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Live to fight another day

5/22/2016

I'm taking a page out of the Sun Tzu playbook and am conceding the frequent position changes by the Federal Reserve are creating no-win situation for US stock market. We will revert back to a very defensive posture before any substantial damage is done. Simply stated I was wrong in taking the Fed seriously when they implied rate hikes were not on the table till the Fall '16 or 2017. They've changed positions three times in 9 months which does not inspire confidence or trust.

As a rule it's always best to invest according to the current Federal Reserve policy, back in the 1970's Martin Zweig coined the term "Never fight the Fed" and it's as valid today as it was then. The Fed is supposed to be prudent and act in the best interests of the country and not micro manage the economy. Recessions and expansions are part of the natural cycle of economies and micromanaging to stave off recessions creates its own set of potentially devastating repercussions.

In the era before Alan Greenspan we used to have recessions every 4-5 years, now we have them on the order of once every 7-10 years. During the Greenspan era the short term Federal Funds rate became a tool to prop up stock markets during periods of weakness. This became known as the "Greenspan Put".

The Greenspan Put placed a floor underneath the stock market which halted many potential bear markets. By not having a bear market the underlying economic rot continued to grow. The issue with longer expansions is greater and longer abuse of personal corporate debt and credit which can create bear markets of greater magnitude.

IMHO, micromanagement by the Fed has reached the point of absurdity. Last December the Fed signaled that they intended to raise short term interest rates (they can only control short term rates, not long term rates). The result of the ¼ rate hike in January was a decline in the S&P 500 of approximately -15%. But we were prepared for this so we never took the 15% hit. This is not to mention of the August 15% sell off as well which we hedged.

Post-January the Fed realized the mistake in raising rates and provided guidance that pushed out the time horizon for future rates hikes to 2017. The dovish guidance sent the dollar into a free fall which is a tailwind for commodities, Emerging Markets, the economy and stocks in general.

On May 21, 2016 the Fed provided another change in guidance. This is the THIRD policy change in 9 months! This time they telegraphed that there is a strong possibility that they will raise rates in June. Since February the economy has improved and weekly leading indicators came back to life implying there was another up-leg to the economy and the weakness we witnessed was more of a soft patch than a recession. My guess is the Fed now thinks that the improving economy now has the strength to sustain more rate hikes, possibly three more in 2016.

Regardless of the improving economy and the siren call to remain invested with traditional common stocks, the message of the Fed tilts the risk of the S&P 500 heavily in favor of lower prices and correspondingly lower long term interest rates. IMO, for the potential of a 5% gain in stocks we'd risk 30% or more in downside risk. Despite the improving economy the stock market will react very negatively to rate hikes since investors will be looking at the inevitability of a recession.

I need to explain the distinction between short term interest rates which are controlled by the Federal Reserve and long term interest rates which are determined by the marketplace. Should the Fed continue to raise short term rates it will have an opposite effect on long term rates. Think of it like a see-saw. In other words, higher short term rates raise the odds of recession and a slower economy so investors flock to buy long term rates and their purchases they drive the yield lower. This is how Yield Inversion is created when long term rates drop below short term rates and usually signal a recession.

All of this brings us back to the potential for miniscule long term interest rates (think below 1% for a 10-year Treasury bond) in the United States, where the long term secular trend in rates will continue downward and possibly lower and longer than we'd realistically consider. Consider that 40% of the world's sovereign debt is at 0% or lower.

The irony in all of this is that the Federal Reserve is attempting to normalize short term interest rates so that they'll have some ammunition to fight a future recession and in due course they create the recession.

