May 4th, 2015

Tough backdrop for bonds…

The herky-jerky nature that has gripped capital markets for 2015 continued last week as investors closed the books on the month of April. Equities spent the earlier part of last week consolidating after making new all-time highs during the previous week, but a significant reversal in interest rates across the Atlantic pushed rates higher here in the U.S., causing a subtle pickup in volatility. The S&P plunged 21 points on Thursday to only recapture those losses in Friday's trading session (although Friday's move was on lower volume), with the major market averages ending the week little changed (Dow -0.3%, S&P 500 -0.4%, while the Nasdaq and Russell Small cap indices registered more material setbacks of -1.7% and -3.1%, respectively).

With April in the books the scorecard for the capital markets through the first four months of the year shows the S&P 500 up 1.9%, ahead of investment grade bonds +1.7%, long-term Treasury bonds +0.6%, and Gold -1.6%. Where the real profit has been made this year is in international equity markets with the MSCI All Cap World index ex U.S. up 11.54% and the MSCI Emerging Markets index gaining 10.93%. On a sector level in the U.S., Telecom (+4.95%), Health Care (+4.66%) and Consumer Discretionary (4.29%) sectors are leading the charge with Utilities (-6.48%), Financials (-2.43%), and Industrials (-1.48%) the biggest laggards on the year thus far.

At times it's astonishing how quickly the tide can turn with the action in the German Bund market being the latest example. Over the term of only a couple of days the yield on the benchmark 10-year German Bund more than doubled and is up more than 10-fold (ending last week at 0.36%) from the 0.033% low it reached in mid-April. This activity – along with recent data showing that inflation is staging a revival and migrating towards the Fed's 2.0% target – sent the yield on the 10-year Treasury back above 2%. On the year the 10- year Treasury yield has now declined just 6.5bps while 30-year rates are actually 6.6bps higher.

It will be really interesting to observe the tug-of-war in bond yields over the balance of the year and through the more mature stages of this economic cycle. All deference to the squishy soft economic backdrop in Q1, but the view among investors in the capital markets appears to have started to evolve in the latter part of April, as concerns about economic weakness are being dispelled by evidence that the U.S. economy is showing signs of a rebound from the temporary effects of harsh winter weather and West Coast port shutdowns which impaired growth in the first part of the year.

Yes, last week's GDP report for the first quarter which showed that the economy grew by a paltry 0.2% annual rate was a bit sobering. But in digging through the report you can isolate four points of drag: 1) West Coast port shutdown, 2) adverse weather, 3) dollar impact on exports, and 4) depressed capital spending in the energy industry – all of which are non-recurring events. In other words they are transitory: 1) the port shutdown is resolved with cargo traffic at the Ports of L.A. and Long Beach recovering from the 40% annualized decline in

Q1, 2) the abnormal weather is over, 3) the precipitous increase in the dollar has halted, and 4) oil prices appear to have put in their floor in mid-March.

This doesn't mean that a bright neon lit "all clear sign" is glowing, but similar bouts of temporary economic weak patches have been a staple in the archives of financial history. We remain in a moderate growth economic recovery which will require patience from an investing standpoint. Attempting to front-run every turn is surely a recipe for sub-par returns. My guess is that some of these drags on economic growth will linger into the second quarter, keeping the quick snap-back recovery many would like to see at bay, but the outlook for 3% or better growth in the second half of the year looks to be intact.

This will likely keep the Fed sitting on their hands until they become comfortable that the economy is strong enough to overcome what on the surface appears to be transitory forces. While many comparisons have been made between the slow start in 2014 and this year, it looks to me as though the economy is materially stronger this year on both of the Fed's mandates. In terms of employment, Jobless Claims have collapsed to 283K (4-week average) from 323K at the same time last year. Last week's 262K reading on claims was the second lowest since 1973! The only better print was 259K for the week of 4/14/2000. Furthermore on the inflation mandate (this will be the biggest threat to bond investors), last week's Employment Cost Index grew by 0.7% quarter-over-quarter in Q1 and is up 2.6% year-over-year, the strongest pace of wage growth on this metric since Q4 2008.

Given the progress the economy has made towards meeting the Fed's dual mandates and the significantly lagged effect of monetary policy, it appears perfectly rational to begin hiking interest rates this year if most of the economic weakness to begin the year is indeed temporary. This in conjunction with the sell-off in German Bunds is perhaps what is spooking bond investors at the current time and one justifiable rationale for why interest rates rose sharply toward the end of April and credit spreads widened in liquid benchmarks.

Investors buying government bonds today at current microscopic yields need to consider how they would be impacted if we experience a material pickup in economic growth and/or the interest rate normalization process by the Fed is implemented at a much faster pace than is currently priced into the market. The reality for today's government bond investors is that the only way you could garner a double digit return is for the world economy to collapse which causes the yield on the 10-year Treasury to plunge to a sub 1.0% level. Conversely, if the world staves off damnation and the yield on a 10-year Treasury note moves up a measly 40 basis points from current levels, investors holding this investment will have incurred a negative return on an investment that is believed to be safe. To be fair, if you are buying new issues and holding to maturity you will get your principal back at maturity, but you just might have to wait that long before getting that principal back as it will likely be underwater prior to maturity.

