June 22nd, 2015

Follow the leader (as in the LEI index)…

In the midst of headline grabbing news from the conclusion of a Fed meeting and continued back and forth (deal, no deal) between Greece and its creditors, U.S. equities managed to register modest gains last week. However, stocks continue to do nothing more than tread water as the 0.8% gain in the S&P 500 was the eighth straight week where the major average logged a gain or loss of less than 1.0%. This weekend's Barron's publication indicated that it's been 1,350 days since the S&P last experienced a 10% correction, but this is far from the longest such run of uninterrupted gains: the S&P 500 went 1,600 days between 2003 and 2007 without such an occurrence and 2,500 days between 1990 and 1997 without a 10% correction.

Foreign equity markets (which have been the outperformers this year relative to U.S. markets) had a tougher week with Europe and emerging markets losing approximately 1.0% and 0.5% respectively. Europe has now moved into full scale correction territory with declines in the double digits from their highs earlier in the year. This pullback has driven the forward P/E down to sub 15x levels and back to an attractive relative valuation versus the 17.5 forward P/E on the S&P 500. While investor attention appropriately focuses on what will ultimately transpire in the Greek debt negotiations and the unknown risk of what a default or Grexit (roughly a coin flip probability of this outcome) would do to capital markets, it may pay to recall the face-ripping rally in the global equity markets almost two weeks ago (June 10th) when the S&P 500 surged by 24 points after rumors hit the news wires that a deal had been reached.

The potential for a rubber band rally if cooler heads and logic prevail is considerable and once again proves that trying to time the ups and downs of this Greek drama is virtually an impossible way to successfully navigate this event. Not that this situation carries a similar scale, but for context, the S&P 500 rallied more than 2% and continued to run by 6% in the ensuing week after the Cuban Missile crisis was defused back in late October of 1962. FYI, as this goes to print it looks as if some progress is being made on hashing out a deal and the global equity markets are rallying in tandem. Europe is ripping, up roughly 4.0%, although this could change over the next 24-48 hours if talks were to hit an intermittent snag. This type of market action reinforces the notion for a prudently allocated and globally diversified portfolio that allows an investor to endure the short-term vicissitudes of a rumor driven market.

I’m not going to belabor the point of laying out the positions of each side of this dilemma, as I believe investors can garner a solid foundation from any number of respected periodicals. The risk is that this Greek tragedy gets materially worse before it gets better with the IMF no longer giving extensions to Greece. Either a resolution or some sort of accident is very likely by July – it’s the latter outcome that concerns the Fed and why Chair Yellen referenced the situation in Greece during her press conference last week as one of several variables causing the Fed to not move too early in removing the monetary punch bowl. The

Chairwoman stated in her remarks that the U.S. "has very limited direct exposure to Greece" and that the risks reflect "the potential for disruptions that could affect the European economic outlook and the global financial markets." She went on to say that should a disruptive outcome occur, "there would undoubtedly be spillovers to the U.S. that would affect our outlook as well."

One last point of perspective before moving on from the Greek file is the fact that Greece is a $240 billion dollar economy (roughly equivalent to the output of Rhode Island) or 2% of the Eurozone GDP. So a complete collapse of the Greek economy – where if the entire output of this region were to vanish overnight – wouldn't even cause the global economy to blink. However, it's not the repercussions from a complete loss of output out of this region that concerns policy makers or investors, but rather the fallout in financial markets and banking channels that would be material in today's interwoven and interconnected world.

Last Friday, China's Shanghai index plunged by 6.4% sending the index into correction territory with a decline of 13% for the week, but this market is still up by more than 100% in the past year so there remains a lot of air in this balloon should the recent trend of declines continue. India is a market that is showing some life and is up in seven of the last eight trading days. Supporting a constructive long-term investment opportunity in India is the fact that inflation is rolling over, yet still running at 5% year-over-year (so there is some top-line growth in this country), bond yields are declining, the currency has depreciated about 4% against the dollar in the past year (this should help revive a sagging export performance), fund flows into India stocks from the locals are turning positive, and the central bank has begun to ease monetary policy with tremendous room for further easing, if necessary. Additionally, India has perhaps the most favorable demographic profile of any developing economy on the planet – all of these characteristics support our recent foray into the region for our client portfolios.

