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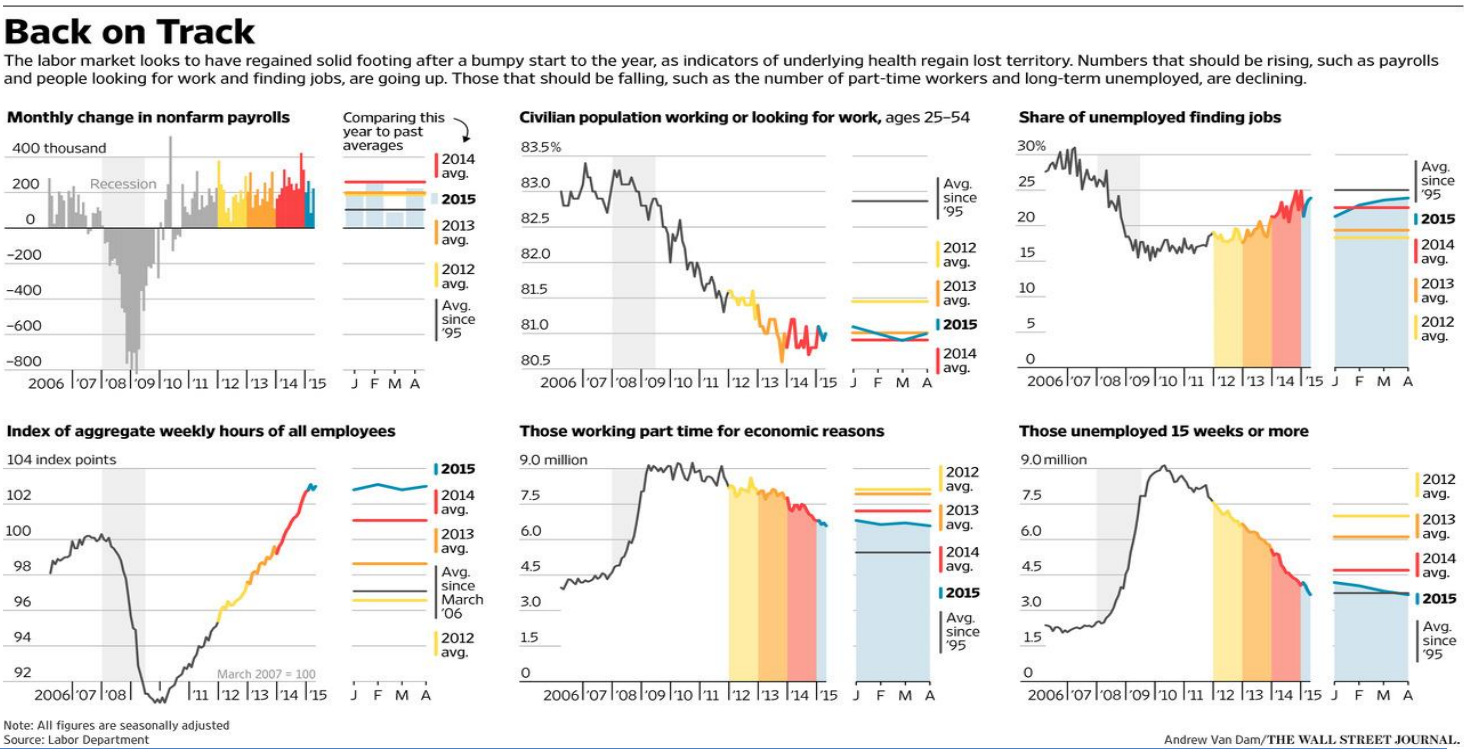
What we can learn from the taper tantrum…

Equity investors surely rejoiced following last week's non-farm payroll numbers sending the Dow Jones higher by more than 200 points in Friday's trading session – erasing a 2% decline in the major stock market averages at the lows earlier in the week. From an investment standpoint, April's employment report was almost nirvana like, given that it was strong enough to placate concerns that the Q1 soft patch looks to be nothing more than just that – a soft patch, but not too strong so as to put a Fed rate hike in play over the summer months. For now it looks like a June hike is off the table, but a potential initial volley in September remains a distinct possibility, especially with a tightening labor market.

The headline figure showed that the economy added 223k jobs in April (right in line with expectations of 228k) while negative revisions of 39k to the last two months took the March print down to a dismal 85k. Looking at the longer-term trend in job growth shows that the employment backdrop is moderating from the blistering 324k in average monthly job growth in 4Q 2014, with the average over the last six months clocking in at 255k (still very decent growth). The strong dollar and weak energy prices were on full display in this report with the manufacturing sector only adding 1k jobs and the mining sector losing 15k in April. All in all, as depicted in the graphic below, the employment situation in the U.S. economy is on very solid footing.



