March 9th, 2015

Revisiting Bob Farrell's "10 Market Rules to Remember"…

If ever there were a real-time example of the phrase "the economy is not the market", it was last Friday following what was a very strong employment report where the U.S. economy added 295k jobs in February (consensus was expecting 235k) as the unemployment rate fell to a cycle low of 5.5% from 5.7% in January. This marked the 12th month in a row of job growth over 200k with an average monthly gain over that time of 275k – the highest level since 1994. The pace of gains over the last six months has been even more robust with an average gain of 293k. The only blemish in what was yet another blowout report was that wage growth remained sluggish, increasing only 0.1% month-over-month and 2.0% year-over-year (lower than the 2.2% year-over-year pace in January).

However, as impressive as the employment report was, the reaction across the wide swath of asset classes that comprise the entirety of the capital markets was even more eye-opening. By the end of trading on Friday the carnage left no stone unturned:

- Stocks cratered – the Dow lost 1.5%, S&P 500 -1.4%, Russell 2000 -1.4%, Nasdaq -1.1% (even with Apple – the largest weighted position in the Nasdaq – trading higher following the news it is going to be added to the Dow Jones Industrial Average). Utilities – a bond proxy in equity clothing –

tumbled 3.1% as the yield on the 10-year Treasury notes spiked 13 basis points to 2.25% (its highest level of the year). Interest rates rose across the yield curve causing prices to stumble – long-term Treasuries were crushed to the tune of almost 2.5% on the day as both broad based corporate and municipal bond indices declined 1.0%.

- The U.S. dollar surged to its strongest level in more than 11 years, sending the Euro down 1.69% to 1.08 versus the dollar. The Yen spiked to 120.83 and the British Pound fell 1.33% versus the dollar.

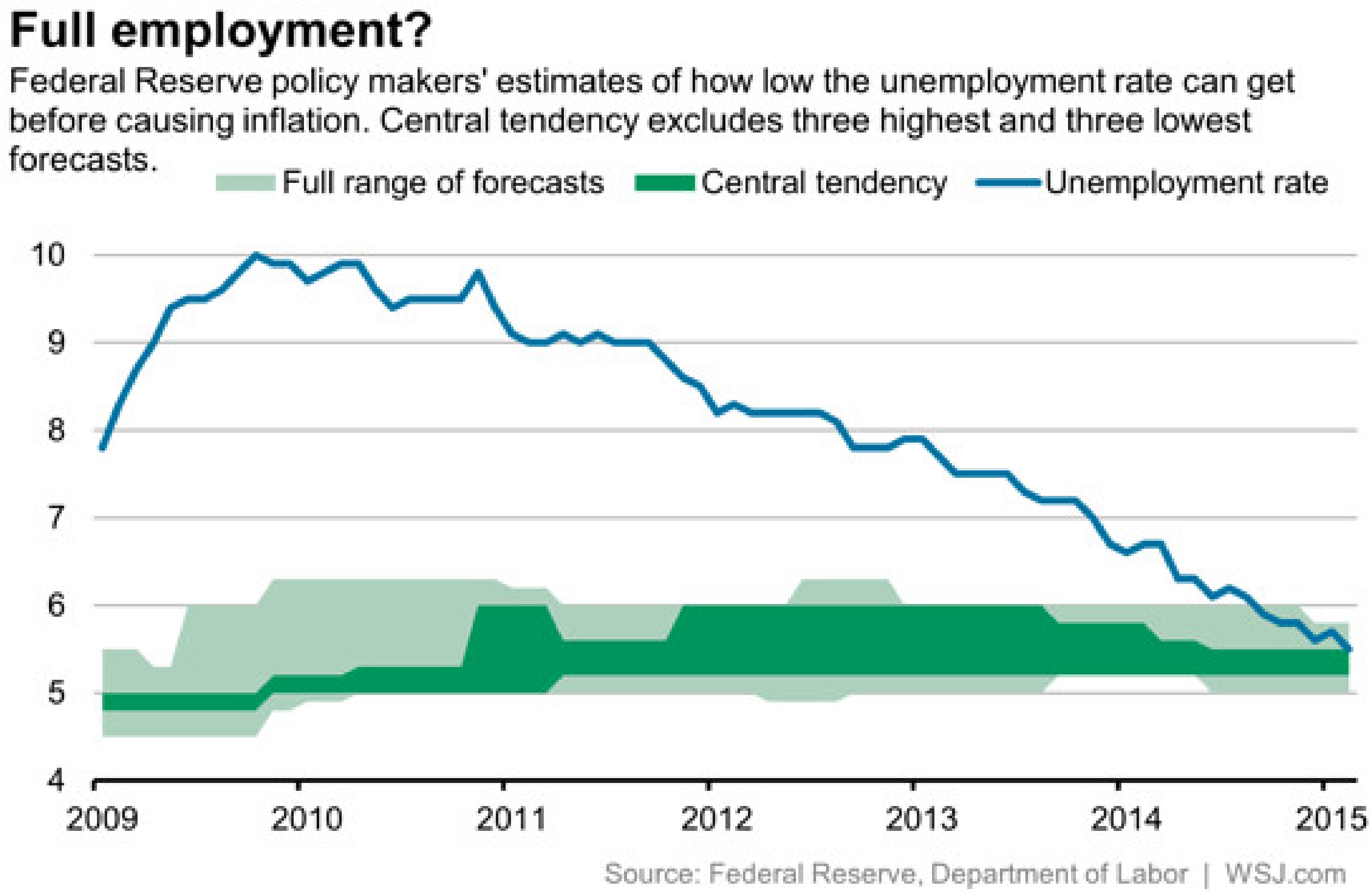
- With the dollar strengthening, commodities tanked as gold (-2.60%), silver (-1.95%), platinum (-1.57%), and copper (-1.64%) all traded lower. WTI crude oil fell 2.27% on the day to as low as $48.88 with the latest