As for last week's FOMC meeting, the net take away is that the Fed leaned in the dovish direction where a slightly more bullish statement more than offset the downward revisions to their previous economic forecasts. Perhaps the most interesting message from the Fed came from the change in the "dot plot" for funds rate projections. In the old forecasts, two FOMC members had no rate hike this year, one person had one hike, and seven had two hikes. The latest forecasts show two members still with no hikes this year, but now five forecast just one hike for the remainder of the year (15 of the 17 FOMC members see at least one rate hike this year and 10 of 17 see at least two). This is a significant shift for investors as it increases the odds that the Fed could take a pass for the balance of the year – this is not a certainty, but Fed funds futures place an almost 40% probability of such an outcome occurring. So, the "buy everything the Fed has your back" investment philosophy remains in vogue and hence the almost 200 point rally last Thursday (the day following the conclusion of the Fed meeting).

The following remarks in Chair Yellen's post-meeting press conference were notable, in my opinion:

> *"The stance of monetary policy will likely remain highly accommodative for quite some time after the initial increase in the*

federal funds rate in order to support continued progress toward our objectives of maximum employment and 2 percent inflation."

"... I want to emphasize, sometimes too much attention is placed on the timing of the first increase in the federal funds rate. And what should matter to market participants is the entire trajectory, the entire expected trajectory of policy"

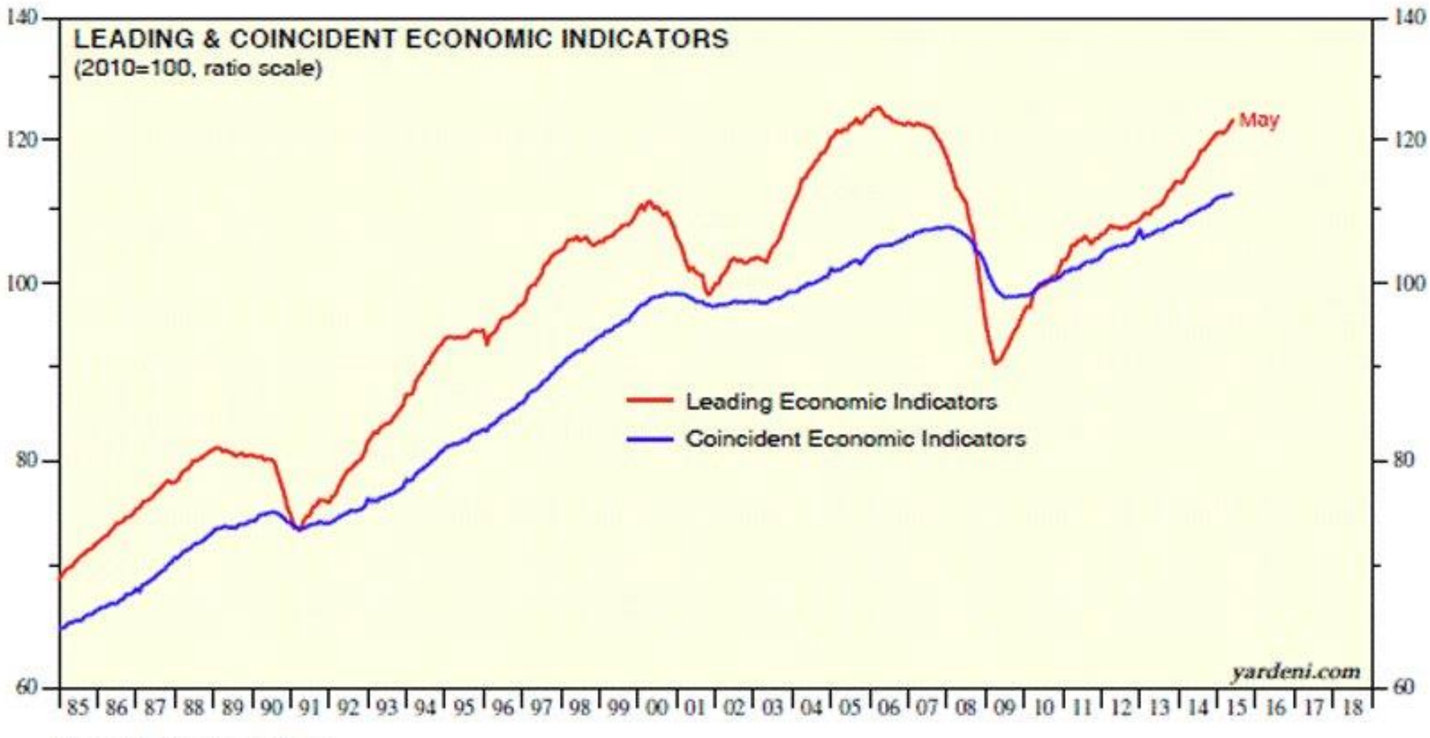
"... I want to emphasize and I think the IMF would agree with this, that the importance of the timing of the first decision to raise rates is something that should not be overblown whether it is September or December or March. What matters is the entire path of rates and, as I have said, the committee anticipates economic conditions that would

call for a gradual evolution of the Fed funds rate towards normalization."

