Innealta
CAPITAL

COMMENTARY: JUNE 3, 2014

AS THE MARKETS DRIFT

After the S&P 500's 2013 performance, a tally that arguably surprised even many of the more vehement U.S. stock market bulls, year-to-date 2014 has proved a bit of a sleeper. At worst described as choppy, daily moves so far have proved tame, with measures of volatility bouncing along the bottom of historical registers.

Through more than $4.5 trillion in purchases of assets ranging from T-bills to mortgage-backed securities, the U.S. Federal Reserve has wrought rare stillness in capital markets. We might otherwise be inclined to view the relative calm as warranting expanded exposure to beta. On the contrary, we do not expect such serenity for long and therefore remain relatively conservatively positioned in our portfolios, prepared to take advantage of any opportunities that arise with what we expect will prove more tumultuous markets as the Fed continues to unwind its unprecedented accommodation.

AMONG OUR CONCERNS

There are several reasons we retain a relatively conservative stance in our portfolios. First, Federal Reserve policies have had a tremendously distortionary effect on asset prices. By driving benchmark rates down, investors have been forced to search for yield elsewhere, turning to increasingly risky exposures to find it. As prices within these asset classes have been bid up, valuations have soared and yields have shrunk, meaning weaker expected returns, despite the added risk. In sum, capital markets are juiced up on systemic risk that is not being factored into prices.

Secondly, our belief is that the Fed has QE'd itself into a corner. Tapering is a mere reduction in purchases, not an unwinding of the now enormous portfolio. As we will discuss in further detail in a moment, even as the taper thus continues we are left only to wonder what the Fed intends to do with this balance sheet. The potential repercussions of all of the various choices the Fed may make are just as enormous as the balance sheet itself.

FED FOSTERS UNCERTAINTY

As we near the end of tapering, now generally expected to conclude this October, attention has narrowed to the still very unclear manners through which the Fed will return its balance sheet to more fitting historical standards. No small wonder, then, that late-May market chatter was all about the Fed's attention to its path to 'normalcy'. To be clear, that path remains highly uncertain. And that uncertainty is bound to begin to be reflected in the capital markets.

A quote on these matters from the minutes from the Board's April meeting is telling:

> "A staff presentation outlined several approaches to raising short-term interest rates when it becomes appropriate to do so, and to controlling the level of short-term interest rates once they are above the effective lower bound, during a period when the Federal Reserve will have a very large balance sheet. The approaches differed in terms of the combination of policy tools that might be used to accomplish those objectives. In addition to the rate of interest paid on excess reserve balances, the tools considered included fixed-rate overnight reverse repurchase (ON RRP) operations, term reverse repurchase agreements, and the Term Deposit

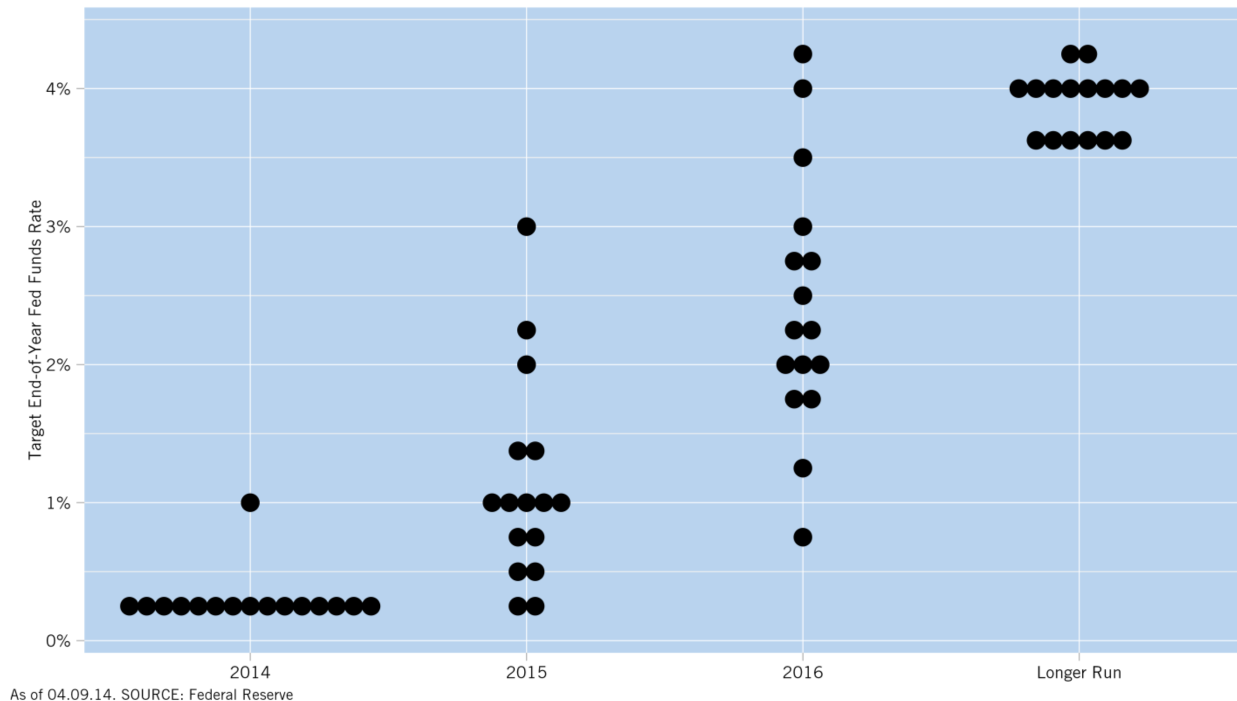
> Facility (TDF). The staff presentation discussed the potential implications of each approach for financial intermediation and financial markets, including the federal funds market, and the possible implications for financial stability."

