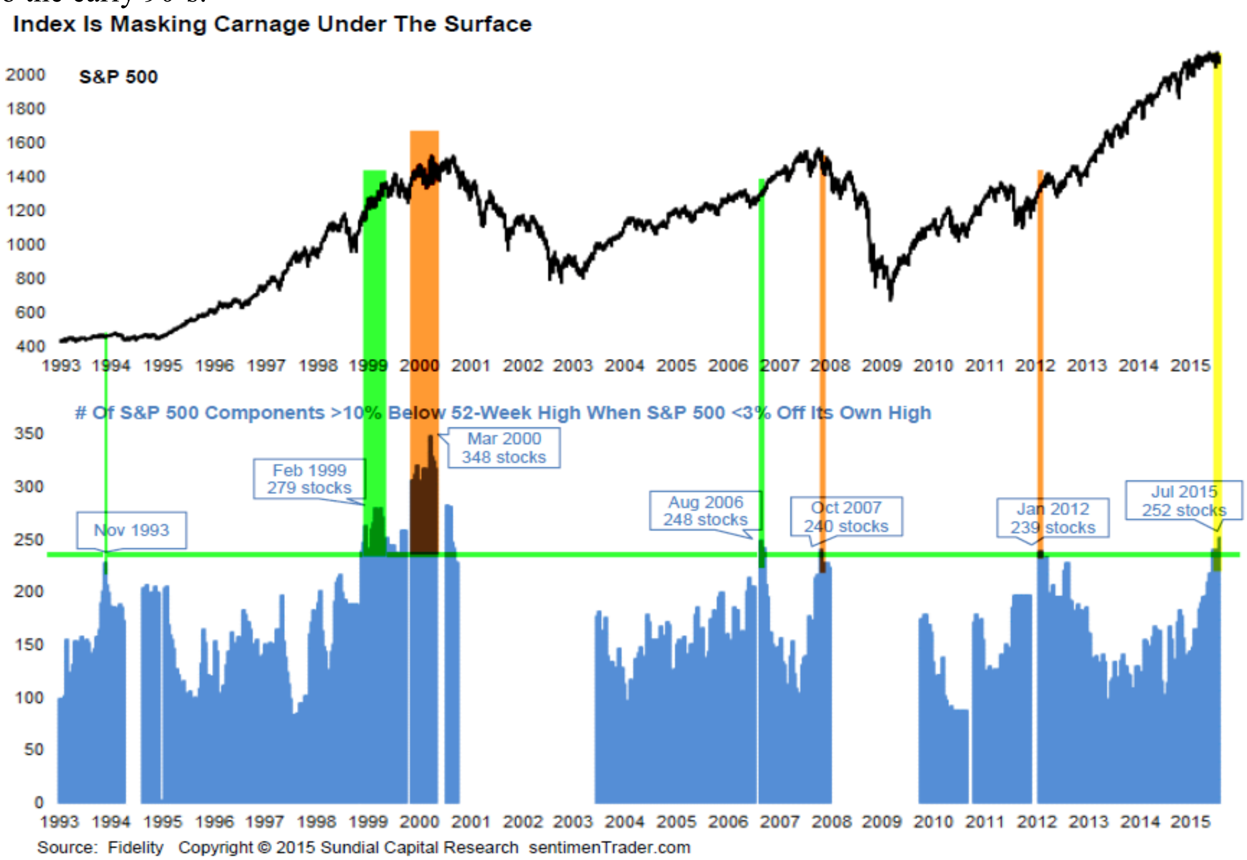
August 3rd, 2015

Rate hikes, what's the rush?

U.S. equity markets grinded higher last week with the Dow Jones Industrial Average rising 122 points (0.7%), while the S&P 500 added 24 points (1.2%) to end the week at 2103.92 – just 30 points (1.4%) shy of its all-time high reached on May 20th. Market breadth (the number of stocks seeing their share prices rise compared to the number of stocks seeing their share prices fall) has been garnering a lot of attention from investors, with fears elevating that it could be foreshadowing the end of this bull market. True, weakening market breadth has historically not been a constructive sign for stocks, but I believe investors should analyze this metric a little deeper and put it in its proper context – as one variable of many in a thorough capital market analysis – before they accept it as the coup de grâce for stocks.