As I've said, before it's not the first rate hike that coincides with the end of a bull market, it's the last. And on this front the first hike continues to get pushed further down the road – "September or December or March" – so the last hike looks to be a 2018 story, and that is a long ways away. This isn't to suggest that markets will not have to contend with intermittent bouts of volatility and white knuckle pullbacks as this era of unprecedented monetary policy runs its course, but from a Fed policy standpoint the intermediate horizon looks to have some obstacles and speed bumps in its path, but no roadblocks.

So for the remainder of the year it looks as though the Fed is on course for a "one and done" or a "two and through" course for rate hikes. You can throw a traditional rate hiking cycle (where the Fed incrementally hikes at every meeting, as was the case in 2004 – 2006, or every other) out the window as this cycle is anything but traditional. However, it is not unprecedented for interest rates to be anchored at extremely low levels for a sustained period of time: from 1930 to 1950 short term rates were held near zero for almost 20 years. Heck, we are only in year seven which looks like a blink of an eye on a relative basis.

Piggybacking on Chair Yellen's comments that the Fed needs "to see more evidence" of sustained growth and that the outlook for jobs and inflation evolves towards their objectives, the latest Conference Board's Index of leading economic indicators suggests we are on our way. May's LEI reading jumped 0.7% month-over-month, matching last month's gain, and marking the 14th time in the last 15 months that this index has increased. The year-over-year trend came in at 5.7% and represents the strongest pace of increase since February. The below chart from Ed Yardeni indicates that we are at the cusp of moving beyond the all-time highs on this metric reached in the last expansion:



Source: The Conference Board.

The breadth of the improvement among the components that make-up the LEI index was encouraging as well with the one-month diffusion index reaching an eight-month high of

90% while the six-month diffusion measure held steady at a not too shabby 70% for the third straight month. Recall that the year-over-year trend in the LEI is a key indicator, along with the shape of the yield curve, which we follow quite closely given its historical track record at forecasting the timing of a potential recession.

Historically when we are within six months of a recession, the year-over-year trend in the LEI turns negative as the diffusion index falls below 30%. Three months before a recession the LEI is down 1% year-over-year and by the time a recession begins the LEI is down 4% year-over-year with the diffusion index at 20%. As you can see, unless this metric has lost its mojo the probability of a recession occurring in the U.S. economy remains very low. This is also spelled out in the recent steepening in the yield curve as the 10s/2s spread (difference between 10-

year U.S. Treasury note yield and 2-year Treasury bill yield) to 171 basis points which is up from 146 basis points at the start of the year.

As for the investment backdrop, without question the U.S. economic data has improved since the transitory soft-patch in Q1: auto sales are near cycle highs, housing is picking up steam, job growth is holding steady at a 200k per month clip, jobless claims continue to hover near multi-decade lows, and the Fed remains accommodative. However, these positive tailwinds continue to collide with some cautionary headwinds, namely: high valuations in the equity market (not frothy, but far from cheap), low EPS growth (FedEx and Oracle are two of the latest big-cap bell-weathers singing this tune), a subtle positive turn in inflation (which lowers the multiple investors should pay for stocks in most valuation models), a lack of liquidity in fixed income markets, and a trend change in interest rates where fixed income investors are pushing rates higher notwithstanding a Fed that remains on hold (the yield on the 10-year Treasury bond is up almost 70 basis points from the 1.63 level in reached at the end of January).

So all noise aside, we continue to advocate and believe the best course of action for investors going forward is to remain disciplined, stay the course with a prudently diversified portfolio, keep six or seven toes in the water, but don't get too far out over your skis given the risk/reward pendulum on many asset classes is balanced, in our opinion, whereas the pay-off for incurring incrementally more risk in the current global capital market is marginal at best. Yes, there remain areas where this pendulum is slightly skewed towards the return side, but equity market correlations in a globally connected world gravitate towards one (implying minimal benefits from diversification) when a significant risk event occurs.

I will be traveling in the later part of this week and over the weekend which will occupy my time and unfortunately inhibit me from composing a commentary for dissemination next week. I know I cheated readers out of my ramblings two weeks ago, but life happens and I promise not to make this a normal occurrence.

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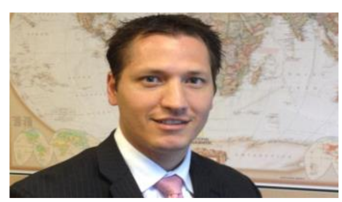

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