April 6th, 2015

Déjà vu…

Action in the capital markets last week was rather quiet in the lead-up to the Easter holiday as both the S&P 500 and Dow Jones Industrial Average rose 0.3%. With most of the first quarter economic data coming in on the soft side, investor attention was focused on Friday's release of the March Non-farm payroll report with hopes that it would quell some of the near-term growth concerns. However, these hopes were dashed with what amounted to being the weakest employment report in over a year.

Payrolls for the month of March expanded just 126k, handily below consensus expectations for a print of 245k, with downward revisions for January and February tallying 69k. The household survey confirmed the weak reading from the establishment survey with household employment rising just 34k, which kept the unemployment rate steady at 5.5% as the work week contracted. The lone positive in the report came from the wage data as wage growth accelerated from 2.0% year-over-year (YoY) to 2.1% YoY. Surely, one month does not make a trend, but with the previous month's revisions, monthly average payroll growth in Q1 now stands at 197k (a respectable increase), but a measurable step down from the 324k monthly average pace in Q4.

With the disappointing March jobs report confirming that the U.S. economy hit a soft patch in Q1, financial markets have started the second quarter trading much more concerned about deteriorating fundamentals than technical headwinds associated with an anticipated Fed rate hiking cycle. The most concerning aspect of the jobs report is not the report itself – after all we have still seen very solid average nonfarm payrolls growth of 260K per month over the past six months – it is that it validates other weak activity data to start the year.   For example, last Wednesday's ISM Manufacturing Index reading for March dropped to 51.5 from 52.9 in February and is at the lowest level since May 2013. This is the fifth straight month of decline and March's 51.5 reading is down considerably from the nearby high of 57.9 reached last October.

What is somewhat confounding from an investment standpoint is the continual divergence in various economic data points. Last week's below-expected prints from construction spending, ISM manufacturing, and Non-farm payrolls runs counter to a surge in auto sales which spiked 5.6% to a four month high of 17.1 million units at an annual rate (led by light trucks and SUVs blowing out to a 10-year high as consumers are revisiting their gas guzzling roots). The housing market continues to gain momentum with pending home sales beating expectations with a 3.1% month-over-month gain and reached its highest level since June 2013. Consumer confidence rebounded to 101.3 in March (the second highest reading since the recovery began) compared to expectations for a print of 96.4, after falling to 98.8 in February. And initial jobless claims plunged to 268k for the week ending March 28th, from 288k in the prior week. This pushed the 4-week moving average to 285.5k from 300.25k, back down near the lowest levels of this recovery.

So while the U.S. data has been mixed to soft of late, investors need to separate what is transitory (West Coast port shutdown and weather) from what may likely be more persistent (dollar strength). Navigating through this maze of twists and turns will likely take some time before a clearer trend worthy of actionable portfolio adjustments takes shape. There is hint of déjà vu in the air as we move into the second quarter with the S&P 500 falling 3.1% in January (it fell 3.6% in January 2014), reversed in February with a 5.5% bounce (rebounded 4.3% in February 2014), and experienced a modest decline of 1.7% in March (eked out a slight gain of 0.7% in March 2014).

In the near-term, it may prove to be prescient for investors to exercise some patience with the capital markets and the economic data as the outright decline in GDP during last year's first quarter turned out to be a false alarm as the spring thaw brought with it two of the strongest growth quarters of this recovery. Like the recovery in the economic data the S&P 500 went on to generate double-digit gains following a volatile first quarter (this is not a prediction – just an observation).

Investors should take a cue from the Fed and exhibit a little data dependence at the present time, being sure not to overact to the heightened level of noise that is currently canvassing the horizon. While the FOMC may have removed "patient" from their most recent statement it by no means implies that Chair Yellen is going to be impatient with normalizing interest rate as was eloquently articulated in her speech two weeks ago, to wit:

> "*The Committee's decision about when to begin reducing accommodation will depend*

importantly on how economic conditions actually evolve over time."

"...In assessing the actual strength of the labor market and the broader economy, we must bear in mind that these very welcome improvements have been achieved in the context of extraordinary monetary accommodation. While the overall level of real activity now appears to be much closer to its potential than it was a year or two ago, the economy in an "underlying" sense remains quite weak by historical standards, for the simple reason that the increases in hiring and output that have been achieved thus far have required exceptionally low levels of short- and longer-term interest rates, reflecting a highly accommodative stance of monetary policy. Interest rates have been, and remain, very low, and if

underlying conditions had truly returned to normal, the economy should be booming."