Right now, about 50% of the companies in the S&P 500 are trading below their 50-dma (day moving average) and 44% are below their 200-dma. The below chart details similar levels of weak breadth in the S&P 500 going back to the early 90's:



On the six prior occurrences that a set-up similar to today existed (where approximately 50% of the companies in the S&P 500 were trading more than 10% below their 52-week highs while the index was within 3% of its all-time high) a significant correction ensued within six months on half of those occasions. Similar odds to the flip of a coin on a technical indicator, while not insignificant, is not exactly the probability level threshold one should look for when evaluating making material adjustments to a portfolio. Moreover, the outcome of similar set-ups in the past is far from the foregone conclusion of pending doom I'm seeing litter the headlines and the financial blogosphere over the weekend. We all know few things grab an investor's attention better than fear that an impending crash awaits.

One last thing on market breadth: it's being skewed primarily by two sectors – energy and materials, as both are more than 5% below their 50-dma, 100-dma, and 200-dma. Telecom and industrials are also weak, but the remaining sectors in the S&P 500 (financials, technology, discretionary, staples, and healthcare) all made bull market highs during the past month (utilities didn't make a bull market high last month, but ended July at close to a 3-month high).

Healthcare is one sector that seems impervious to the cross currents in the stock market, or global economy for that matter. The sector is up more than 20% over the last year, has generated a 22% annualized gain over the last five years, 9% over the last 10 years, and a 10% annualized gain over the last 20 years. The demographics are such that this sector has a long runway to be a growth leader for years to come with a prime example being the fact that the life expectancy for the median U.S. male has expanded from 48 years of age at the turn of the 20th century to almost 78 years today.

Yes, it's been a trying year for many investors who have allowed themselves to get lulled into the mindset that the 15% annualized gains in the S&P 500 over the last three years was a divine right of equity ownership and that a flat market (albeit less than 2% below all-time highs) is an unacceptable outcome. However, I would argue that the equity market has been rather resilient (Teflon like) this year given all the headwinds and crosscurrents that have been thrown its way: anemic economic growth, collapse in commodity prices, continued turmoil in Greece, crash in Chinese equity markets, and flat corporate earnings growth. There has been enough divergences in the equity market for tactical, more active investors to distance their performance from the broad indices, for example:

- The Russell 3000 Growth index is up 7.61% through July compared to a 0.34% decline in the Russell 3000 Value index.
- The Nasdaq 100 is up 9.03% on the year compared to the Dow Jones Industrial Average gaining 0.55%.
- The MSCI ACWI ex USA is up 5.99% on the year compared to the S&P 500 appreciating 2.41%.
- Europe is up 7.06% compared to Emerging Markets losing 4.19%
- Russia, Italy, Japan, the Netherlands, France, and Hong Kong are all up double digits on the year, while Brazil and Canada have declined by double digits.
- Healthcare is the best performing sector in the U.S. year-to-date, up 13.88%, compared to Energy registering the worst performance this year at -11.86%.
- Commodities have been crushed with the S&P GSCI down 14.28% through July while fixed income markets have been roughly flat: Barclays Capital US Aggregate Bond Index 0.59%, Barclays Capital U.S. Total Treasury 0.87%, S&P National AMT-Free Muni 0.70%, and Markit iBoxx High Yield Index gaining 1.17% on the year.

Stocks continue to fight the headwind of demanding valuation levels while bullish investor sentiment has moderated over the last couple months (a positive development for contrarians), but perhaps the most significant obstacles in the present wall of worry confronting equities is: earnings growth (or lack of), uncertainty surrounding future Fed policy moves, and sluggish economic growth.

On the earnings front, 71% of the S&P 500 has reported results for the second quarter with 73% of companies beating EPS estimates while 52% of companies have beaten on revenue. According to data from Factset, earnings are expected to decline 1.3% for the quarter (well below the 4.6% contraction expected by analysts as of June 30). If the dramatic decline in earnings from the Energy sector is excluded the EPS growth rate jumps to 5.4%, which suggests that the earnings fundamentals in the rest of the equity market are okay (not great). If the current expectations for negative EPS growth hold up, this will represent the first year-over-year decline in EPS since the third quarter of 2012 (-1.0%) and the largest year-over-year decline since Q3 2009 (-15.5%).

