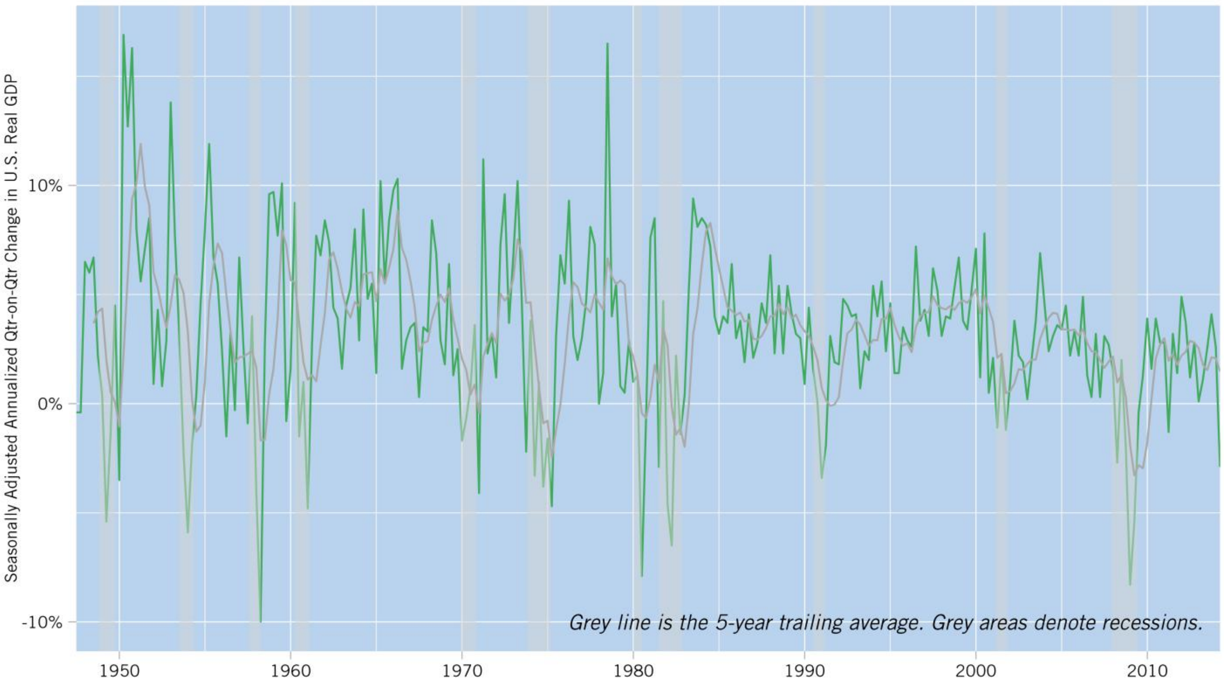
Innealta CAPITAL

COMMENTARY: JULY 1, 2014

HIGH-STAKES OPTIMISM

Early last week, the U.S. Bureau of Economic Analysis offered its final assessment of first-quarter GDP. After having initially thought economic activity rose by 0.1% in Q1, the second "preliminary" estimate was lowered in late May to a decline of 1.0%. The "final" tally was a whopping decline of 2.9%. For the record, a quarter with that level of a decline always has overlapped with a recession. Our point is not to suggest that we believe we either are inside a recession or that one is imminent. Rather, the greater wonder is over the durability of the optimist narrative, despite so many years now of ongoing disappointment and more recent trends that should otherwise warrant increased caution.

Figure 1: U.S. GDP Growth



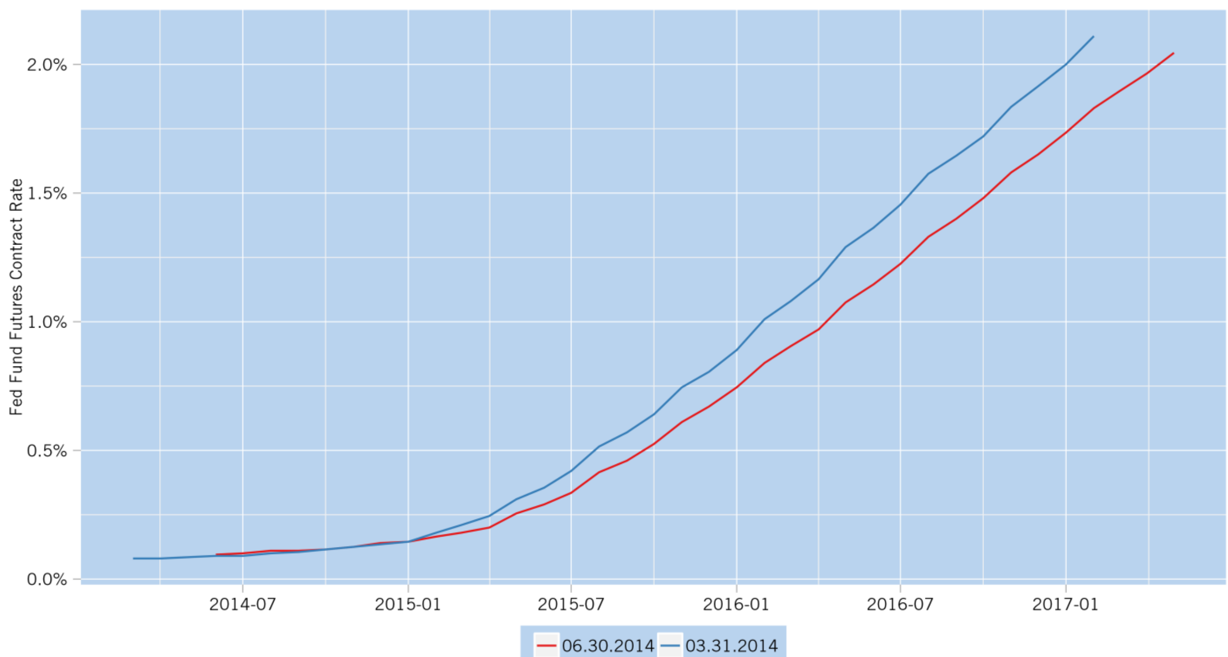
From 06.30.47 to 03.31.14. SOURCE: Innealta Capital using data from the Bureau of Economic Analysis via Bloomberg

