INVESTMENT COMMENTARY: Q1 2016

April | 2016

Lower for Longer

The first quarter of 2016 offered plenty of volatility and nervousness, but in the end it didn't bring much progress or resolution. The market dropped in January and cascaded lower in early February, with the S&P 500 down as low as -11% year-to-date on February 11th, before embarking on an impressive recovery into March that brought the stock market back to where it was at the start of the year. The stock market is struggling to predict whether the economy will finally produce above-average growth, or will growth remain subpar. While the health of the US economy is the key ingredient for the stock market, several other factors will influence market returns in 2016 – interest rates, currencies, commodities, and the Presidential election, to name just a few.

The prevailing wisdom entering 2016 was that interest rates would continue to trend higher, but that has proven false. U.S. interest rates moved higher in 2015 thanks in large part to the Federal Reserve's long-anticipated rate hike in December, and it was expected that the Fed would embark on a series of rate hikes in an effort to "normalize" interest rates following several years of low rates. We were skeptical; we believed that the US economy was too fragile to support multiple rate hikes, and that the strong dollar would get too strong if the Fed continued to raise rates. In our 2015 year-end commentary we stated: "we think that the US Federal Reserve will not be aggressive in hiking interest rates in 2016… while the Fed is projecting up to 4 rate hikes this year, the market – as indicated by Fed Fund futures – thinks that there will be no more than 2 rate hikes in 2016, and we think that the market is right."

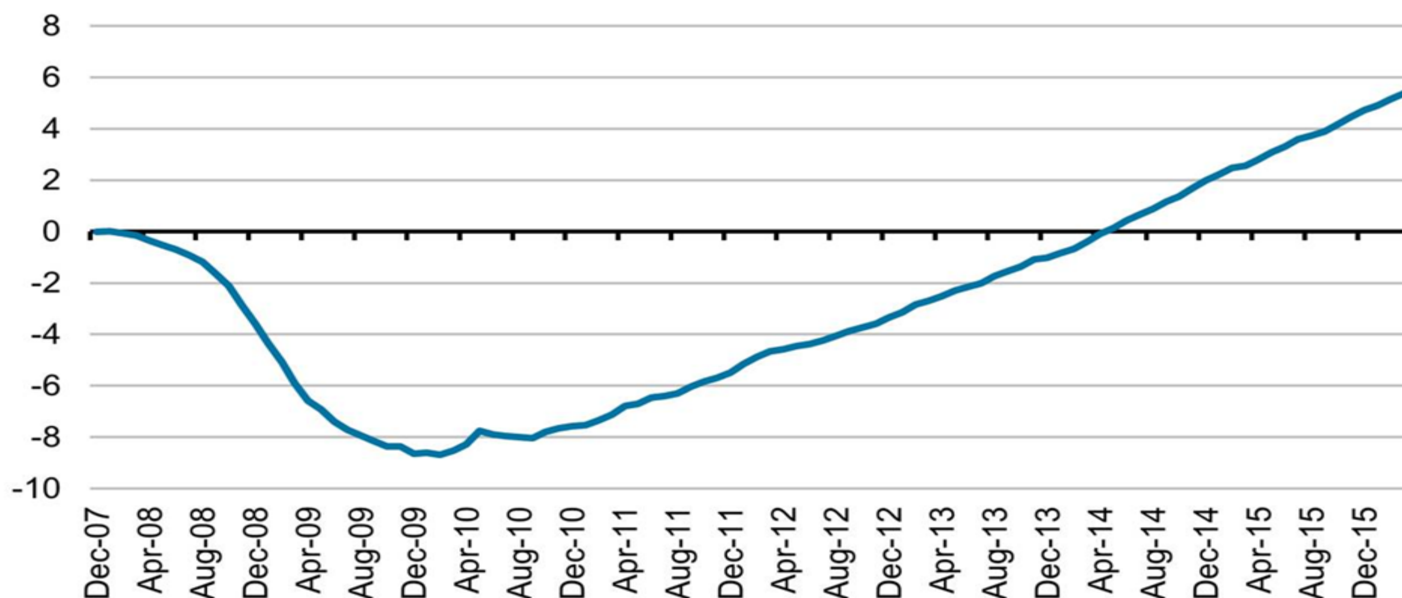
The worst threats that hung over the global economy at the start of the year—higher U.S. interest rates, an oil-price collapse and a Chinese economic slump—have receded. The global economy isn't about to take off, but its miserable first quarter may mark the bottom. Ironically, this improvement has come about precisely via the channel that policy makers sought to de-emphasize, namely monetary policy. Federal Reserve members have been trying to convince global policy makers to emphasize fiscal policy and structural reforms as the way to lift global economic growth. So far, little on that front has happened. The U.S. government is deeply divided, and there is little chance of any policy reforms ahead of the 2016 Presidential election. Elsewhere, while China and Canada have blessed bigger budget deficits, the British government has doubled down on austerity. As a result, central banks have dialed up their activism; the U.S. Federal Reserve is now on hold, while Europe and Japan are experimenting with negative interest rates as a tool to spark economic growth.

