September 25, 2015

THE VOLATILITY OF COIN TOSSES.

- The FOMC decided to delay raising the Federal Funds rate at its September 17th meeting citing, among other things, financial market volatility. However, according to metrics from the Chicago Board Options Exchange Volatility Index (the VIX), volatility is only up significantly from what we grew used to over the last year (which was abnormally low). The historical average of the VIX is 19.8, and it closed at only 21.4 on the 17th.
- Financial markets did not react well to the FOMC's communication after its September 17th meeting, and volatility is likely to increase as markets continue to grow uncertain about the Fed's intentions.
- The FOMC made it clear that the majority of voting members expect that a rate hike would be appropriate in 2015.
- A week after the FOMC meeting, on September 24th, Fed Chair Janet Yellen used a speech to make progress in reducing some of the uncertainty surrounding the future path of monetary policy.

It seemed like pretty much a coin toss at the September meeting as to whether or not the Federal Open Market Committee (FOMC) would raise the Federal Funds interest rate at that time. Despite the fact that whether it happened in September, December, or early 2016, that it really didn't matter to the economy, there was an inordinate amount of media attention on the FOMC meeting. It didn't matter economically because the pace and magnitude of the rate hikes (assuming it would be a process and not a singular event) matters significantly more than the starting date. But, admittedly, it did matter from the standpoint of media attention because this would have been the first rate hike since June 2004.

I would argue that a hike, or not a hike, did not cause the stock market to sell off. The stock market is more interested in certainty than timing.

We did learn from the press conference following the meeting that the Fed is seemingly no longer a two-mandate body (written only somewhat sarcastically). The Fed's mandates are US growth and inflation, but there was a list of reasons the Fed used regarding delaying a hike - the dollar's strength, stock market volatility, emerging market economic growth, commodity prices. Given this list of reasons, Fed Chair Janet Yellen and almost every other FOMC member voted in favor of status quo in regard to maintaining the current range for the rate (there was one dissent that advised for a 25-basis point increase).

What was not considered to be a coin toss was the language from the Fed IF they decided not to raise rates. There was a growing consensus that if the Fed didn't raise rates at their last meeting, they'd all but outright say "it's coming next meeting; really. We mean it. Get ready for it." Instead of such hawkish commentary, the FOMC's statements were surprisingly dovish. The Fed expressed little

concern about the US economy, but it was clear that they decided to emphasize risk management, as they did express concerns over volatility in financial markets (Which is ridiculous given that volatility, as measured by the Chicago Board Of Options Exchange's VIX index, is about average for the last couple decades; it's only up just over the last year), global financial developments (with a nod to declining economic growth rates in emerging markets), a stronger US dollar in expectation of a rate hike, and, in particular, too low US inflation.
In June, the Fed projected that inflation would reach its target of two percent inflation growth in 2017, but in the September meeting, underscoring the damage done to prices in the commodity markets, especially oil, they moved their forecast to 2018. But outside of inflation, the US story seems to justify a rate hike sometime still in 2015 (likely in the December meeting). At 5.1%, the unemployment rate is lower than when the Fed last raised rates in June 2004. And the year-over-year employment growth rate as of the last employment report was stronger than June 2004 (2% now versus 1.2% in June 2004). Sure, we could pick this data point or that data point to argue for or against a rate hike. But the point is you'd really have to argue the point because; at the very least, it's close. And what does that mean? US growth is good and getting better.

Our view is that the Fed won't necessarily wait for inflation to be above its two percent target. We believe that they put a premium on risk and used volatility in the financial markets and weakness in foreign economies as two non-mandated reasons that they could later walk away from should they see any improvements and/or just feel as if we, the collective global economic citizenry, could handle a rate hike. The specific statement to which we refer from the FOMC's statement is "Recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." That sentence allowed them to give reasons that affected their mandate of US growth and inflation, but without actually saying those were the reasons. We know, it sounds like a bit of double-talk. The point is that the Fed can, and likely will, react to inflation expectations and not merely calculated inflation – i.e. the Fed can move before the inflation rate hits its target.

So, in part, here's a good argument why the Fed should have moved now versus a couple or few months from now. First, regarding creating an economic headwind, the math is minimal. As stated above, it's more about the path and the magnitude than the start date. A lone quarter-point hike in September, as opposed to months later, would have meant that both GDP growth and employment would have translated into something like one-tenth of a percent lower in 2016. Second, the unemployment rate is falling steadily and, as job openings are at a record high, the US economy is expected to be at full employment by summer 2016. Third, the Federal Reserve spent a lot of time arguing that a pause in hiking rates was warranted because of volatility in financial markets. But if that is a legitimate concern of the Fed, they likely gain nothing by waiting.