Baker Hughes rig count data showing U.S. oil rigs fell last week by 64 to 922 (the lowest level since April 2011). Combined oil and gas rigs fell by 75 to 1,192, the lowest level since the week ending December 31, 2009.

- REIT's – another income favorite among investors – cratered 3.2%.

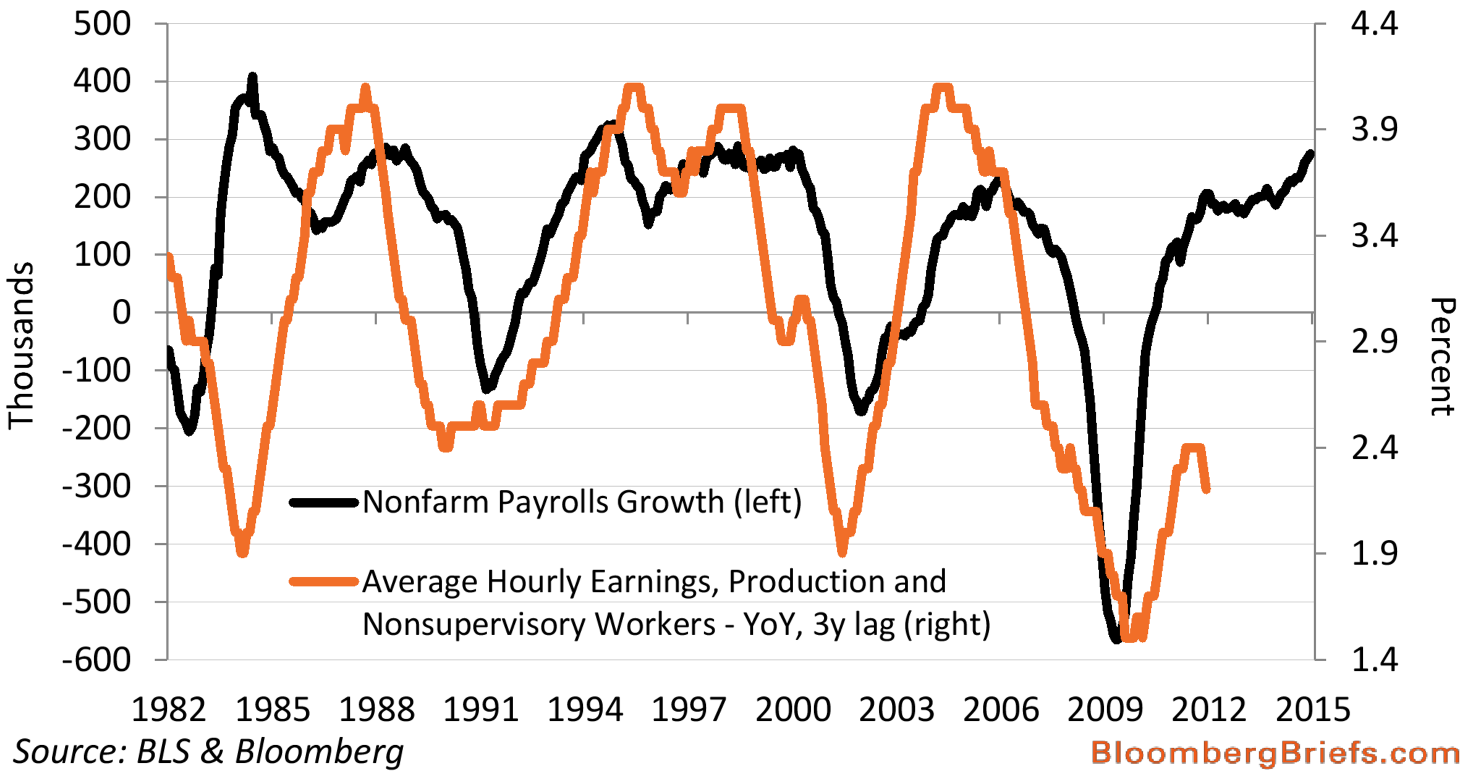
As you can surmise, there was no place for an investor to hide in Friday's action – unless you were in cash or short almost any asset class. The reaction in capital markets was in large part driven by investors moving forward the timetable for liftoff of the Fed's first rate hike in nine years. The June fed-funds futures contract was pricing in a 70% probability of a move to between 0.25% and 0.5% at Friday's settlement (up from 48% on Thursday) with the probability of a September hike moving up to 82%.

