November 23rd, 2015

What if?...

Stocks raced higher last week as investors ignored a steady stream of horrific terrorist activity (bookended by the fallout from the shootings in Paris to start the week was a bomb threat in Hanover, Germany mid-week and a hostage situation at a hotel in Mali, West Africa to close out the week) as the S&P 500, Dow Jones Industrial Average, and Nasdaq all gained more than 3%. It was the strongest weekly gain on the year as the S&P 500 gained back virtually all of the 3.6% it shed the prior week (this truly has become a market with no memory).

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The following statistic illustrates just how frustrating this year is shaping up to be for investors: the top 10 stocks in the S&P 500 are up +13.9% so far this year while the other 490 are down -5.8%. This is the largest spread since the heydays of the Tech bubble in ’98-’99. As any technician will tell you, it’s nice to have leadership in the market, but it’s more important for the soldiers to follow, and even after this rapid rise following the August – September correction market breadth is even worse than it was prior to the pullback.

Stocks were firm from Monday’s opening bell with the S&P 500 going on to register a 30 point gain on the first trading day of the week, but that momentum picked up in earnest on Wednesday following the release of the October FOMC minutes (the S&P 500 gained 18 points after the release) which affirmed that

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a December rate hike is a strong possibility. At this time it appears investors have not only acclimated themselves to the looming Fed rate liftoff but are viewing the policy rhetoric as validation that the U.S. economy is in self-sustaining growth mode (I remain skeptical of this thesis, but I'm also willing to keep an open mind).

So, the long awaited, and endlessly discussed, initial lift-off in the Federal Reserve's interest rate target from near-zero that's been in place since the dark days of the financial crisis in December 2008 might finally be at hand. Moreover, a stock market that has spent the last seven years flourishing on an abundance of liquidity and ultra-accommodative monetary policy is now rallying on the notion that the punchbowl is set to be gradually pulled away.

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However, not all markets were signaling full-speed ahead. Overlooked in last week's sizable move higher in stocks was the action in the credit markets which reacted in a risk-averse fashion (see chart below). High yield bonds, which normally move in tandem with equities, declined and are hovering near their lows for the year with yields lifting into double digit territory (10.05% according to the sample of bonds from S&P's Leveraged Commentary & Data). Granted, some of this is being driven by the distress in low-quality energy companies, as WTI briefly traded below $40/barrel.

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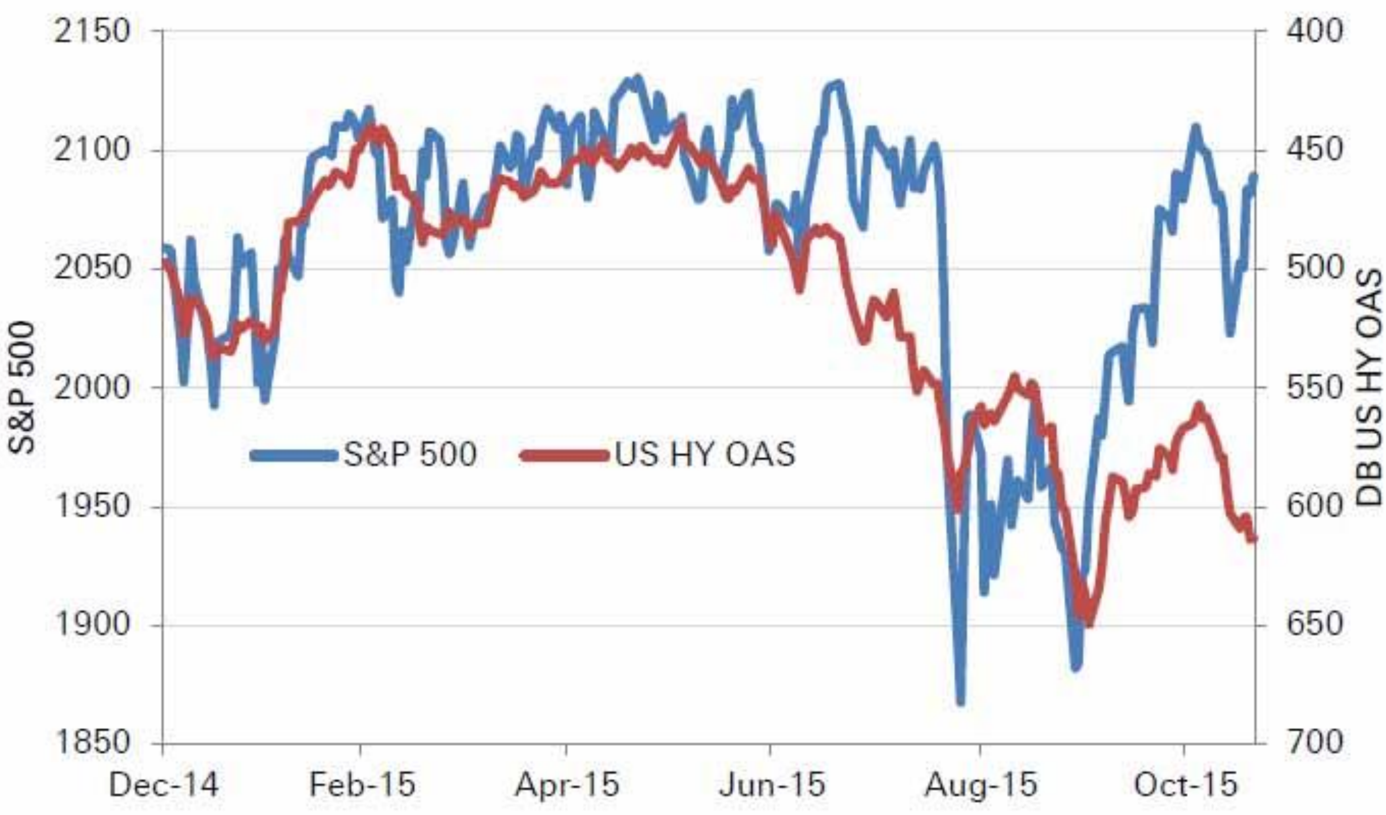
Figure 1: S&P 500 (LHS) vs. US HY Spread (RHS) year-to-date