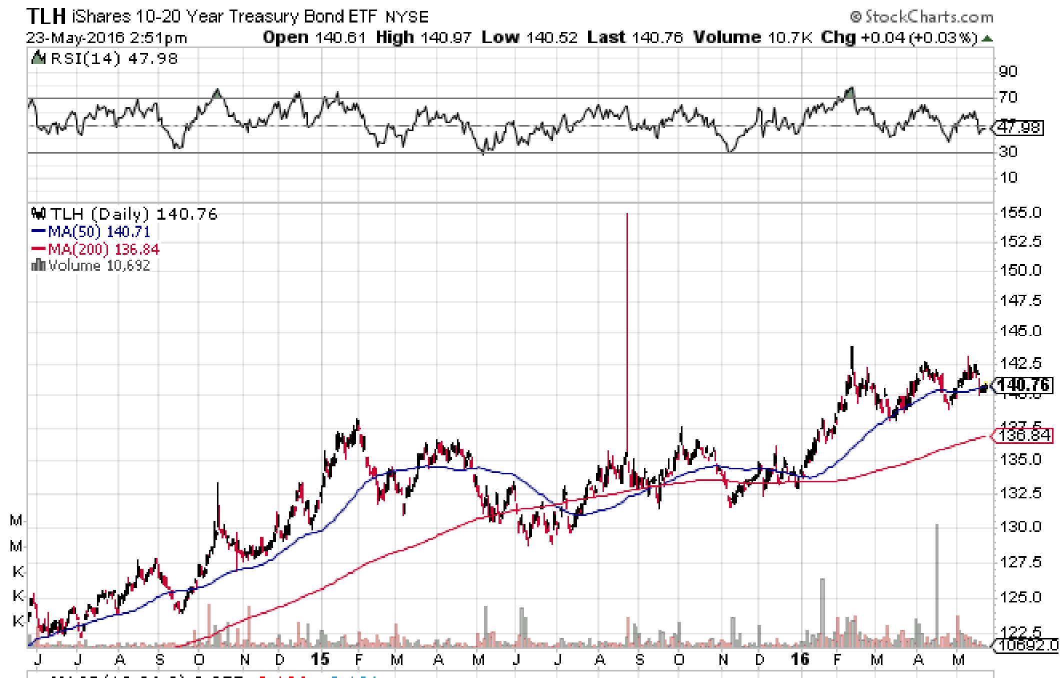
<u>What won't be working in this environment?</u>

Common stocks including just about every small cap stock and NASDAQ stock (except Utilities and other interest rate sensitive securities).

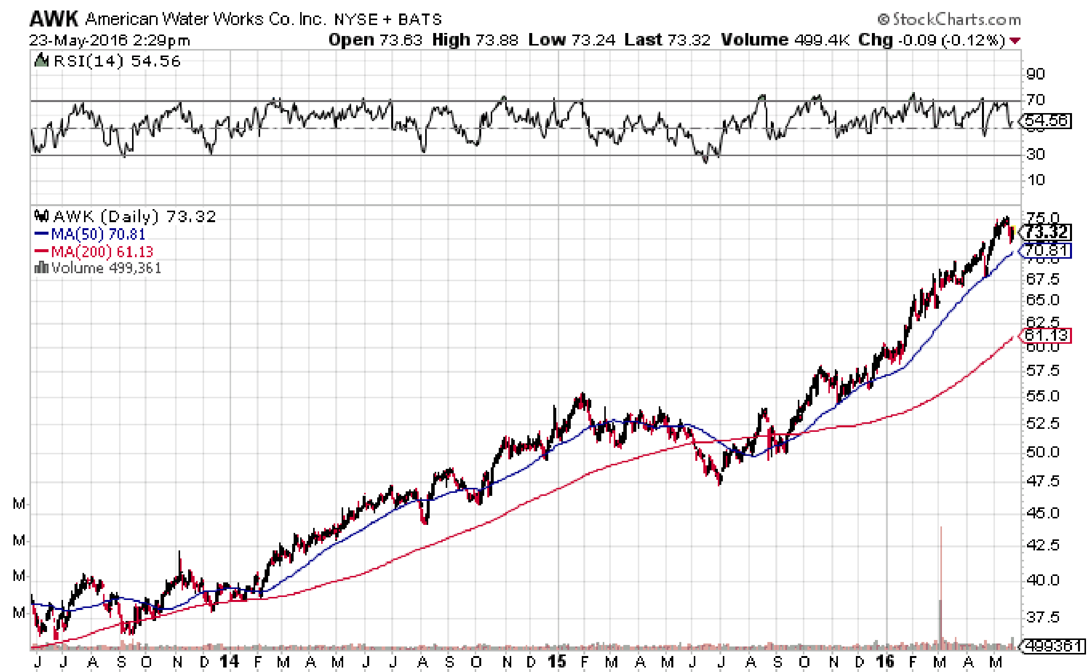
<u>What will work? (Beneficiaries of lower long term interest rates)</u>

1. Long term Treasuries – Last week's Fed minutes regarding raising the Fed funds rate initially had a negative impact on long term bonds like the TLH or TLT. But this should be very short lived. Prices of long term bonds should continue to rise. As signs of recession appear the price gains will accelerate.