Putting aside excuses for the very weak quarter, most of which seem to focus on a dramatic recalc of healthcare spending (so convenient for the "nothing to see here" crowd, given the broader healthcare drama), even a glance at Figure 1 suggests this much: macroeconomic growth in the United States has for the most part disappointed coming out of this latest recession and, in fact, is beginning to slow again. Not surprisingly, then, the reaction in bond markets was positive to the idea that yields would remain lower for longer as a result of the ongoing paucity of reasons to expect stronger forthcoming growth.

Whether the economy is more rubber ball or dead cat is becoming ever more difficult to discern from the increasing volatility of reported metrics, though we'll admit to finding more reasonable support for the latter. Either way, recent trends somewhat fly in the face of expectations presently promulgated by officials at the U.S. Federal Reserve suggesting rates may need to rise sooner and more rapidly than expectations signaled by the bond market and the broader economy. As we noted in our commentary last month, though the range of expectations is wide, the bulk of Fed officials foresee the first increase in the target federal funds rate from its current range of 0% to 0.25% in 2015. And the median rate they expect to see is between 1% and 1.25% by the end of next year. That's actually up from a median of 1% from the chart we showed last month, as the June Fed projections have since become available. A similar bump was seen in expectations for the target fed funds rate at the end of 2016, now showing a median 2.5%, up from 2.25% in the April projections.

As noted earlier, those ranges remain well above expectations currently expressed by the bond market. Charted in Figure 2, interest rate futures presently submit a year-end value of 0.7% for 2015 and nearer to 1.70% for 2016. And those levels are actually down from market expectations of just three months ago. As economic activity has waned, so have expectations for interest rates over the next several years.

Figure 2: Fed Funds Futures Rates



As of 06.30.14. SOURCE: Bloomberg

Seems to us a substantial disconnect. Presumably, the Fed might be overestimating macroeconomic health going forward, and as such might have set too high of an expectation for rates in the medium term. In this case, since the markets might be more correct, downward shifts in Fed thinking might have not so grand an impact. But, the process by which the two sides come to meet via the passage of time can prove tumultuous. For example, both sides might be underestimating the potential impact of rising inflation, perhaps spurred on by unexpectedly stronger gains in employment. The Fed might have to lift rates sooner and higher than even they expect, a surprise that could send risk markets reeling. Indeed, comments to that effect from Federal Reserve Bank of St. Louis President James Bullard caused a few wobbles in fixed income and equity markets in late June. Mr. Bullard believes markets and his Fed peers are actually underestimating the strength of the U.S. economy, with similar potential impact on the timing of interest rate hikes.

OUR TAKE AND PORTFOLIO POSITIONING

Readers should note that, as suggested earlier, we do not share Mr. Bullard's view that we are in for stronger-than-expected growth. Rather, we believe the uncertainty caused by the Fed's ongoing withdrawal of quantitative easing, the still very weak macroeconomic backdrop and the generally excessive valuations among risk markets warrant an approach that incorporates a broad set of potential outcomes that necessitate a generally conservative stance.

Most plausible progressions from here, in our view, involve generally increasing volatility among risk markets, in no small part driven by greater investor uncertainty in regard to the Fed's post-taper management of its now grossly bloated balance sheet. We also expect rates to generally rise, and while our prognosis is for a relatively slow uptrend, we have to be prepared for a not-unlikely scenario in which the rise is more rapid. Hence the relatively light exposure to duration, as compared to the wider fixed income market. Even so, we have found shorter-duration exposures that can enhance portfolio yield among both dollar- and non-dollar-denominated bonds. Still, the Investment Committee retains a heightened sensitivity to credit risk, given the potential for spreads to gap out on the heels of any dislocation related to inconsistencies in expectations for rates going forward and even the potential for continued slowing in macroeconomic growth.

Meantime, broad-market equity valuations keep us very selective in our beta exposures, with potential opportunities more prevalent among the emerging-market set, though we have of late seen some developed markets becoming more attractive. Recent trades among beta exposures within the Rotation Portfolio reflect these observations.

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