Source: Deutsche Bank, Bloomberg Finance LP as of 23- November 2015. Left had axis represents S&P 500, Right hand axis represents the Deutsche Bank US HY option adjusted spread index

The Treasury yield curve flattened with the two-year T-note (the maturity most sensitive to Fed actions) holding in near its high for the year (0.89%). Meanwhile, the 10 and 30-year Treasury bond yields ticked down and are hovering near the middle of their trading ranges, 2.26% and 3.02% respectively. For

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sure, these yields look remarkably plush relative to yields in other developed markets, namely Europe, where German two-year notes traded at a record low negative yield of -.38% last week (yes, investors are paying for the security of owning these notes)! In a speech on Friday, ECB President Mario Draghi built upon his 2012 “whatever it takes” statement as he all but announced that additional QE was in the cards come December.

> *“If we decide that the current trajectory of our policy is not sufficient to achieve our objective, we will do what we must to raise inflation as quickly as possible.”*

The 10’s - 2’s Treasury yield spread is down to 135 basis points from 182 basis points a year ago and nearing the low reached at the end of January (121 basis points) – mind you, the 10-year T-note was trading at a yield of

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1.68% at that time. Strength at the long end of the Treasury curve and softness in speculative grade credits are indications that the bond market views the economic backdrop as lacking in both growth and inflation – not exactly the typical set-up going into a rate hiking cycle.

Furthermore, the diverging central bank policies between the U.S. and the rest of the Developed Market economies is likely to continue to underpin the dollar which is a depressant for already weak commodity prices as well as earnings for big-cap U.S. multi-nationals.

Back to the October FOMC minutes for a moment as I want to highlight a section that in my mind warrants some definite consideration on the part of investors (emphasis mine):

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“The staff presented several briefings regarding the concept of an equilibrium real interest rate--sometimes labeled the "neutral" or "natural" real interest rate, or "r"--that can serve as a benchmark to help gauge the stance of monetary policy. Various concepts of r* were discussed. According to one definition, short-run r* is the level of the real short-term interest rate that, if obtained currently, would result in the economy operating at full employment or, in some simple models of the economy, at full employment and price stability. The staff summarized the behavior of estimates of the short-run equilibrium real rate over recent business cycles as well as longer-run trends in real interest rates and key factors that influence those trends. <u>Estimates derived using a variety of empirical models of the U.S. economy and a range of econometric techniques</u>*

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indicated that short-run r fell sharply with the onset of the 2008-09 financial crisis and recession, quite likely to negative levels. Short-run r* was estimated to have recovered only partially and to be close to zero currently, still well below levels that prevailed during recent economic expansions when the unemployment rate was close to estimates of its longer-run normal level.*

With respect to longer-run trends, the staff noted that multiyear averages of short-term real interest rates had been declining not only in the United States, but also in many other large economies for the past quarter-century and stood near zero in most of those economies. Moreover, economic theory indicates that the equilibrium level of short-term real interest rates would likely remain low relative to estimates of its level before the financial crisis if trend

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<u>growth of total factor productivity does not pick up and if demographic projections for slow growth in working-age populations are borne out.</u> Finally, the staff discussed the implications of uncertainty about the level of the equilibrium real rate for using estimates of short-run r as a guideline for appropriate monetary policy.*

In their comments on the briefings and in their discussion of the potential use of r in monetary policy deliberations, policymakers made a number of observations. The unemployment rate has declined gradually in recent years, indicating that real gross domestic product (GDP) growth has, on average, exceeded growth of potential GDP, but not by a substantial margin. This outcome, in turn, suggested that the actual level of short-term real interest rates has been below but not substantially below the equilibrium*

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real rate, consistent with estimates that r currently is close to zero, notably below its historical average.*

A number of participants indicated that they expected short-run r to rise as the economic expansion continued, but probably only gradually. <u>Moreover, it was noted that the longer-run downward trend in real interest rates suggested that short-run r* would likely remain below levels that were normal during previous business cycle expansions, and that the longer-run normal level to which the nominal federal funds rate might be expected to converge in the absence of further shocks to the economy--that is, the level that would be consistent, in the long run, with maximum employment and 2 percent inflation--would likely be lower than was the case in previous decades. A lower long-run level of r* would also imply that the gap between</u>*

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the actual level of the federal funds rate and its near-zero effective lower bound would be smaller on average. A smaller gap might increase the frequency of episodes in which policymakers would not be able to reduce the federal funds rate enough to promote a strong economic recovery and rapid return to maximum employment or to maintain price stability in the aftermath of negative shocks to aggregate demand. Some participants noted that it would be prudent to have additional policy tools that could be used in such situations."