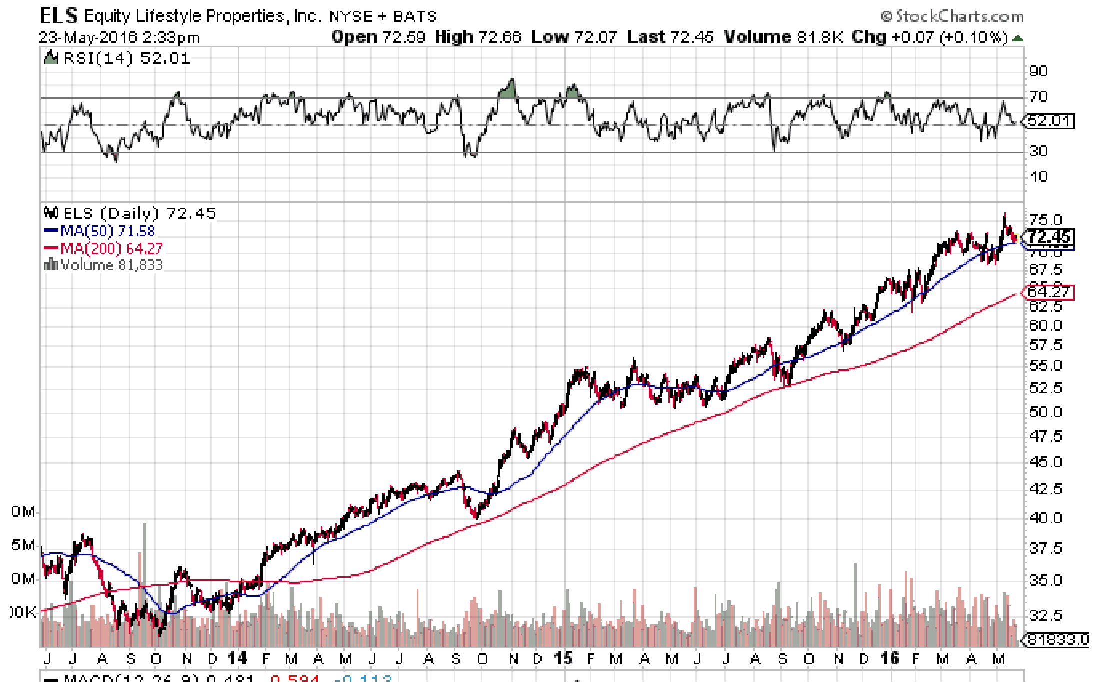
   Ordinarily, I'd be concerned about the chart of the TLH (10-20 year Treasury) as it looks like there is a topping pattern in place. With the Fed hiking short term rates I would expect the rally to continue.