Fortunately investors will not have to wait long for an update on the Fed's thinking with a FOMC meeting slated for March 17 – 18. Next week's meeting is accompanied by a press conference which the Fed has used in the past to add context to adjustments in policy and forward guidance language. With the unemployment rate moving down to 5.5% (at the top end of the Fed's range for non-accelerating inflation rate of unemployment – NAIRU) Chair Yellen and the FOMC have very little wiggle room to support pushing rate hikes out to later in the year.



Surely the Fed would like to see indications that inflation is progressing towards its 2.0% target, but with much of the globe fighting deflation, the U.S. may be in a prolonged state of disinflation. Furthermore, wage growth has been tepid in this recovery. Job growth is humming along at its strongest pace since the first half of 2000 – yet average hourly earnings are growing at half the rate they were in early

2001. Historically, wage growth has lagged job growth as slack in the labor market gets soaked up as more unemployed workers find jobs. So the Fed likely anticipates that the strong job growth over the last 6 – 12 months will create a pick-up in wages, but the degree of this lag varies by cycle. Therefore, the Fed may not have the luxury of being too patient before merely starting to normalize rates. The below Bloomberg chart shows that since 1982 wages have lagged job growth by about three years.



This setup has backed the Fed into a corner where meeting their objectives on their dual-mandate (price stability and full-employment) dictates the pursuit of monetary policy strategies that are in complete contradiction to each other – aggressive monetary policy for the former (in an effort to increase inflation) and a tightening of monetary policy for the latter (as full-employment is within reach). The biggest risk facing the Fed is a loss of credibility by investors whereby capital markets lose confidence and begin pricing in expectations inconsistent with where the Fed would like them to be.

Threading this needle will be no easy task, but Chair Yellen and other Fed officials have so far been able to deliver on this front since the inception of this unprecedented monetary policy following the fallout of the '08 credit crisis. Former Fed Chair Bernanke and now Dr. Yellen have become masters at talk therapy – every time the markets have gotten worried about some aspect of Fed communication they have been there to offer soothing words to calm anxieties. Recent examples of such tactics by Dr. Yellen were when the markets zeroed in on the "dot plot" and noticed that the Fed is forecasting a lot of rate hikes, she warned not to take dots too seriously. When the market worried about the signal of dropping the "considerable time" promise, she substituted "patience" and said it means roughly the same thing. Then as the markets zeroed in on the patient promise she assured us that dropping that word does not mean a rate hike is imminent.

I don't quite know how to interpret last Friday's widespread sell-off across most major asset classes: is it an omen of things to come or just a knee-jerk reaction on the part of weak-handed investors? My guess is a bit of both, but I do believe that as this year unfolds we will experience an elevated level of volatility. This isn't a bold call as heightened volatility is usually accompanied with a transition in monetary policy – especially when the initiation of a rate hiking cycle is involved.

One thing I do believe was unearthed in Fridays action is the dependency asset prices continue to have on low rates and high liquidity. The capital markets have yet to transition to what will ultimately become an environment with higher rates and lower liquidity. Perhaps we will start to see this transition take shape over the next couple of quarters as investors adjust their positioning to reflect this eventuality. This would be akin to slowly pulling the Band-Aid off, however, if investors revert back to their old ways and fail to adapt – then I believe when this reality takes shape it will be more akin to ripping the Band-Aid off.

