March 23rd, 2015

Newton's Laws of Motion…

Last week was all about the Federal Reserve meeting that concluded on Wednesday in which Chair Yellen and her FOMC constituents masterfully crafted a message to market participants that monetary policy accommodation will be around for some time to come. The focus on the part of investors going into the meeting was whether or not the term "patient" would remain or be dropped from the Fed statement and how the Fed would 'wordsmith' it's message regarding forward guidance. Capital markets were braced for the dropping of "patient" as a logical next step in the evolution of policy normalization, but there was a lot more that came out of the statement and Chair Yellen's press conference that wasn't priced in – hence the jovial reaction in security prices.

In the Summary of Economic Projections (SEP) the FOMC took the opportunity to mark its forecasts to market by significantly reducing its growth and inflation forecasts for this year and next with the mid-point of the central tendency for 2015 falling from 2.8% to 2.5% for GDP growth, 1.3% to 0.7% for PCE inflation and 1.65% to 1.35% for core PCE inflation. The unemployment rate was also revised lower but the implied NAIRU (Non-accelerating Rate of Unemployment) was cut even more to 5.0% - 5.2% from 5.2% - 5.5% — suggesting that the Fed sees more slack in the labor market than it did previously. Finally, the increasingly implausible "dot plot" of funds rate forecasts was lowered by 50 basis points through 2017 (0.675% for the end of 2015, 1.875% for the end of 2016, and 3.125% for the end of 2017).

The forecasts for the number and pace of rate hikes downshifted demonstrably where in December the median number of implied hikes for 2015 was four, with the top six hawkish dots pricing in six to seven hikes this year. Following this meeting the median was reduced to a more reasonable two hikes this year. The pace slipped from six to five hikes in 2016, and the Committee no longer sees normalization concluding by the end of 2017. Thus, the reaction function is slightly shallower, emphasizing the gradual pace of hikes versus history or simple policy rules. Most of the capitulation on the hiking cycle came from the hawks, who arguably had to acknowledge their prior dots simply were no longer plausible. That ultimately is good news for Yellen and the markets, as it suggests less disagreement on the Committee going forward — and perhaps less volatility.

Interestingly, the Fed noted the negative impact the appreciating U.S. dollar was having on exports – this is the first time the Fed has expressly pointed out the greenback and shows that the FOMC is monitoring more developments than just prices and jobs.

In a nutshell, interest rates are expected to remain lower for longer. The changes in the SEP were consistent with verbiage in the Fed statement which acknowledged that the macro backdrop was "moderating" instead of "expanding at a solid pace" (language they used at the January meeting); these adjustments brought their forecasts more in-line with the market. Since the FOMC last published its forecasts in December, GDP growth has slowed (expectations in December were for Q1 GDP to come in around 2.85% compared to sub 2.0% expectations today), the U.S. dollar has appreciated by an additional 6.0% (pushing the increase to north of 20% over the last twelve months), the Euro has declined by more than 10% versus the greenback, the unemployment rate was 5.8% compared to 5.5% today, and headline inflation has almost flat-lined on its way to going negative on a year-over-year basis.

All of this added up to a more dovish message from the Fed as Chair Yellen expressed in her press conference "just because we removed the word 'patient' doesn't mean we're going to be impatient". This was music to the ears of investors as capital markets across the spectrum of asset classes went into full-fledged rally mode with the exception of a few select commodities and the U.S. dollar. The below table is a snapshot of the rally that gained momentum throughout the trading day following the FOMC statement and Chair Yellen’s testimony, attesting to the breadth of buying on the part of investors.