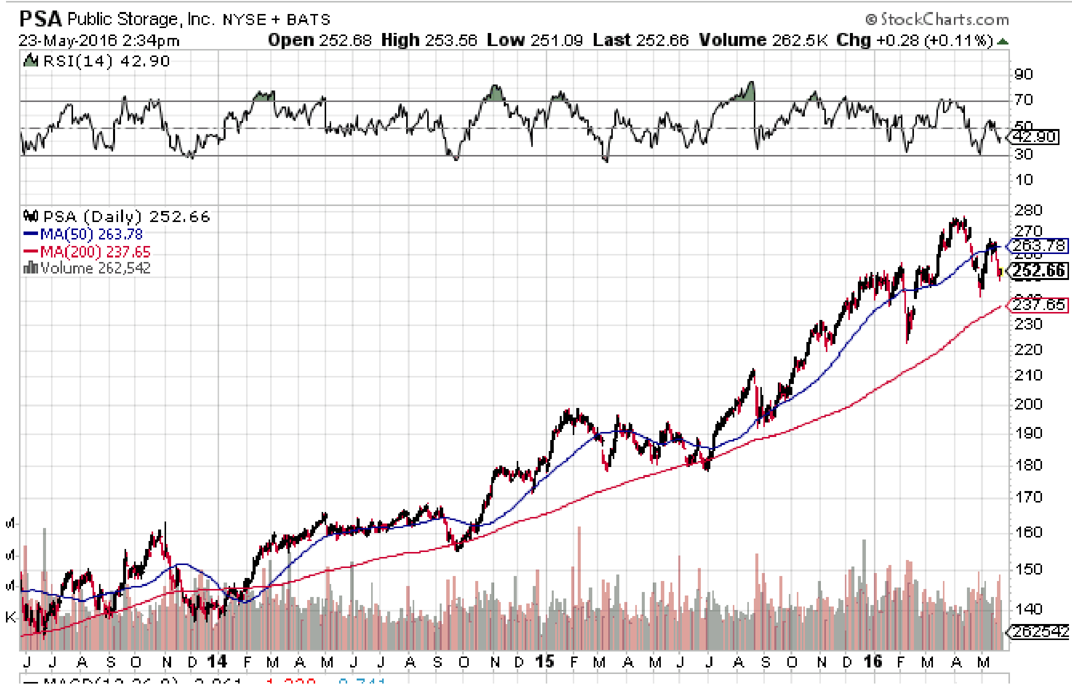


2. Utility stocks – Utility stocks tend to move with long term interest rates. The underlying business is extremely stable thus not cyclical and they pay a decent dividend. Our favorite is American Water Works.

