September 21st, 2015

Lower for longer…

The much anticipated Fed meeting concluded last week with the FOMC deciding to delay the interest rate normalization process a little while longer. Instead of hiking in response to the ongoing improvement in U.S. data, the Fed took on the role as the world's central bank, citing:

> *"Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term".*

Not since the Asian crisis in the fall of 1998 has the Fed specifically called out global events as a variable in its consideration for monetary policy. The big takeaway from the Fed meeting is that the brass at the FOMC see developments abroad as posing significant enough downside risks to the U.S. economy that they prefer to take a 'wait and see' approach to evaluate how recent dislocations impact the labor market and their 2% inflation target.

The FOMC updated their latest Summary of Economic Projections where the key takeaways were that they lowered their inflation targets out to 2018, with 2018 being the new bogey for when the Fed expects to reach its 2.0% inflation target (previous estimates were for the Fed to reach its target in 2017). As for real GDP growth, the downward assessment of global growth based on the events over the past few months forced the Fed to lower 2016 estimates to 2.3% from 2.5%, to 2.2% from 2.3% for 2017, and then to 2% for 2018. Mind you, these are not recessionary levels but according to their estimates they are projecting a gradual slowing in growth.

Given a lower expected profile for inflation and growth, the Fed's dot plot (interest rate projections) showed a visible reduction across the board. Estimates for the fed funds rate by the end of 2015 were trimmed to 0.375% from 0.625% in March and 1.375% a year ago. I'm no better than the next guy at conquering the unenviable task of accurately predicting the future, but it is somewhat befuddling that the Fed has been so off the mark with its expectations for short-term interest rates when this variable is within its complete control. Be that as it may, the dot plot of FOMC member projections pegs the fed funds rate ending 2016 at 1.375% (down from 1.625% in June, 1.875% in March, 2.5% last December, and 2.875% a year ago), 2.625% in 2017, and the new neutral long-term funds rate was lowered to 3.5% from 3.75% (in 2014 the terminal rate was estimated to be 4%).

As such, this suggests that when the Fed finally does decide to get off the zero lower bound it is very likely to be a long, drawn out cycle – a far cry from the 17 straight 25bps hikes during the last rate hiking cycle from June 2004 to June 2006. This should assuage some of the concern among long-term bond holders as lower for longer appears to be around for some time to come. However, this does very little to help those investors out there that have had to contend with the financial repression they have been subjected to in this almost seven year period of 0% short term interest rates.

The confusion among market participants going into the meeting was widespread with 50% of economists in a WSJ poll expecting a rate hike to occur, but the capital markets handicapped it differently with the fed funds futures pegging the probability of a hike occurring at less than a 1 in 3 chance.

It's fair to surmise that there remains an equal level of confusion following the meeting as there was going into it which was evident in the way capital markets reacted. Going into the announcement bond yields were roughly flat following a multi-week move from the recent lows reached in late August. Similarly, equity prices were treading water as they traded modestly in the green.

Following the announcement and throughout Chair Yellen's press conference, uncertainty among investors elevated – causing a sell-off in the equity market and a rally in the bond market. By the end of the trading day on Friday a global equity market rout was on as the S&P 500 had lost 32 points (1.6%), sending it into the red on the week. European equities were rocked as the euro currency proceeded to plunge versus the dollar, the German DAX fell 3.1%, France's CAC 40 lost 2.6%, London's FTSE 100 gave back 1.3% and over in Asia Japan's Nikkei Average ended the day lower by 2%.

My view has been for some time now that the health of the U.S. economy was intact and if the Fed was truly data dependent then the time was right to kick-off this interest rate normalization cycle. After all, housing is booming with the NAHB homebuilder index at a 10-year high, single-family housing starts up 15% from year ago levels and multifamily up 20%. The consumer is in great shape as can be discerned from the July/August core retail sales running at over a 6% annual rate. Not to mention the latest Flow of Funds report released on Friday which showed the net worth of U.S. households climbing by $695 billion in Q2 to an all-time high of $85.7 trillion.

Furthermore, the labor market is as strong as it's been during this entire expansion with 1 million full-time jobs having been created in the last two months alone and jobless claims falling to a two month low last week of 264k (initial jobless claims have now been below 300k for 28 straight weeks). I can understand the argument (heck I've made it in this commentary before) that the 5.1% unemployment rate is misleading relative to the overall tightness in the labor market – given that it would be north of 8% if adjusted for the fall in the participation rate.
But the near zero percent interest rates that are in place today were unveiled in 2008 to deal with an emergency that no longer exists.

Beyond the obvious dislocations from overseas economies perhaps another not so obvious risk weighing on the Fed's mind is the increasing possibility of a government shutdown looming come the start of the new fiscal year on September 30th. Over the last several years Chair Yellen has witnessed on numerous occasions just how dysfunctional our legislative leaders can be when they are saddled with the responsibility of compromising on fiscal policy decisions. Just maybe she knows something we don't and is taking out a little insurance given the divide on several material budget issues with only a few precious weeks remaining until a shutdown would occur.

The Fed has spent considerable time over the last several years massaging the capital markets interpretation of 'data dependent' in an effort to be more transparent with the capital markets. However, the success in achieving this objective is calling into question the Fed's credibility given the continuous shifting of the goal posts.