This entire section of the minutes suggests that interest rates are likely to remain 'lower for longer' even in the midst of a rate hiking cycle – a rate hiking cycle that sets up to be very truncated with the path of hikes assuredly being gradual.

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Most striking was the comment about the "smaller than average gap" between the actual fed funds rate and its zero lower bound where the staff goes on to acknowledge that given this setup it is a distinct possibility that monetary policy could very well be an ineffective tool to counteract a negative economic shock.

> *"A smaller gap might increase the frequency of episodes in which policymakers would not be able to reduce the federal funds rate enough to promote a strong economic recovery and rapid return to maximum employment or to maintain price stability in the aftermath of negative shocks to aggregate demand."*

In my opinion this poses one of the most material risks facing investors today. Keep in mind that investing is a very complex and

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confusing endeavor as success isn’t as simple as correctly deciding on a black or white outcome. Most outcomes are not binary, just as most trends are non-linear which creates a lack of certainty and conviction when attempting to forecast what the future will hold for the capital markets.

It is for this reason that analysts derive scenarios of potential outcomes and assign probabilities to their belief in what outcomes could transpire – assigning the highest probability to their base case and lower probabilities to outcomes on the tails of a distribution.

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In my opinion, the consensus expectation (the base case) for the year ahead is that the economy continues to muddle along at the subdued but positive trend rate of growth that has persisted since this expansion began in 2009. This includes expectations that the following continues: job growth remains positive, unemployment declines (both, albeit at a slower pace), the housing market remains firm, inflation remains in check while trending towards the Fed's 2.0% target, the weakness in the manufacturing sector reverses, the consumer continues to spend, the soft-patch in corporate earnings growth is a pause that refreshes as EPS growth reaccelerates in the 6-8% range in 2016, consumer confidence remains near expansionary highs which keeps a bid under equity valuations, central banks

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can thread the needle despite increasingly divergent central bank policies, and global economic growth improves ever so subtly.

With this being the base case, investors need to be aware that this is what is currently being reflected in capital market prices today and this is what will guide expectations for the year ahead. So, if everything plays out according to plan then it would be reasonable to expect stocks to have a solid next 12 months, appreciating somewhere between 5-10% depending on where investors take the multiple they are willing to pay for stocks, and most parts of the fixed income market will struggle with a stiff headwind from modestly rising rates.

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A prudent investor, one who is astute to the possibility that there are known unknowns and unknown unknowns when it comes to framing future return expectations, is aware of the risks that come with anchoring and blindly accepting the consensus view. It is important to contemplate, evaluate, and understand what could derail the base case scenario. Furthermore, what is the probability of an alternative scenario materializing and to what degree could this impact an investor's portfolio – in terms of volatility, timing, and potential permanent loss of capital?

What if? What if industrial production, which is on the verge of contracting year-over-year and has declined in 9 of 10 months this year, continues its descent? What if this expansion,

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which is moving into its 79th month – handily surpassing the length of the average expansion (59 months) going back to 1930 – is not just in a mid-cycle slowdown but actually on its last legs? What if consumption starts to roll-over like job growth (peaked in Q4 and trending down ever since), corporate profit growth (peaked in Q1), and consumer confidence (peaked in Q2)? What if the Fed hikes rates into a slowing expansion but has to reverse course like many other central banks have already done in this post-credit crisis era (Australia, Norway, New Zealand, South Korea, Canada, Denmark, Sweden, and the ECB)?

What if "policymakers are not able to reduce the federal funds rate enough to promote a

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strong economic recovery and rapid return to maximum employment or to maintain price stability in the aftermath of negative shocks to aggregate demand" as was referenced in the latest FOMC minutes?

My point here is that a stock market that is trading within 2.0% of all-time highs, at valuations above historical averages, and on the precipice of unwinding the most aggressive and unprecedented monetary policy experiment in history is not immune to a hiccup. Furthermore, I believe it is not only prudent, but a necessity for investors to consider alternative outcomes to what is imbedded into current prices as the status quo of a continuation of the trend that has persisted for the last 6 ½ years.

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Long-term investing success is built on the ability to be aware of what your upside potential is benchmarked against the downside risk possibilities. It is naive to believe that the outlook today for the economy and capital markets over the next 12-24 months will follow a path consistent with the early stages of this business cycle. All I'm suggesting is that investors keep an open mind on the range of possible outcomes from what is sure to be a significant change to the fundamental setup that prevailed in the earlier stages of this business cycle.

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From all of us at Casilio Leitch Investments, we would like to wish you and your families a safe and Happy Thanksgiving.

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