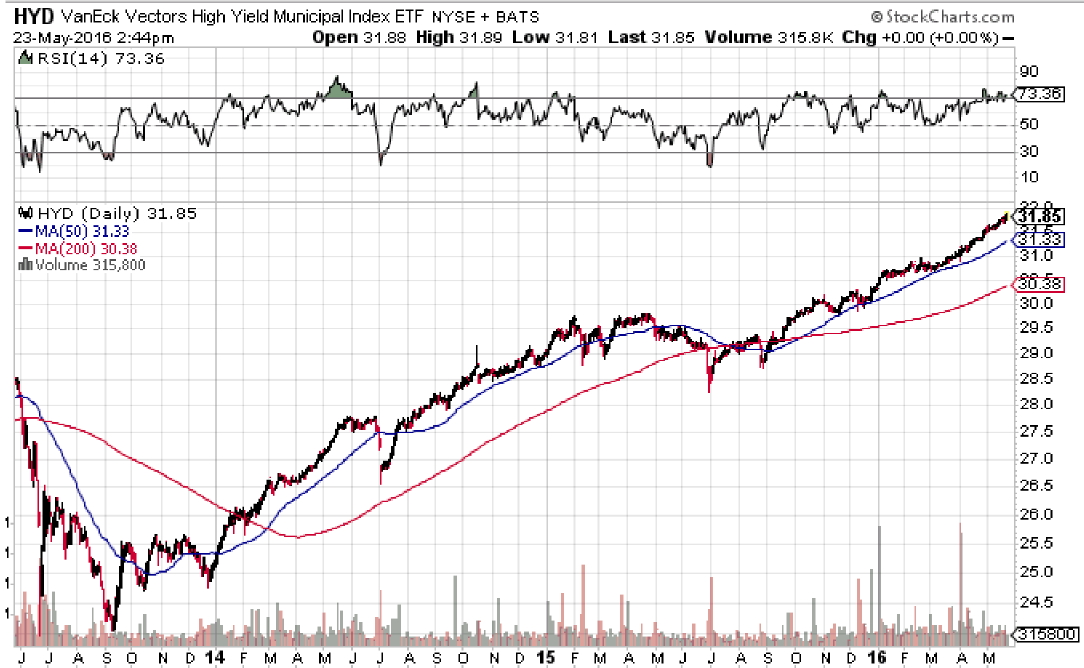


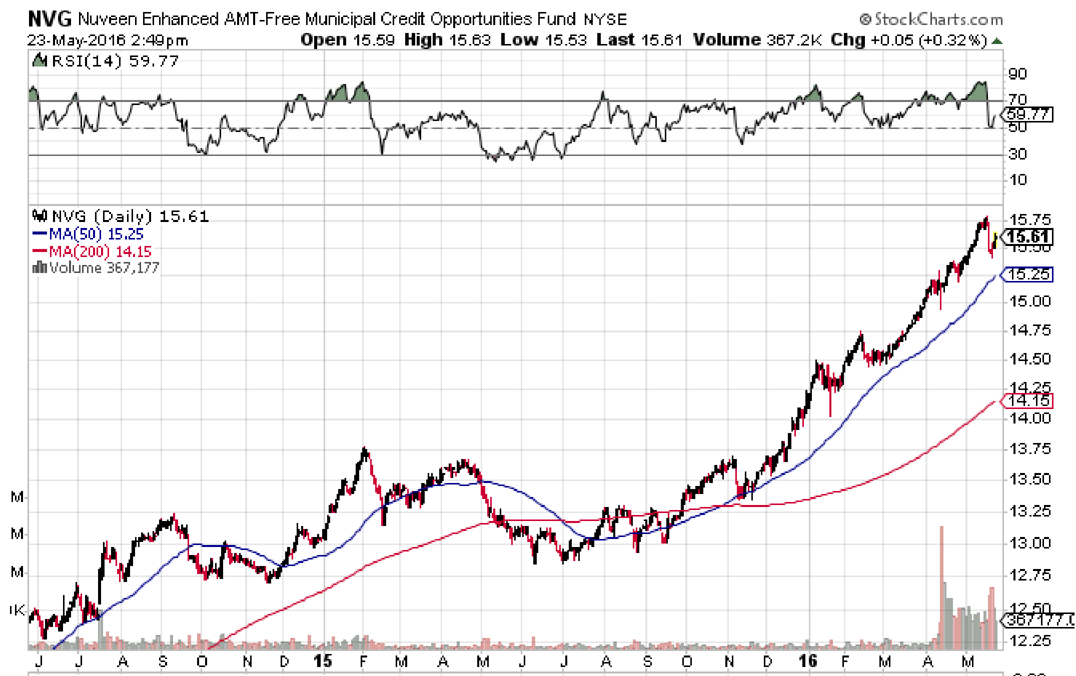
3. Real Estate Investment Trusts (REIT's) – like Utility stocks REIT's tend to move with long term interest rates. We have a few favorites that are being placed in portfolios. Here are two:





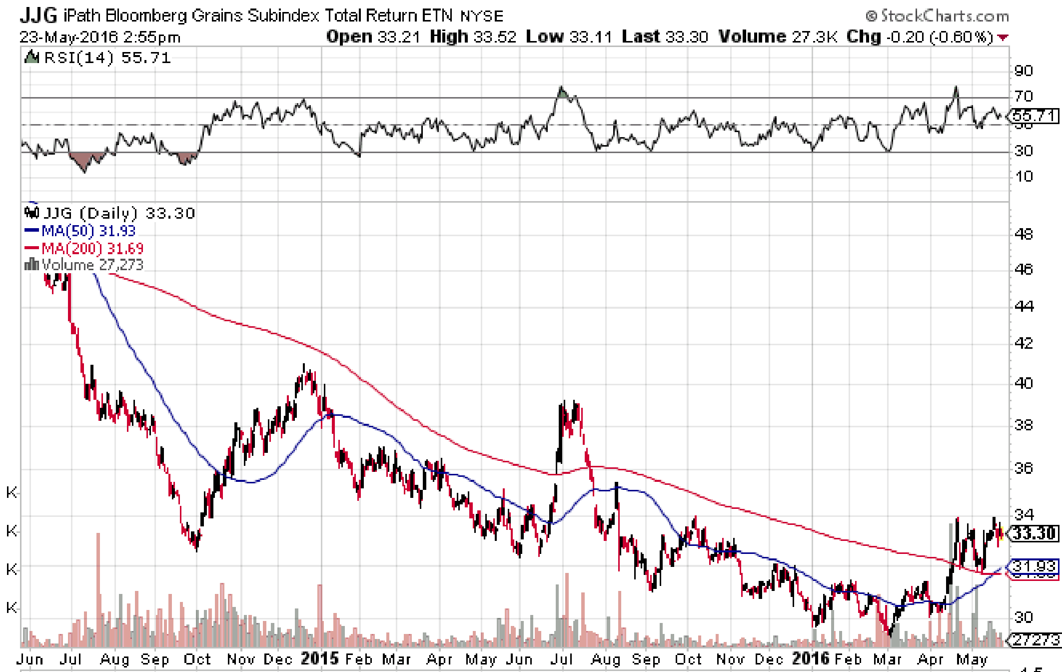
4. Municipal Bonds – At present we are using two Municipals but will add more opportunistically. Even though HYD yields 4.58 and NVG yields 5.9% the yields are attractive for both taxable and non-taxable accounts. I would expect buying pressure to continue.