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Some metrics that are likely to bring some comfort to Chair Yellen are the participation rate edging up to 62.8% from 62.7%, yet the labor market continued to tighten with the unemployment rate ticking down to 5.4% from 5.5%. The broader U-6 measure of unemployment also declined, moving to 10.8% from 10.9% – both of these measures currently sit at seven-year lows and indicate the resilience and health of the labor market.

On the wage front, average hourly earnings came in a little light at 0.1% month-over-month and March data was revised down a tenth to 0.2%, putting the year-over-year rate at 2.2%. This contrasts with the acceleration seen in the employment cost index and suggests that wage inflation is yet to show real signs of breaking out to the upside.

Overall, the labor market looks to be on track with job growth trending at a level that will cause the labor market to continue to tighten, achievement of the Fed's full employment level (5.0 – 5.2%) is well within reach (perhaps as early as year-end), and more signs of wage acceleration are showing up in the data.

The data flow so far this year has been muddled at best and as such has left many prognosticators and investors (myself included) looking for signals that may provide an indication that a break-out in one direction or the other for the economy and capital markets is near. I find that at times like these it's always useful to attempt to reengineer the landscape from the bottom up (piece by piece) to gain some context on the bigger picture.

- GDP growth: Undeniably, GDP growth of 0.2% in the first quarter was poor, and following last week's trade data, Q1 GDP will be revised down into negative territory which does not usher in much confidence from an investment standpoint. But as I've pointed out over the last couple of weeks this soft patch has more to do with transitory factors that are already in the rearview mirror and less to do with the underlying fundamental growth trend. The port shutdown is over and activity is already picking up as the backlog of built up inventories gets worked through. The fifth coldest March on record has come and gone making the weather (outside of severe hurricane, tsunami, or typhoons) a non-event for another nine months. The more than 50% decline in oil prices has abated and crude looks to have found a floor (having risen almost 40% from its March 17th lows) and the relentless decline in the trade weighted dollar (the greenback falling by over 20%) has stabilized. So yes, it may take another quarter for these variables to work their way through the system, but as we move into the second half of the year, the comparisons on a year-over-year basis become much more constructive from a measurement standpoint.

  Using the soft patch in Q1 2014 as a reference point, it can be illustrative to look at what happened over the balance of 2014 to provide some context of what is possible for the rest of this year. Over the final three quarters of 2014, real personal consumer spending growth averaged an annualized 3.4% rate and led "real final private domestic demand" to grow a little over 4% over that period, which was the strongest pace since 2005.

  Achieving a comparable level of activity this year will be highly dependent on consumer activity gaining some momentum, which looks like a reasonable bet given the improvement over the last year on the labor front and household balance sheets. I've already touched on the snapback to trend growth in the most recent employment report with the six-month average clipping along at 255k, but the jobless claims data shows an even stronger backdrop. Last week's jobless claims data came in at a 15 year low with the four-week moving average under 280k (keep in mind that jobless claims is a leading indicator) – levels that strongly suggest 200k in payroll growth going forward is a likely expectation.

  Here's the underpinnings supporting a pick-up in the 70% of the economy we call the consumer: job creation continues to run at a solid clip, wage and compensation growth is starting to reach respectable levels, household net worth is at all-time highs, and the savings rate is near cycle highs. If this isn't a recipe to support the most significant growth pillar of our economy, then I don't know what is.

One other item worth noting is the recovery we are seeing in the commodities markets as the CRB index moves up to its highest levels of the year. Keep in mind that the commodities group is an extremely cyclical asset class and – while subject to speculation on the part of investors – moves like we've seen of late look to me to be built on stronger global growth fundamentals. This move in commodities comes on the back of recent reports that China has become the largest buyer of almost every commodity**.** In April, the world's second-largest economy passed the U.S. as the top importer of crude oil, buying 7.4 million barrels a day (compared to the 7.2 million barrels bought by the US. According to Reuters, China is now the top user of coal, iron ore, and most metals.

Although, we did learn over the weekend that the PBOC lowered its one-year lending rate 25 basis points to 5.10%. This is the third such move in the past six months as China continues to try and support growth amid its transformation from an export and investment reliant economy to a consumption based one.

- Another significant variable is the Fed, where we have moved from an if/when scenario regarding rate hikes (which was the mantra over the last seven months) to a strictly "when" scenario. The Fed has now removed themselves from the forward guidance game and at the current time is strictly data dependent. A similar shift was exhibited under former Chairman Bernanke's reign back in 2013 during the taper tantrum. It was on May 22nd that Bernanke announced that the Fed would taper its asset purchases later in the year, but this statement was conditional on the economic data supporting such a move. The 10-year Treasury yield traded down to 1.66% in the early part of May only to ratchet higher throughout the summer to as high as 2.70% following Bernanke's comments.