Indices	DJIA	17981.00	H 18017.00	L 17609.00	+204.00	(1.15%)
Indices	S&P 500	2094.50	H 2099.75	L 2052.25	+28.25	(1.37%)
Indices	Nasdaq 100	4422.75	H 4434.25	L 4335.75	+52.25	(1.20%)
Indices	Russell 2000	1248.40	H 1252.30	L 1229.20	+11.40	(0.92%)
Indices	Nikkei 225	19565.00	H 19585.00	L 19360.00	+135.00	(0.69%)
Indices	VIX	16.55	H 17.65	L 16.45	+0.93	(5.92%)
Bonds	30 Year Bond	163.66	H 163.94	L 161.28	+2.28	(1.41%)
Bonds	10 Year Note	128.84	H 128.95	L 127.50	+1.34	(1.05%)
Metals	Gold	1167.40	H 1175.10	L 1144.90	+19.20	(1.67%)
Metals	Silver	15.92	H 16.04	L 15.43	+0.34	(2.20%)
Metals	Platinum	1116.30	H 1120.90	L 1087.60	+22.60	(2.07%)
Metals	Copper	2.6085	H 2.6425	L 2.5525	-0.0245	(0.93%)
Metals	Palladium	776.70	H 779.40	L 757.10	+14.55	(1.91%)
Energy	Crude Oil	46.64	H 47.07	L 44.03	+1.45	(3.21%)
Energy	Natural Gas	2.9090	H 2.9350	L 2.7750	+0.0540	(1.89%)
Energy	Heating Oil	1.7704	H 1.7809	L 1.6792	+0.0765	(4.52%)
Grains	Corn	375.00	H 375.25	L 367.00	+4.00	(1.08%)
Grains	Soybeans	964.00	H 967.00	L 953.50	+9.50	(1.00%)
Grains	Soybean Meal	321.10	H 321.60	L 317.40	+3.60	(1.13%)
Grains	Soybean oil	30.62	H 30.81	L 29.93	+0.58	(1.93%)
Grains	Wheat	511.00	H 512.50	L 500.75	+7.50	(1.49%)
Grains	Rough Rice	10.98	H 11.06	L 10.58	+0.36	(3.34%)
Grains	Oats	273.25	H 274.25	L 270.00	+2.25	(0.83%)
	Feeder Cattle	214.33	H 214.50	L 210.48	+2.75	(1.30%)
Softs	Cocoa	2752.00	H 2785.00	L 2727.00	-36.00	(1.29%)
Softs	Cotton	62.47	H 62.65	L 59.83	+2.26	(3.75%)
Softs	Orange Juice	113.50	H 113.75	L 110.05	+1.25	(1.11%)
Softs	Coffee	139.70	H 141.50	L 133.25	+1.55	(1.12%)
Softs	Lumber	279.40	H 283.10	L 275.70	+6.30	(2.31%)
Softs	Sugar	12.71	H 12.97	L 12.64	-0.11	(0.86%)
Meats	Live Cattle	156.58	H 156.58	L 153.40	+3.00	(1.95%)
Meats	Lean Hogs	60.73	H 62.30	L 60.43	-1.05	(1.70%)
Currencies	USD	98.50	H 100.12	L 98.08	-1.45	(1.45%)
Currencies	EUR	1.0792	H 1.0838	L 1.0591	+0.0181	(1.71%)
Currencies	JPY	0.8302	H 0.8325	L 0.8246	+0.0055	(0.67%)
Currencies	GBP	1.4880	H 1.4943	L 1.4625	+0.0135	(0.92%)
Currencies	CAD	0.7910	H 0.7959	L 0.7781	+0.0092	(1.18%)
Currencies	CHF	1.0189	H 1.0243	L 0.9963	+0.0223	(2.24%)
Currencies	AUD	0.7708	H 0.7762	L 0.7550	+0.0123	(1.62%)
Currencies	NZD	0.7402	H 0.7468	L 0.7213	+0.0147	(2.03%)

The Dow Jones Industrial Average was trading lower by 150 points going into the release of the FOMC statement only to finish the day up 227 points, the S&P 500 closed up 25 points with every sector in the green, and the Nasdaq was up 45 points. Bonds rallied as yields fell with the 10-year U.S. Treasury yield dropping back below 2%. After touching a four-month low, Gold climbed almost 2% and oil prices raced higher with WTI crude increasing 10% in a two day span after touching its lowest level in six years the day before. The Euro had its best day since July 2012 while the dollar had its worst day since November 2009.