In fact, with each subsequent FOMC meeting that passes and the normalization of rates are delayed, the volatility could become greater. The market wants clarity. And not only has the Fed removed clarity, but financial markets tend to get more, not less, volatile in the weeks ahead of rate hikes. The uncertainty of their guidance could keep the horizon unclear straight through to their October meeting, keeping financial markets volatile, and forcing a further delay in hiking rates. Taking them at their word, if the volatility continues to exist, the Fed will have to see growth in US sales and inflation in a short period of time to support the fact that the majority of FOMC participants do expect a start of the normalization cycle would be appropriate in 2015. Their next meeting is October 28th, and a rate hike then seems unlikely since the factors that delayed the Fed's hike are unlikely to improve appreciably over that short period. And even if there are improvements, the committee may not have enough data at that time to properly evaluate, given the lag in aggregating information.

Nonetheless, we should expect a rate hike this year, likely at the December 16 meeting. Thirteen of 17 FOMC members argued that it expects this to be appropriate. Although the majority of members expect a rate hike this year, their median rate of projection for the federal funds rate was reduced somewhat in this past meeting to 1.375% at year-end 2016, down from 1.625%, and down to 2.625% from 2.875% for year-end 2017. Clearly the expected path of rate hikes could be considered slow, which tends to be more favorable for equity prices than a faster pace.

Also healthy for equity prices is the outsized amount of pessimism currently built into the stock market. As of September 23rd, according to the Investors Intelligence US Advisor's Sentiment report, the number of bears in the market was 30.2% (compared to 26.0 bulls). This was the highest level of bears since late 2011 as fears of a global slowdown had investors selling stocks. This is a contrarian indicator, where the outsized amount of pessimism argues that most people who want to sell stocks have sold stocks, leaving the downside to be limited from here.

On the subject of global recessions, as you gather a number of leading economic indicators meant to tell the story of a global slowdown, those indicators are beginning to tilt more and more toward that possibility. But, even if a global recession does happen (or is happening), most of the damage to US equity markets has likely already been realized. It is no surprise that equity prices tend to perform worse going into a global recession. But when the US did not accompany the global economy into recession, the impact on prices was far less. And the indicators just do not argue that the US economy is close to recession. In the stock market, there are far fewer statistical samples than we'd generally like to have, but going back to 1987 there have been three cases where the US avoided slipping into a global recession: 2012, 1998, and 1995. Of course each instance saw a correction during or around the time of global recession, but the US market was always higher by the end of the economic downturn. The average correction was 13.6%, close to the 13.1% decline we saw from the May high to the August 24 low. Assuming that we actually do experience a global recession which does not include a contraction in the U.S. (seemingly a concern of the Federal Reserve), this suggests that most of the damage to the market has already been done.

Also good for the US stock market is that Federal Reserve Chair Janet Yellen made progress in reducing some of the uncertainty surrounding the future path of monetary policy in a speech she made September 24, a week after the FOMC meeting. The speech supported our expectation that a rate hike on December 16th is the most likely scenario (of course, as oft repeated by the Fed, any move is data dependent but that is our baseline expectation). This speech also gave further support to our expectation that the path of rate hikes will be gradual. In particular, she noted the benefits of allowing the economy to operate beyond full employment for some time. In other words, she prefers to allow the economy to run hot to put upward pressure on inflation and help return it to the 2% target more quickly.

Bottom Line

We expect the FOMC to raise the federal funds rate at their December 16th meeting. The expected path of rate hikes should be slow, which tends to be more favorable for equity prices than a faster pace.

Also healthy for equity prices is the outsized amount of pessimism currently built into the stock market. The market is hosting the highest level of bears since late 2011 as fears of a global slowdown had investors selling stocks. This is a contrarian indicator, where the outsized amount of pessimism argues that most people who want to sell stocks have sold stocks, leaving the downside to be limited from here.

On the subject of a global slowdown, this was in part a reason the Fed gave in delaying a rate hike at their most recent meeting. As you gather a number of leading economic indicators meant to tell the story of a global slowdown, those indicators are beginning to tilt more and more toward that possibility. But, even if a global recession does happen (or is happening), most of the damage of US equity markets has likely already been realized. For the US economy specifically, the indicators just do not argue that the US economy is close to recession. In past global slowdowns that did not also include a US recession, the US stock market did correct in sympathy an average of 13.6%. The correction we saw from the May high to the August 24 low exceeded thirteen percent, which argues that most of the damage to the market has already been done.