  I point this event and time period out because it provides (in my opinion) some perspective for the sell-off we've experienced in bond yields over the last couple of weeks. Today, like in 2013 where the economic data was muddled and investors feared an economic relapse (like the one that happened in 1937 when both monetary and fiscal policy moved too early to a restrictive state, causing a recession) capital markets have taken action by pushing rates to their highest levels of the year. As 2013 progressed the economy improved with both Q3 and Q4 GDP growth coming in above expectations and payroll growth averaged 193k per month from September to November, handily above the 154k average over the summer.

This experience can provide investors with many lessons:

1) The markets are forward looking, always discounting investments for expectations on future outcomes. In the 2013 taper tantrum the pricing adjustments in the capital markets occurred in the summer months and by the time the Fed actually started tapering in December the market barely moved. Today, the Fed has already set the stage that a rate hike was likely to come this year depending on the data. As the data corroborates this expectation (which I believe is beginning to occur with data showing a pick up from a sluggish Q1) it becomes a question of "when" the first hike will occur, with the futures market currently pricing in greater than 60% odds that at least one hike happens before year-end.

2) Once the Fed shifts gears and articulates to the markets what its next step will be, the threshold for changing policy is not very high. For example, in 2013 the economic backdrop during the summer months (when Bernanke announced tapering was expected to happen within the calendar year) was a bit soft, but it took only a few months of better data to trigger tapering. Presumably the data threshold is a bit higher this time around given the view that a rate hike is a more material event than tapering. If this

experience proves prescient then if the data starts to turn in a more decisive way over the next couple of months a September rate hike sets up to be a real possibility.

3) Patience remains a virtue that the Fed has not lost. While patience may have been removed from the Fed statement, it by no means implies that the prevailing Fed is becoming impatient. This Fed has adamantly stated on many occasions that they fear moving too early than moving too late. The FOMC would much rather prefer the problem of trying to temper an overheated economy than back track on a shift to remove accommodation too early to only then have the economy lose steam.

- The last big picture topic I'll hit on is the interconnectedness of global markets across the world. U.S. markets have become very sensitive to European developments in particular. Historically, this relationship has been the other way around where causation typically stemmed from the U.S. and funneled through the rest of the world, but now Europe has assumed more of a leadership role.

  The activity and yield levels in the Europe bond market is one of the explanatory variables for the reversal in U.S. yields over the last few weeks, where the roughly 50 basis point spike in German Bund yields triggered a 25 basis point upturn in the 10-year T-note. Similarly the moderate pullback and choppy trading action in European equities coincides with a cooling in U.S. equity market trading.

  In my opinion, the drop in European interest rates to the levels reached at the lows was a clear case of overshooting, as a near-zero return – negative yields out to the 8-year maturity on German debt – only makes sense in a highly restricted market. Heck, even in Japan, with its years of deflation and repeated bouts of QE, 10-year yields never got as low as they recently did in Germany.

  However, recent economic data in Europe has turned for the better and is showing signs of increased output and activity. The introduction of QE by the ECB in March has caused European government debt markets to become removed from fundamentals as both growth and inflation improve. What we are witnessing now is a retracement of this excessive move and an effort by capital markets to ascertain an appropriate level based on long-term fundamentals.

This confluence of conflicting variables has heightened the uncertainty level in the capital markets. One thing that has always been apparent in investing is that markets have a fond distaste for uncertainty. Therefore, with stocks trading near their highest valuation levels of this bull market cycle, earnings growth flat for Q1 (while coming in above beaten down expectation), sales growth barely exhibiting a pulse, and sentiment shaded toward the bullish side of the ledger, it makes sense that stocks have been range bound.

I will stress once again that this is not an environment you want to be overly complacent in, nor should you try to be a hero. Strategically position your portfolio in an allocation mix of diversified investments that will afford you the ability to stay the course through what may be some choppy waters, but allows you the opportunity to achieve your long-term investment objectives. On a tactical level investors should focus on companies with a strong history of high returns on total capital, a disciplined capital allocation approach, and a strong balance sheet. My interpretation of where we are in the business cycle suggests that investors want to gravitate their equity exposure up in quality with less exposure to interest rate sensitive and highly debt-laden entities.

In the fixed income market you want to shorten durations, but don't abandon one of only a few asset classes that has historically proven to have a low correlation to the equity market. It is a prudent fixture in a properly diversified portfolio, but the times of "buy, hold, and forget it" in this asset class is over, as the 30-plus year bull market in bonds ended in the summer of 2012 and the majority of money managers in the business today have never experienced a sustained bear market in bonds.

I will be traveling over the upcoming weekend for some personal activities and unable to cobble together a missive for next week. I will return with a vengeance following the Memorial Day weekend and would like to be the first to wish you all a safe and enjoyable holiday.

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