The continued reaction on the part of investors in the capital markets to more than seven years of unprecedented monetary policy support is akin to a Pavlovian experiment where an unconditioned dependence has become engrained into investor psychology. The extent to which investors are willing to bid up asset prices in an unabated fashion as a result of the Fed's liquidity spigot continuing to flow has been a fruitful investment strategy for several years now. After all, what we are witnessing in capital markets is consistent with Newton's First Law of Motion where an object in motion continues in motion with the same speed and in the same direction unless acted upon by an unbalanced force. Newton's Third Law of Motion is relevant as well: for every action there is an equal and opposite re-action (central bank support/stimulus, risk-asset rally).

Last week's Fed policy decision was yet the latest move by a central bank adapting its monetary policy to combat the prevailing disinflationary environment by either easing or postponing tightening. Here we are not even a quarter of the way into 2015 and we've had 27 monetary authorities move in the direction of easier monetary policy.

Central Bank Easing in 2015			
Count	Country	Date	Easing Measure
1	Romania	7-Jan	25 bps cut to 2.5%
2	India	15-Jan	25 bps cut to 7.75%
3	Switzerland	15-Jan	50 bps cut to -0.75%
4	Egypt	15-Jan	50 bps cut to 8.75%
5	Peru	15-Jan	25 bps cut to 3.25%
6	Denmark	19-Jan	15 bps cut to 0.05%
7	Turkey	20-Jan	50 bps cut to 7.75%
8	Canada	21-Jan	25 bps cut to 0.75%
9	Eurozone	22-Jan	QE (1.1 trillion Euros)
10	Pakistan	24-Jan	100 bps cut to 8.5%
11	Albania	28-Jan	25 bps cut to 2.00%
12	Russia	30-Jan	200 bps cut to 15.0%
13	Australia	3-Feb	25 bps cut to 2.25%
14	Romania	4-Feb	25 bps cut to 2.25%
15	Sweden	12-Feb	10 bps cut to -0.1%
16	Indonesia	17-Feb	25 bps cut to 7.5%
17	Israel	23-Feb	15 bps cut to 0.1%
18	Turkey	24-Feb	25 bps cut to 7.5%
19	China	28-Feb	25 bps cut to 5.35%
20	India	4-Mar	25 bps cut to 7.5%
21	Poland	4-Mar	50 bps cut to 1.5%
22	Thailand	11-Mar	25 bps cut to 1.75%
23	South Korea	12-Mar	25 bps cut to 1.75%
24	Serbia	12-Mar	50 bps cut to 7.5%
25	Russia	13-Mar	100 bps cut to 14.0%
26	Sweden	18-Mar	15 bps cut to -0.25%
27	Pakistan	21-Mar	50 bps cut to 8.0%

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What will be instrumental for investors to accurately assess as this cycle evolves is the timing and extent to which ‘unbalanced forces’ begin to percolate in the capital market backdrop which at some point will create enough friction to alter the rate and force of the current bull markets in stocks and bonds.

The recent economic data has a certain ‘Goldilocks’ element to it where it is neither ‘too hot’ nor ‘too cold’. Optimists point to the exceptionally strong labor market, with average job growth of 293k over the past six months and an unemployment rate of 5.5%. The U.S. economy requires only about 100k jobs to “breakeven”, keeping up with growth in the labor force, suggesting the economy is creating nearly three times as many jobs. On a similar note, aggregate hours worked have grown at a 3.6% annual rate in the past six months. This is normally associated with GDP growth well above 4%.

Furthermore, we learned last week that The Conference Board LEI for the U.S. improved again in February, driven mostly by positive contributions from the financial components and building permits. In the six-month period ending February 2015, the leading economic index increased 2.4 percent (about a 5.0 percent annual rate), slower than the growth of 3.7 percent (about a 7.5 percent annual rate) during the previous six months. Additionally, the strength among the leading indicators have remained widespread. History suggests that we don't need to worry about a recession until the year-over-year rate of growth on this metric crosses the zero threshold, and even then a recession is usually a good six months out.