Each year I like to revisit and reflect in this missive on Bob Farrell's "10 Market Rules to Remember" and attempt to provide some context, relevance, and parallels to the current capital market backdrop. For those of you who don't know Mr. Farrell, he was the Chief Stock Market Analyst at Merrill Lynch for several decades and is considered a legend in many Wall St. circles given the depth and breadth of investing acumen which stemmed many decades before he retired from his post in 1992. So without further ado here they are:

1. **Markets tend to return to the mean over time**

   Investments don't go up or down in a straight line forever. Euphoria and pessimism drive market prices to extremes at peaks and troughs of cycles. When the outer ends of the spectrum of possibilities is reached they are not reflective of intrinsic value, but in time cooler heads prevail causing asset prices to move towards a value consistent with their fundamentals. Today marks the six year anniversary of the current bull market in which the S&P 500 has increased approximately 215% from the bear market nadir reached on March 9th, 2009 – a bear market that caused the S&P 500 to lose 57% of its value. Even if I believe the equity market today is a bit pricey, I would argue that we are closer to the true intrinsic value of the stock market today than we were when the S&P 500 traded down to 666 six years ago. Stocks have mean reverted the significant under-valuation that existed at that low six years ago, and now are perhaps in the early stages of heading towards the other end of the spectrum.

2. **Excesses in one direction will lead to an opposite excess in the other direction**
   Perhaps the most compelling example of this in the capital markets today is the historically low interest rates around the globe. Never in our history have we experienced a time when global central banks commanded such a pivotal role in the pricing of securities markets through their actions to lower interest rates and their ownership of financial assets. Corporations have not been idle in identifying an opportunity to take advantage of this cheap financing opportunity. According to data from legendary hedge fund manager Stanley Drunkenmiller of Duquesne Capital, corporate debt totaled $3.5 trillion in 2007 compared to a level of $7 trillion today.

This is one of the more glaring illustrations of a possible unintended consequence for the Feds ultra-loose monetary policy.

3. **There are no new eras — excesses are never permanent**

   According to famed investor Sir John Templeton, the four most expensive words in investing are “it’s different this time”.

4. **Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways**

5. **The public buys the most at the top and the least at the bottom**

   According to fund flow data from Investment Company Institute, since the beginning of 2009 (just as the bear market was set to end following the credit crisis) investors have poured more than a trillion dollars in bond funds while pulling almost $100billion out of equity funds. Since the beginning of 2013 – almost 4 years into the bull market and with interest rates matriculating their way to historic lows – investors have continued to pour money into bond funds to the tune of $76billion relative to $51billion going into equity funds. Of the two markets, stocks or bonds, I believe bonds are more representative of a frothy market – yet investors remain undeterred.

6. **Fear and greed are stronger than long-term resolve**

   Many investors are their own worst enemy by not being able to control their emotions. Gains on investments, whether it be from stocks or bonds, make investors exuberant which leads to unchecked optimism and unfettered confidence. Losses cause despair, anxiety, and regret which creates fear and leads to an increased sense of risk. Not having the ability to control these emotions often times leads to irrational decisions and mistakes.

7. **Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names**

   Market breadth had started to roll-over in late 2014 which foreshadowed some weakness coming into the year. The strong rally since the beginning of February reestablished strength pushing the NYSE advance/decline line to new highs, but this breadth indicator has begun to show some weakness in the last couple of weeks.

8. **Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend**

9. **When all the experts and forecasts agree — something else is going to happen**
Security prices react to marginal change, not good or bad, but to better or worse. By the time consensus opinion becomes defined and well known it's already reflected in market prices. It's the unknown or marginal change that causes prices to adjust. Coming into 2014 it was highly expected that interest rates had nowhere to go but up – yet the bond market (long-duration bonds in particular) had one of their best performing years in history because yields declined throughout 2014. It's difficult to walk out on a ledge all by yourself because if you're wrong there is no one else to blame but yourself. However, if you're wrong in a crowd, well you can take solace because you weren't alone. Yet, often times it's those who walk out on that ledge – and are right –

that make the most money in the investment world, because everyone else has to reposition their capital to where you already are.

10. Bull markets are more fun than bear markets

I agree!!

This missive will be taking a brief respite next week as I am committed to some social endeavors that will inhibit my ability to spend time writing a commentary next weekend, but I look forward to sharing my thoughts in a fortnight.

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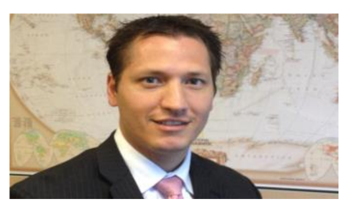

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