Commodities – Grains should get the benefit of the doubt as they show no substantial weakness. These are traditionally strong performers in the late stages of an economic cycle as inflation picks up.

Grain (JJG) charts continue to look positive and have held up well given that the dollar has rallied. I am not inclined to sell as we may be at the initial period of a major rally. The JGG is a composite of corn, wheat and soybeans.



Soybeans (SOYB) have been the star so far in the Grain complex rally. SOYB has pulled back a bit but all signs remain positive.

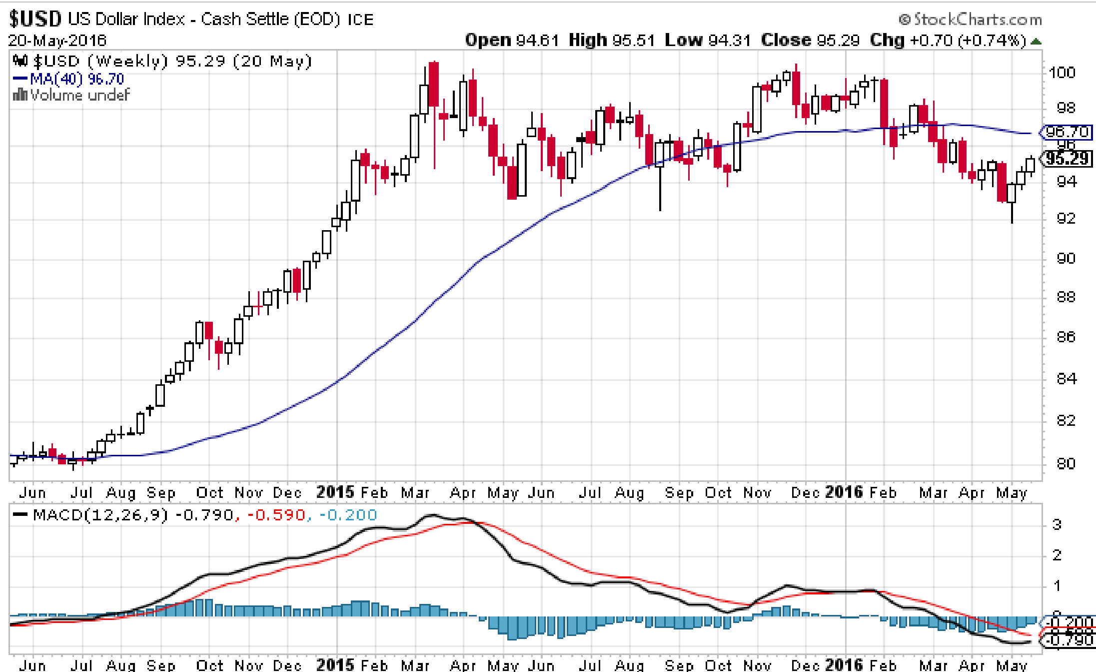
Central Fund of Canada / Gold – CEF

CEF continues to look good as well as this is a hedge against currency manipulation and a weaker dollar. Continue to hold.

The US Dollar (the tail that wags the dog)

The USD has been in a downtrend since November 2015 but it really peaked in terms of velocity in April 2015. A rising USD hurts virtually everyone as it stifles US industrial and multinationals as well as Emerging Markets.

The USD remains below its 40 week moving average so based on this the long term perspective is bearish. However, with the Fed reversing course to raise short term rates the USD could continue to rally until the tipping point of recession.



Summary: Error free investing is impossible and the difference between poor and great investors usually comes down to how quickly you realize your wrong and keeping losses small. In his career George Soros had just a 55% win rate.

I believe it's a fool's errand to wait until June *hoping and wishing* that they don't raise rates but it's just not worth the risk. Even if they don't bump rates in June, we'd be looking at a rate hike in August or September and any new traction gained by the economy would probably never materialize for investors as the Fed would squash any rally with rate hikes.

This does mean that the very strong secular trend in lower rates will continue into the next year. Securities like utilities, mortgage etf's and REIT's which move with interest rates should continue to see strength.

Brad Pappas
5/22/16

Disclosures

Long all securities mentioned.

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