But pessimists can point to a long list of disappointing data: GDP is adding up to 1.8% in 1Q on the back of sluggish retail sales, weak capital goods orders and a decline in housing activity. The surveys have also cracked lower with ISM slipping, consumer confidence reversing the gains over the past four months and Challenger announced job cuts climbing. The relentless string of soft U.S. economic data can no longer just be blamed on the weather and is something to watch as we move into spring with both the Bloomberg and BofA Merrill Lynch data surprise indices having tumbled to their lowest levels since March 2009.

Valuations and earnings momentum are at the top of my list of opposing 'unbalanced forces' that could prove to be the most significant near and long-term obstacles to the current bull market. Equity valuations across an array of metrics are near cycle highs and pushing beyond historical averages. These rich levels are coinciding with a time when earnings are being revised lower in a meaningful way, due in large part to the cutting in half of oil prices and the huge run in the U.S. dollar.

Consensus EPS estimates are for an almost 5% contraction in Q1 earnings – at the turn of the year estimates were for EPS growth of 4% for Q1. This is a 900 basis point delta and Q1 guidance is setting up to be one of the worst on record since the Great Recession ended six years ago. Furthermore, analysts are penciling in negative EPS growth for Q2 as well. Prior to the global financial crisis in 2008 there were four other times when corporate earnings in the U.S. contracted for two straight quarters with trailing P/E multiples north of 16x: 1961, 1969-70, 1997-1998, and 2000-01. All of these periods coincided with either a recession or asset bubble.

I believe one of the most important things for an investor today to understand and acknowledge is that we are in an entirely different environment than we've ever experienced before. With the Fed's balance sheet equivalent to 25% of GDP, U.S. short-term interest rates pegged at 0% for over six years, interest rates at zero or negative going out to the five year part of the yield curve in countries like Sweden, Belgium, France, and Germany, Italian and Spanish 10-year yields approaching the 1% level, and currencies swinging as much in a day as it has historically taken them a year to do – I believe it's appropriate to take a step back and assess one's risk exposure.

I myself am having a difficult time making heads or tails of some of the incongruities taking shape in capital markets:

- The Chinese stock market is up almost 75% over the last year (over 10% year-to-date), yet economic growth is floundering to its lowest level in 25 years. I guess the relentless rumors that additional policy stimulus is around the corner provides some solace to appreciation minded investors, but don't fundamentals eventually have to be accounted for?
- U.S. corporate earnings are on the door-step of contracting to a degree that we haven't seen since the global credit crisis – yet stock prices have done little more than blink at this possibility.
- U.S. employment growth is raging ahead at its most robust pace since the late 90's with the unemployment rate having declined

from 10% at its recessionary peak to 5.5%, yet the Fed remains fearful of hiking the federal funds rate by 25 basis points.

- There has been almost 600 interest rate cuts by global central banks since the credit crisis with the majority of Developed Market economies having instituted some form of QE (U.S. Fed, BOJ, BOE, SNB, ECB), yet these actions have been unable to arrest global deflationary forces.
- Debt on the balance sheets of U.S. corporations have swelled to levels three times greater than where they were prior to the credit boom in the middle of the last decade. During the midst of the fallout from the credit crisis many pundits looked back and pointed to the excess stating that it was obviously a bubble, yet this easily gets dismissed today (go figure).
- A possible exit by Greece from the Eurozone, which caused a severe sell-off in

risk assets back in 2011 (much less so at the start of this year), gets little more than a yawn today. I admit that the potential financial ramifications from a Grexit is much less impactful than in years past, but to believe that any fallout is nontrivial to asset prices and thus risk-premiums already reflect this possibility seems unrealistic to me.

All I'm saying is that six years into a cyclical bull market (which possibly could morph into a secular bull market), it's easy to become complacent and allow psychological biases of the recent past to dominate your thinking and rationale for the road ahead. Last week's market reaction to a dovish and continued stimulative central bank has become well entrenched into market psychology. The important question to answer for future investment success is the following: If virtually every major asset class rallied in tandem on continued accommodative central bank action, is it reasonable to think that every major asset class can/will sell-off when that pendulum swings the other way? My guess is yes, but neither I nor anyone else yet know if this will be true. However, I do believe it is prudent and responsible to begin to prepare for this eventuality. Forewarned is forearmed.

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