Coming in to 2016, the combination of a rising dollar and weaker commodity prices was pressuring both U.S. investment grade and junk-bond markets, and squeezing commodity-dependent emerging markets whose companies carried significant dollar-denominated debt. Because the Chinese Yuan is linked to the dollar, the rising greenback squeezed Chinese exporters. When the People's Bank of China responded by devaluing the Yuan, it triggered expectations of even bigger devaluations and a flood of capital outflows. The dollar peaked in January, while stocks and corporate bonds bottomed out in mid-February. Several factors played a part: Oil prices stabilized on expected supply cuts and investors began exiting a crowded bet on a rising dollar. But the most important factor was the Fed's decision to dial back on its plan to raise interest rates a full percentage point this year. On March 16 it signaled it would raise rates only by half that much, if that. This was driven not by any change in the U.S. economic data but by a desire to pre-empt some of the Fed's newfound fears.

The Federal Reserve has moved to the sidelines for the remainder of 2016. While they are sticking to their "data-dependent" mantra, it appears unlikely to us that they will move again this year. The Federal Reserve has decided that a fragile global economy requires more caution about raising rates.

This benefits the U.S. but even more so China and emerging markets, whose economies remain deeply linked to the fortunes of the dollar, still the world's reserve currency. On the other hand, it makes it even harder for the Eurozone and Japan to get their inflation rates up and puts pressure on them to dial up their monetary medicine.

The U.S. employment picture remains the bright spot, and March was another strong month for hiring. The Labor Department on Friday reported that the economy added a seasonally adjusted 215,000 nonfarm payrolls, putting the U.S. job count 2.8 million higher than a year earlier. The unemployment rate ticked up to 5% from 4.9%, but for a good reason: More people were looking for work and got counted in the denominator.



Indeed, the labor-force participation rate—the share of working-age people who were employed or actively looking for employment—rose to 63% from 62.9%, putting it at its highest level in two years. That counts as evidence that the job market's strength is drawing more people into the labor force and that it may not be as tight as the unemployment figure suggests. Fed Chairwoman Janet Yellen has been arguing that for some time, and now the data are backing her up. How much higher participation can go is an open question. At least some of its decline from the 66% it held in December 2007, when the recession started, is related to structural changes like the baby-boom generation slipping into retirement age and young people continuing their education for longer. But it also is related to the cyclical effect of many people, in the wake of the recession, putting their chances of getting a job so low that they didn't look for one.

Part one of the Fed's dual mandate is to maximize employment, so it has a great interest in finding out exactly where the boundary between the structural and cyclical deterioration in participation lies. This is especially true when inflation still is running well below its 2% target, leaving the other half of its mandate, price stability, unfilled. This isn't to say that, with its target range on overnight rates at a low 0.25% to 0.5%, the Fed doesn't think the job market couldn't handle a bit tighter policy. Its reason for keeping rates on hold at its March meeting, and the reason it likely will keep them steady for the foreseeable future, is that it is wary of what a fragile global environment could do to the U.S. economy.

In a March speech, Janet Yellen emphasized her concerns about global growth and markets' expectations of too-low inflation. "If I am seeing a downgrading of the outlook for global growth…we'd want to get ahead of that development," she said. It would be too strong to call this a new "Fed put," a commitment akin to a financial derivative that protects investors against losses. Nonetheless, the Fed's new posture suggests a greater willingness to risk inflation breaching its 2%

target in order to prevent worse scenarios for the global economy. That's a new—and invaluable—safety net.

The Fed's shift has halted the capital outflows that had pushed emerging-market currencies down. In February, foreign purchases of emerging-market stocks and bonds turned positive for the first time in eight months and in March hit a 21-month high, according to the Institute of International Finance. Indeed, the PBOC has guided the yuan higher since mid-February. Stable commodity prices could signal a near-term recovery for exports and manufacturing production world-wide. Purchasing-manager surveys show that industrial activity around the world accelerated modestly in March, according to J.P. Morgan Chase. In the U.S., it is growing again after five months of contraction. That suggests the first quarter—when the U.S. economy probably grew less than 1% annualized, and the world just 2%—might be the low point for GDP, with stronger growth in the coming quarters.

Provided the U.S. economy can maintain its health, the U.S. stock market should produce decent returns in 2016. The U.S. consumer is in good shape, with a healthy employment market and wages finally starting to increase, and now the weakening U.S. dollar will help exporters compete overseas. U.S. stocks are not expensive and offer good opportunities for long-term appreciation. Interest rates are low and likely to remain lower for longer. The remainder of 2016 will likely contain moments of volatility and uncertainty; investors will be best served by tuning out the noise, instead focusing on maintaining their investments in quality companies.

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