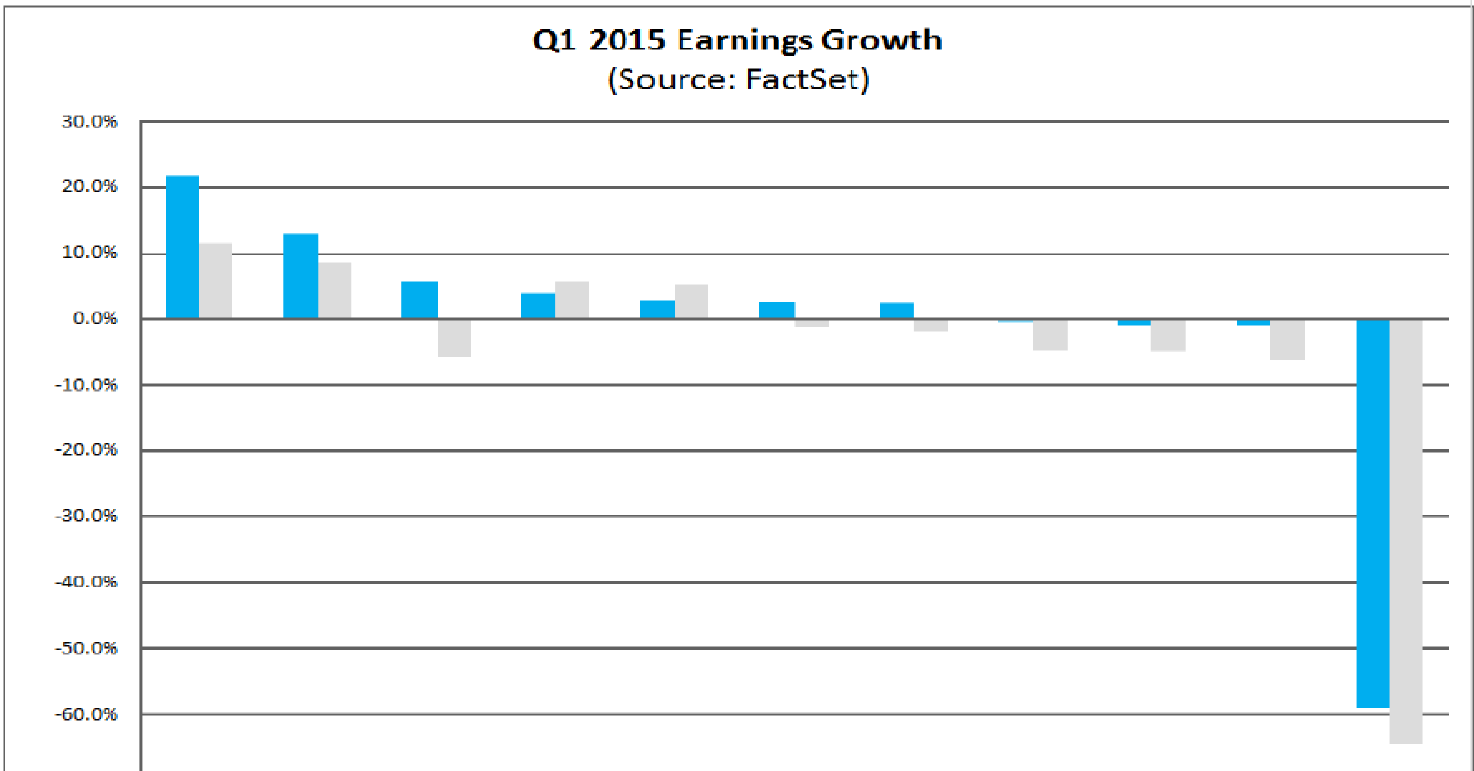
Recall that the lows in the 10-year T-note yield bottomed back in July 2012 at 1.43% and the total return for an investor in this security since then has been paltry 1.3% especially when compared to the 80% total return (capital appreciation and dividend reinvestment) generated in the equity market over that same time frame.

Also framing our risk aversion for certain areas of the fixed income markets is our concern that the coming Fed rate hiking cycle is much riskier than normal given the fact that we are now in year six of an unprecedented zero interest rate environment, which has led investors into an unprecedented reach for yield trade, i.e.: corporate cash balances are invested in short-duration bonds but should be in money market accounts, foreign official money is buying corporate bonds 5-years and in but should be in Treasuries, retail investors have piled into bond funds but should be in high quality equities, CD's, or money markets, and insurance money is in high yield but should be in investment grade credit, etc…

The most important revolution in the corporate bond market over the past couple of decades is the ability of investors to trade in and out of illiquid corporate bonds in a very liquid way through mutual funds and ETFs. For example Merrill Lynch's Credit Markets team estimates that by the end of 2014, 25.3% of the corporate bond market was owned by mutual funds and ETFs, up from 14.6% prior to the financial crisis (Q2 2007) and 9.3% as of the end of 1993. Although a lot of this is in stable hands, the problem is that mutual fund/ETF flows also tend to follow returns. Hence the risk of large scale redemptions that would illuminate just how illiquid the underlying bonds are – especially given the lack of dealer balance sheet.