The earnings backdrop doesn't usher in a lot of confidence for a stock market that is trading at a slight premium to fair valuation. I can understand and I'm even willing to give some credence to the notion that stocks deserve the benefit of the doubt in regards to higher valuation levels, given the low interest rate environment and moderate inflation. But, with EPS growth checking in at 1.0% in Q1, second quarter earnings expected to contract (flat at best), and now we see analysts penciling in another contraction in earnings for Q3, it's not quite the backdrop a languishing bull market was looking for, let alone a much needed catalyst (which earnings can be) to send stocks on another leg higher.

As for the Fed, it's becoming more difficult for them to justify starting the process of normalizing interest rates this year, let alone beginning in September. This isn't so much a call by me that they will hike or not hike in September – I'll readily admit I don't know the answer to this question – furthermore I don't know who really could benefit from handicapping this outcome unless you're a fed funds futures trader. Nevertheless, it's becoming widely expected that the Fed is going to get off the zero interest rate floor at some point and this expectation by the investment community is finding its way into security prices – this is best represented by the move in the 2-year T-note from 30 basis points in February of last year to 68 basis points on Friday. The only variable yet to be determined as it relates to the Fed is the 'when' – the 'if' is in the process of being dropped from pricing models – and from my vantage point with the recent incoming economic data, I don't see what the rush is.

If the Fed is truly data dependent (like they suggest) then that second quarter GDP print of 2.3% growth coupled with the lowest ever recorded increase in the Employment Cost Index of 0.2% in Q2 should cause them to pause and scratch their head. This isn't exactly the robust economic growth profile they would like heading into a rate hiking cycle. Averaging out the GDP numbers for the first half of the year and we get 1.5% real growth – this compares to 1.8% growth in the January to June period from a year ago. As if that wasn't enough to make you say hmm – GDP growth for the first half of 2015 is tied for the second worst first-half (2011) showing since the recession ended.

If the Fed decides to move in September (and I don't know what would convince them to do so other than knowing that they would like to move off of ZIRP), they would be doing so at a time when GDP growth is at a lower level than it was at the start of each of the last three tightening cycles ('04 GDP growth was 4.2% YoY, '99 GDP growth was 4.6% YoY, and '94 GDP growth was 3.4% YoY). So, I just don't see what the 80% of the economic communities who expect the Fed to hike in September are seeing, and neither do the markets with fed funds futures pricing in a less than one in five chance that the Fed goes in September and a 50% chance of a hike by the end of this year.

I can fully appreciate and respect the 'unintended consequences' argument that comes with the nearly seven years of zero interest rate policy, but the last thing the Fed needs is to lose credibility. This would be jarring to capital markets, which have become dependent on the 'Fed put' and the confidence investors have knowing the Fed has their back. Look no further than the experiences of the Central Bank of Canada and the BOE for what it is like to prematurely tighten policy to only then have to walk back on that tightening as the impacts ended up being contractionary to economic output.

Look, the economy is doing okay, but unfortunately okay just isn't getting it done. Yes, the unemployment rate has dramatically declined from 10% to 5.3%, but if it is adjusted for the decline in the participation rate, it is near 9%. The Fed's preferred measure of core inflation is running at 1.2% (the lowest level in four years), and consumer confidence is coming off its worst monthly decline since August 2011 (this was when the Fed was getting ready to launch another round of QE).

If the Fed were to move it would be the only central bank in the G7 economies doing so and this would further exacerbate the outsized impact the stronger dollar is having on growth. Economists estimate that the 20% appreciation in the trade weighted dollar over the last twelve months has been equivalent to approximately 200 basis points of rate hikes. Beyond the dollar, fiscal policy has also been a net drag on U.S. economic output as the budget deficit moves down to seven year lows. Even this improvement in our fiscal balance won't stave off what looks like another showdown in D.C. as the $18.1 trillion debt ceiling gets breached later this fall – not exactly what markets need, but investors have become better at ignoring the political sideshow that accompanies these events.