The Fed clearly has its plate full. Not only are the options many in setting a "prudent path" to normalcy, and the intention to give more than a few a try to see what works, some of the methods envisioned have never been exercised at all, let alone at such scale. Also taken from the minutes:

> "Because the Federal Reserve has not previously tightened the stance of policy while holding a large balance sheet, most participants judged that the Committee should consider a range of options and be prepared to adjust the mix of its policy tools as warranted. Participants generally favored the further testing of various tools, including the TDF, to better assess their operational readiness and effectiveness."

So much for predictability. To get to normalcy, the Fed must both reduce its balance sheet by a massive amount and bring rates back to levels that befit a healthy economy. Any such efforts will depend on sufficiently positive progress on the macroeconomic front. We have yet to see much that could be deemed healthy, at least within the contexts of either past recoveries or otherwise better times. On the flipside, the Fed must be wary of having stayed at the table too long. Indeed, there is a faction of members who believe accommodation must be removed sooner for reasons having more to do with the potentially destabilizing effects of past and present policy than they do with the ongoing improvement in the broader economy. No doubt, the perspectives are many and varied among those members. As just one example of this breadth of opinion, Figure 1 shows a wide range of views on the evolution of rates from the present among the 16 members of the Federal Reserve Board.

Figure 1: Wide Range of Thoughts on the "Appropriate Pace of Policy Firming"



As of 04.09.14. SOURCE: Federal Reserve

FRIGHTENING, THE FED

With central banks leveraged to the gills, their ability to back stop the financial system is at an all-time low. Meantime, they must take great care in their efforts to manage rates as they proceed to normality. Unless the economy finds more stable ground for growth, household budget constraints will not tolerate rising rates (i.e. it will reduce the ability to spend on other consumer goods). Already we are seeing signs of many being priced out of even moderate housing. On the flipside, a return to more normal growth in our view will put upward pressure on wage rates, fostering broader inflation and forcing the Fed to move more quickly.

Most Fed officials seem content to bide time, hoping no serious catalyst rocks the boat of investor confidence and risk tolerance. Not standing entirely still, however, Team Yellen is creatively arming itself with more creative policy instruments. Regardless of its composition, the course the Fed takes from here may be prone to error and bouts of market terror. As that path remains dark and cumbersome, we expect capital market volatility to increase.

Our tactical strategies may be particularly well suited to adapt to just such an investment environment as it evolves. The Investment Committee continues to defensively position our portfolios and take advantage of periods of volatility—Fed-induced and otherwise. Recent bouts of investor alarm…Putin's aggression in Ukraine, for example…have proved mere cracks in confidence, easily patched. At some point such cracks will prove too deep and too many. We believe that, given our solidly conservative, yet still opportunistic, foundation in fixed income, in combination with our enhanced flexibility to add beta exposures as their potential risk-relative rewards warrant, our portfolios are uniquely designed to participate in markets of all sorts as the Fed stumbles along its path to normalcy.

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