On the corporate earnings front approximately 70% of companies have reported Q1 earnings results with EPS growth tracking -0.4% versus expectations on December 31st that growth would come in at +4.2%. Revenue growth is looking even worse at -2.6% compared to expectations of +1.6% growth. On the surface these numbers don't evoke much confidence in an equity market that is trading at a forward P/E of 17.5, which is roughly a three point premium to the historical average. But as usual the analysis tells a little different tale than the headline figures suggest.

Unsurprisingly, the energy sector is having a significant negative impact due to the drop in crude prices – the average price of oil in Q1 2014 was roughly $100/barrel compared to an average of roughly $50/barrel in Q1 2015. As a result, EPS for the energy sector fell by 60% and sales by 33% in the first quarter of this year compared to last year (see the following chart from Factset).



	Health Care	Financials	Utilities	Consumer Disc.	Industrials	Info. Technology	Consumer Staples	S&P 500	Telecom Services	Materials	Energy
Today	21.7%	13.0%	5.8%	3.8%	2.8%	2.7%	2.4%	-0.4%	-1.0%	-1.0%	-59.1%
31-Mar	11.5%	8.6%	-5.8%	5.8%	5.2%	-1.3%	-1.9%	-4.7%	-4.9%	-6.1%	-64.5%

The energy sector is clearly an outlier, driven by the rapid fall in the price of a single commodity. The sector had an operating profit weighting of 14.4% a year ago, making it the largest profit contributor in the S&P 500. With the fall in the price of oil, that weighting fell to 10.4% in Q1 of 2015. If you exclude the energy sector from Q1 results, EPS growth for the remaining 90% of the S&P 500 jumps to 7.5% with sales growth increasing to 2.6%. The point of excluding energy is not to imply that it is unimportant or that actual S&P results are better than they are, but rather to see whether the underlying trend has changed for the rest of the S&P, which it hasn't as earnings growth of 7.5% (excluding energy) tracks closely with the roughly 8% trend throughout 2014.

Consensus expectations for the S&P 500 are for EPS growth of 1.8% for full year 2015 which is down considerably from the 10% level analysts were penciling in a year ago. Perhaps even more concerning to me than lowered expectations is the fact that "forward 4-quarter" EPS growth expectations are not increasing even after the bulk of Q1 earnings season is over. Current estimates are for -0.51% EPS growth over the next four quarters, which is down considerably from the +5.02% growth estimate in early January.

The normal pattern off of the March 2009 market low has been just the opposite in terms of when there are worries over a quarter as there was in late 2012, and the forward estimate growth rate shrinks, usually with the new quarter, we see the forward estimate start to rise again. This could be more to do with the U.S. dollar strength, since the strong dollar seems to have impacted S&P 500 revenue more than EPS in Q1 2015.

So we have an equity market that is roughly flat through four months of the trading year and the reasons to support this outcome are many: sluggish economic growth, flat EPS growth, and plump valuation levels (not rich, but fully valued). Furthermore, various metrics that measure investor positioning suggest investors are fully invested – the latest Federal Reserve Flow of Funds reports show equities as a percent of household assets are at their second highest levels in history, and according to the latest data from the New York Stock Exchange, stock-market margin debt hit $476.4 billion in March (the highest level on record going back more than 50 years).

Additionally, the latest sentiment readings indicate investors are having a more difficult time making sense of the cloudy investment backdrop as neutral sentiment – expectations that stock prices will stay essentially unchanged over the next six months – rose 1.9 percentage points to 47.2%. The increase keeps neutral sentiment at or above 45% for the fourth consecutive week, the longest such streak since Dec. – Jan. 1989. It also keeps neutral sentiment above its historical average of 30.5% for the 17th consecutive week.

Bullish sentiment – expectations that stock prices will rise over the next six months – declined 0.6 percentage points to 30.8%. The decline puts optimism below its historical average of 39.0% for an eighth consecutive week. While bearish sentiment – expectations that stock prices will fall over the next six months – fell 1.2 percentage points to 22.0%. This is the lowest amount of pessimism registered by the AAII survey since February (20.3%). It is also the 14th week this year with a bearish sentiment reading below its historical average of 30.5%.

We continue to stand by our base case assumption that returns for the foreseeable future on all asset classes will be muted relative to the first six years of this recovery. But, despite all the blemishes that characterize this recovery the fact remains that we are moving into the 70th month of this expansion which puts it at the sixth longest cycle in the last century, and what this recovery has lacked in magnitude it has made up for in duration. Moreover, at no time in recorded history has the U.S. economy ever entered a recession at the onset of the first Fed rate hike. Historically it's not until well into the rate hiking cycle that the lagged impacts of more restrictive monetary policy start to cause the economic growth engine to sputter.

However, we are well aware that many elements make this cycle unique and may perhaps render historical references as obsolete. Therefore, we continue to advocate that investors moderate risk exposure, maintain discipline, exhibit prudence, and position themselves in a manner that allows them the comfort and confidence to stay fully invested in what is likely to be a more challenging environment going forward.

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