

Let me carry this relative investment comparison a step further. If the yield on the 10-year Treasury-note backed up to 2.5% from its current 2.0% level (a rather moderate 50 basis point increase – we just saw a 40 basis point increase in the month of February) this would generate a negative 2% total return over the next year. This math just amplifies if this increase in yields were more severe – a move to 3% on the 10-year would generate a loss of 6%, if it were to move to 3.5% in the next year this would cause a loss of 10%. This is the level of risk that an investor would expect from the stock market, but in the stock market investors bearing this risk have the potential for unlimited upside return.

This isn't to imply that bonds have no place in a prudently allocated portfolio, as there are parts of the bond market that offer a more favorable risk/reward trade-off than plain vanilla sovereign debt, but any investor flocking into Treasuries today requires an investment thesis that global deflation is inevitable and we are on the doorstep of a recession, neither of which I believe carry a high probability of occurring in 2015.

The other hurdle I see facing equity investors in the ensuing couple of quarters is a material slowing in corporate earnings (analyst earnings estimates are for negative growth for the first two quarters of 2015). According to Factset, S&P earnings growth for the calendar year 2015 is now expected to be just 2.9% (vs. 8.2% expected growth on Jan 1). Through the first four and a half years of this bull market, earnings growth and stock market appreciation was virtually moving in lockstep. For many fundamental investors this provided validation that the underpinnings supporting this bull market were in place. However, as can be seen in the below chart from Factset the continued appreciation in stock prices since Q3 of 2013 has not been coupled with a comparable level of earnings growth.



Justifiably it can be argued that this did nothing more than move equity prices back closer to their historical average valuations and closed the discount that stocks had been trading at following the significant psychological impact from the credit crisis. But, with stocks know having closed that gap and then some (the S&P 500 is now trading at a slight premium on many valuation metrics to their historic averages) the path to further price appreciation is likely to be much more challenging.

Scott Krisiloff, Chief Investment Officer of Avondale Asset Management, recently published some data where he looked at corporate earnings going back to the year 1900. Since 1900, earnings growth was less than 5% on a calendar year basis on 53 occasions, and the S&P 500 managed to increase in 33 of those years. In 45 of those 53 occasions EPS growth was actually negative which only further adds to the intrigue that stocks appreciated in 62% of those occurrences.

This would suggest that investors should have little concern about the potential sanguine earnings backdrop that lies ahead for equity investors. Not exactly, when you factor in the starting conditions in most of the years that the S&P rose, they were much different than they are today. Of these 33 years, the S&P was negative 14 times in the previous year (implying that stocks had discounted the negative earnings growth the year before). Additionally, the average PE multiple was only 11.6x in all years (compared to a current PE of 17.5), meaning that even though earnings didn't rise, the index was usually cheap.

On only two occasions since 1900 did the S&P composite increase despite sluggish earnings growth, a PE multiple above current levels, and double digit price gains in the previous calendar year (all characteristics that prevail today): 1997 and 1998 – the hay day of what turned into the Tech bubble.

To me this doesn't imply that stocks can't/won't go higher because they very well could, and relative to the dearth of competition from other asset classes, they remain the cleanest shirt in the closet. What it does suggest to me is that future return expectations for all asset classes (stocks included) need to be reined in and risk management strategies within a prudently allocated investment portfolio need to be implemented – with diversification to asset classes that have low-correlated relationships to each other owned to compliment a strategically allocated long-term investment strategy.

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