What stands out to me with these remarks is the fact that here we are almost six years into this recovery, a federal funds rate still hugging the zero-lower bound, and the sustainability of economic growth clearly remains in question. Hence, why Chair Yellen and the brass at the Fed remain very sensitive to the consequences of prematurely pushing forward on an interest rate normalization cycle given they do not have many tools left at their disposal to counteract a meaningful slowdown. At this point the Fed pushing forward with rate hikes is more of a conceptual exercise than anything with much vitality, given the uncertainty level surrounding the economic backdrop remains high:

"We cannot be certain about the underlying strength of the expansion, the maximum

level of employment consistent with price stability, or the longer-run level of interest rates is consistent with maximum employment. Policy must adjust as our understanding of these factors changes. However, if conditions do evolve in the manner that most of my FOMC colleagues and I anticipate, I would expect the level of the federal funds rate to be normalized only gradually, reflecting the gradual diminution of headwinds from the financial crisis and the balance of risk I have enumerated of moving either too slowly or too quickly. Nothing about the course of the Committee's actions is predetermined except the Committee's commitment to promote our dual mandate or maximum employment and price stability."

Needless to say, if GDP growth is decelerating on a permanent basis to the 1%-2% range economist’s estimates are tracking for Q1, then it’s a reasonable thesis to expect equity markets to continue to oscillate in the range they’ve been in since early November. In addition to the sluggish U.S. economic growth backdrop, two other contributing factors to this go no-where market are earnings growth (or the lack thereof) and pricey valuation levels.

Since the summer of 2014 consensus EPS forecasts for the S&P 500 for Q12015 have been slashed from just over $32/share to just under $27/share currently (a rather significant 17% haircut). Yet over this time span, the S&P 500 – which was trading around 1,960 back then – has increased by approximately 6% to 2,070. Furthermore, analyst’s estimates have now moved to pencil in earnings declines for not only Q1 and Q2 of 2015, but also Q3. For a little perspective there have only been two other periods in which earnings declined for three quarters in a row without the economy being in a recession (1985-1986 and 1997-1998) – interestingly these periods also fell subject to some of the same headwinds challenging corporations today (declining oil prices, lower bond yields, and dollar strength).

So the fundamentals underpinning U.S. capital markets continue to be mixed with both headwinds and tailwinds colliding to create a directionless market with heightened volatility. One opportunity that has emerged for investors to profit from is the improvement in economic momentum in foreign markets. As I've said many times before, what moves prices is the marginal change (better or worse) not the absolute level (good or bad) of the data. Last week's Eurozone PMI data advanced to 52.1 in March from 51 in February, continuing to build on an improving economic trend that is gaining firmer footing.

Investor capital continues to flow to foreign markets because these markets are where the U.S. was three years ago: monetary policy is in full swing with the ECB initiating QE in March and Japan's BOJ having yet to take its foot off the monetary policy accelerator. This has lowered already historically low interest rates, weakened their respective currencies relative to the rest of the world, and provided a positive boost to confidence.

China's equity market is one of the strongest performing markets this year in part because of the consistent rumors that the PBoC stands ready to step in and support the economy should growth slow too much (yet another market reacting to central bank support – or even just the rumor that support may come).

- The S&P 500 finished the first quarter with a marginal gain of 0.44%
- The MSCI All Countries World Index ex-USA increased 3.5%
- Japan was up 10.21%
- Germany was up 8.28% in U.S. dollar terms and over 20% in Euro's
- Even emerging markets got a bid, returning 2.42% in the quarter

Also increasing the allure of investors toward foreign equity markets is the fact that these markets on balance trade at a cheaper relative valuation to the U.S. equity market. Furthermore, Japan and Europe are both experiencing positive earnings momentum with analyst earnings estimate revisions improving more than any other region over the last several months.

Looking ahead, investor attention will shift to Q1 earnings reports which kick off this week, but the bulk of the results will start flowing in over the ensuing couple of weeks. What will be interesting to watch is whether the bar has been lowered to such a level that earnings surprise to the upside (this has typically been the case). Positive earnings surprises, coupled with April being a seasonally strong month for the equity market, and stock buybacks being reinstated following earnings results could very well create a favorable backdrop to perhaps push the broad averages back to their all-time highs over the next couple of weeks.

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