I remain of the view that the Fed moving the fed funds rate from 0% to 0.50% or even 1.0% won't amount to more than a hill of beans on the overall impact to economic output in the U.S. However, to start hiking with growth this sanguine, inflation this tame, and plenty of holes in economic growth around the globe seems a little premature to me. Either way, as a steward of other people's capital we will adjust and adapt to whatever reality awaits, but at this time we have not taken any significant preemptive actions on what the Fed ends up doing.

As for my advice to investors: it hasn't changed much since the start of the year where we've had expectations that 2015 would be a year of catch-up – a year where the fundamentals caught up to the price advances in stocks over the last three years. While my view hasn't changed materially over the balance of the first seven months of the year, I would be remiss if I didn't acknowledge that my confidence level in fundamental underpinnings supporting current price levels and my belief in the sustainability of this expansion has tempered a bit. On balance we have taken a bit more of a cautious stance with our portfolio positioning – layering in some portfolio hedges and subtly shifting allocations more toward the conservative end of the spectrum. This doesn't imply that we've taken portfolios to all cash or become overly defensive, but my skepticism in the verve of this recovery, the maturity of this cycle, the inability of fundamentals to do much catching up this year, and the narrowing of the risk/reward balance in several asset classes has caused us to take some action.

In doing so we are willing to accept the outcome of missing out on potential returns when it appears that big risk events, such as a disorderly Grexit, have receded for the time being. I also acknowledge that a subtle shift to a more defensive posture succumbs a portfolio to suffer the painful reality of meager yields in a ZIRP world. However, as I indicated in last week's commentary, the investment world is one that is dominated by probabilities. And on this front I am finding it more difficult to find high probability outcomes with a constructive risk/reward profile to allocate capital to.

Take the equity market for example. We are now in the third longest and fourth strongest bull market in U.S. history which means that the current 216% increase in the S&P 500 since the lows in March 2009 have been bested only three other times in history (the 417% rally from '90-'00, the 323% rally from '32-'37, and the 265% rally from '49-'56). Therefore, I would peg the probability of this bull market becoming the greatest in history at below 50% given that a number of strong bull markets have fallen well short of becoming the strongest ever (the 101% rally from '02-'07 is the most recent example). As a nod to the utmost of optimists one must also acknowledge that the probability of this going on to become the greatest bull market in history is higher than 10% as we are already more than half way there.

On a similar note, valuation levels suggest stocks are marginally above historical averages, but far from some of the stretched levels they have reached at the pinnacle of past peaks. This indicates that there indeed may be more room for stocks to run as bull markets don't historically end with valuations just getting back to the averages. But, the probability of being able to time this outcome perfectly, so as to take significant capital out of the equity market as it reaches its valuation peak is, in my opinion, fairly low. Successfully achieving this outcome would be more about luck than skill.

The above references to probabilistic thinking are just two examples of how an investor can think about one asset class. A similar process can be employed across the capital market spectrum of possible investment opportunities. I point out stocks because they are the most recognizable and most widely accessed asset class to investors. Both of these simplified examples suggest that the probability of a good (let alone great) outcome for taking on the risk of an asset class that has shown investors twice in the last fifteen years that it can decline 50% is much lower than one might like when putting a significant chunk of their capital at risk of material loss.

Therefore, in a world where probability expectations are moderating to levels that should cause an investor's conviction level to recede when deciding whether to make a significant capital allocation commitment, valuation levels on many asset classes expensive, a monetary policy environment that is unprecedented, and more late cycle economic indicators than is reasonable to ignore flashing yellow (M&A back at all-time highs, corporate debt issuance near all-time highs, margin debt on the NYSE at all-time highs, equity ownership as a percentage of net worth on household balance sheets at its second highest level in history, and EPS growth momentum waning) I believe the prudent action for an investor to take is to moderate risk exposure.

Notice I didn't say eliminate it, as I do believe some risk exposure is still warranted and necessary for long-term oriented investors that have the capacity, willingness, and fortitude to accept it. However, the obstacles standing in front of investors today are more challenging and complex than has been the case earlier in this recovery, where as an investor your best defenses against the rising risk of a macro accident are: (1) diversification, (2) prudent portfolio hedges, (3) knowledge, and (4) the discipline to act on that knowledge rather than emotion. It would be very difficult today for anyone to question an investor's willingness and discipline to take some precautions in regards to their capital, and to do so requires discipline and courage – kudos to those who do.

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