First, it was all about the unemployment rate with 7% being the initial marker that would set-off policy normalization – this threshold came and went with the level of unemployment that would trigger lift-off being continually lowered. Then the Fed directed markets to look beyond just the unemployment rate and introduced a more eclectic and broader data set to measure the health of the labor market (Labor Market Conditions Index) which would provide evidence of the further improvement in labor markets the Fed was looking for to begin the hiking process. This too, came and went, but not before the Fed shifted the goalposts once again by directing the markets to focus their attention on the inflation data which has been running below the Fed's target for more than three years.

With the cover of not meeting one half of its dual mandate (inflation) the Fed has shifted the goal posts once again, but this time towards global data. Chair Yellen made it clear in her press statement that 'data dependency' now includes events in China as well as Emerging Markets and the possible spillover to the U.S. economy (even though the direct linkages are small). Furthermore, Ms. Yellen also talked about equity prices, credit spreads, and the dollar, so the Fed is really now more 'market dependent' than domestic 'data dependent'.

With all that being said, what's and an investor to do? My advice is to not get caught up in the noise which is exactly what we have a lot of at the current time. I'm not one to argue for an economic or capital market environment that I wish or think should exist as I find it highly inefficient given we have to invest capital in the one that does exist. And this market remains one that is dependent on the Fed's liquidity spigot which is nearing a point where the amount of liquidity is going to be throttled back.

The recent non-move by the Fed did little to change the backdrop that existed before Thursday afternoon's announcement other than it perpetuated the uncertainty around the timing of lift-off. It did nothing to stop the fact that lift-off is an inevitably. Furthermore, given the global rebalancing that is taking hold with the transition in China from an export and infrastructure dependent growth engine to a consumption oriented economy, Japan adopting Abenomics in an attempt to rid itself of the more than 25 years of economic malaise, Europe experiencing growing pains within the Eurozone members, and Emerging Market growth floundering as their dependence on natural resources gets a reality check with the plunge in commodity prices – it should come as little surprise that capital markets are acting erratically in an attempt to price in all this information.

There is nothing more important for an investor than clarity, certainty, and transparency. All of these elements have become less obvious over the last couple of months and in turn caused risk assets – stocks and high yield debt in particular – to decline. My view continues to remain one of cautious optimism on the U.S. economy and I remain of the belief that a U.S. recession (which is always my biggest concern as a steward of other people's capital) is not a near-term risk. However, my skepticism about long-term success of central bank policy around the world continues to elevate as this expansion cycle continues to age and the rate of change in the data continues to decelerate.

Looking ahead the markets will continue to take their cue from global developments around the world and Q3 earnings season will soon be in full bloom as the Fed takes a back seat until their next meeting at the end of October (27^{th}-28^{th}).

In an environment of heightened uncertainty (things are never 100% certain) the multiple investors are willing to pay for equities is what takes the haircut. Analyst estimates are for the S&P 500 to earn approximately $124/share over the next four quarters which puts the S&P 500 trading at a 15.8 P/E multiple. This is a slight premium to the historical average forward multiple of 15x, but far from grossly expensive. A big question facing investors is what the future earnings power of corporate America is in a time when profit margins are at all-time highs, global growth is under pressure, and revenue growth remains tepid.

In an optimistic scenario we could see the S&P 500 trade at a peak cycle multiple of 18x which would put the S&P 500 at around 2,230 (18 P/E x $124EPS = 2,230). An eighteen multiple isn't all that outlandish given that is virtually where we were at the S&P 500's recent high of 2,132 on July 20th. If the equity market continues to check time as has been the case so far this year while allowing the earnings backdrop to play catch up with the stock market rally of the last couple years then there is a strong argument that we are trading near fair value at current levels. A pessimistic scenario could see a recession take hold which would knock S&P earnings down 25% to $93/share and putting a recession multiple of 12x on earnings suggests that the downside possibility in the S&P 500 is 1,116.

This type of scenario analysis is one of many evaluations we go through when attempting to ascertain what our views are on the equity markets and how we want to position our client's capital for the future. That being said it's not hard to do the math on this simple scenario analysis and conclude that the upside in the equity market at the current time is roughly 14% in the optimistic scenario and the downside is 43%.

Please don't misconstrue this analysis as a predication for the future, but rather a view of the risk/reward profile for investors to consider. Assigning a probability to these potential outcomes is another step in this process and these probabilities should be guided by history, fundamentals, sentiment, and interest rates to name a few.

With that said, I do view the capital market environment as one that continues to be skewed toward the risk side of the risk/reward paradigm and as a result believe investors should exhibit prudence and discipline in how their capital is allocated. Should the facts change I will most certainly evaluate them and if necessary change my mind, but for the time being I'm going to heed the advice of a wise market strategists that I've learned a lot form over the years, "fall in love with your partner, not your forecast". The recent market correction has brought some much needed valuation relief to the equity market and reasserted a modest margin of safety level. However, what is needed going forward is some positive momentum in corporate earnings (following flat EPS growth in Q1 and a slight decline in EPS in Q2) to reestablish some confidence in the multiple level investors are willing to pay to own stocks.

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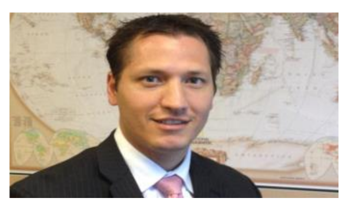

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