Innealta
CAPITAL

COMMENTARY: APRIL 1, 2015

SLOW DANCE TO NORMAL

What once was unconventional is now orthodox, as QE lands on the European continent. But what's to be done when central banks are at war? Volatility in currency markets is on an uptrend, as investors react to conflicting policies. Or at least their expectations for the execution of ongoing policy and the impacts thereof. And those expectations, themselves, are bouncing about as market participants seemingly spend ever more time parsing language than they do data. Makes some sense, we suppose, as most will honestly remain hard-pressed to find empirical evidence that suggests anything more than modestly positive impacts from QE on the broader economy.

Of course, risk-market investors long-since in the aggregate seem to have dropped the notion that reliable empirics were necessary inputs to their valuation work. And the past several years have on rare occasion not offered some small component of positive (if even only weakly so) trends upon which to base their expanded optimism. But, the various bills of an over reliance on rosier-than-possible expectations for the future are coming due. And we continue to believe the consequences of undue reliance on untested (perhaps untestable) central bank policies will be heightened volatility and an eventual rationalization of valuations across the capital markets.

CONFLICTS, BOTH AT HOME AND ABROAD

By the end of this summer, the Federal Reserve may have executed the first increase in its interbank overnight funding target since June 2006. Or it may not have. The jury is still out. But, let's not be too concerned. After all, it's a binary decision, only modestly complicated by its potential timing...

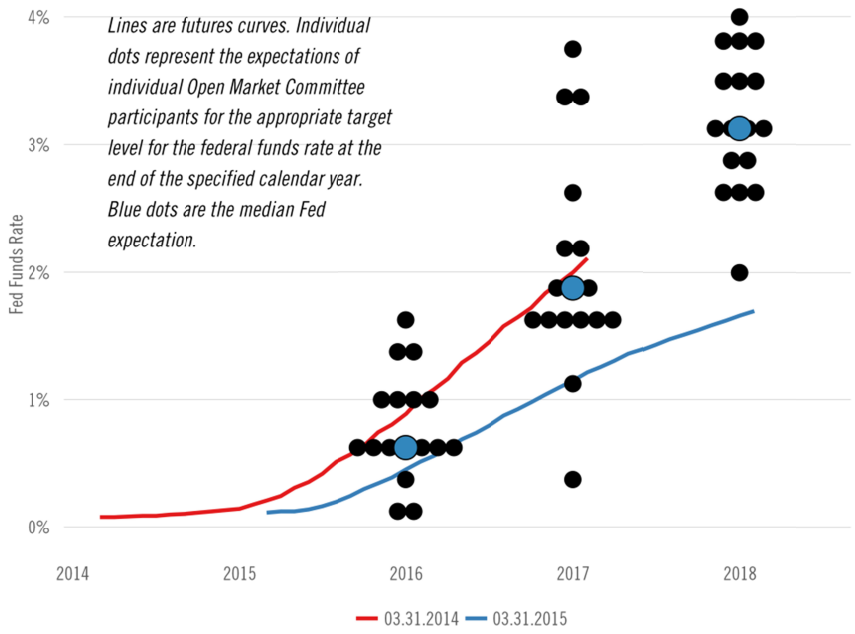
Let's also admit, shall we, that at these levels any potential impact from a liftoff from zero in the fed funds target will prove almost entirely emotional. Of course, we'd argue again that capital markets have long failed to reflect much outside of emotional responses to shifts in monetary policy and an undying belief that the sun'll always come out tomorrow.

Until it happens, the initiation of Fed tightening will remain the talk of the town. Though the futures markets express a medium-term outlook much lower than those of Fed governors (and lower than their own expectations from a year prior), as we see in Figure 1 the expected trend remains upward, with 0.45% now the expectation for year-end 2015. Bets remain heavy for the Fed to be less than patient in waiting to lift the target. Any deviation from those expectations are sure to excite the capital markets.

FIGURE 1

Fed Funds Expectations: Fed Dots and Futures Curves

Fed dots as of 03.18.15.
Futures data as of date noted.
SOURCE: Federal Reserve and Bloomberg



Admittedly, the Fed has proved a constant partner in its slow waltz to normalization. But, any misstep now could wreak havoc on the dance floor. While the homogenously tepid pace of macroeconomic growth has made it rather easy for the Fed to stay in step over the past year, that task is getting harder as more recent data clear a less-obvious path forward.

The Fed has emphasized concerns that the relative interest in global currencies may have swung too far in favor of the dollar. With the 2% inflation target still top-of-mind, the far more relatively valuable greenback will weight domestic prices, pulling that lever in the wrong direction. Further, as non-U.S.-produced goods potentially become more affordable, the trade picture likely will deteriorate, sapping domestic growth. Perhaps more pressing in its potential to undo the "success" the Fed has seen so far, U.S. corporate earnings sourced abroad are under pressure as they are converted back into dollars.

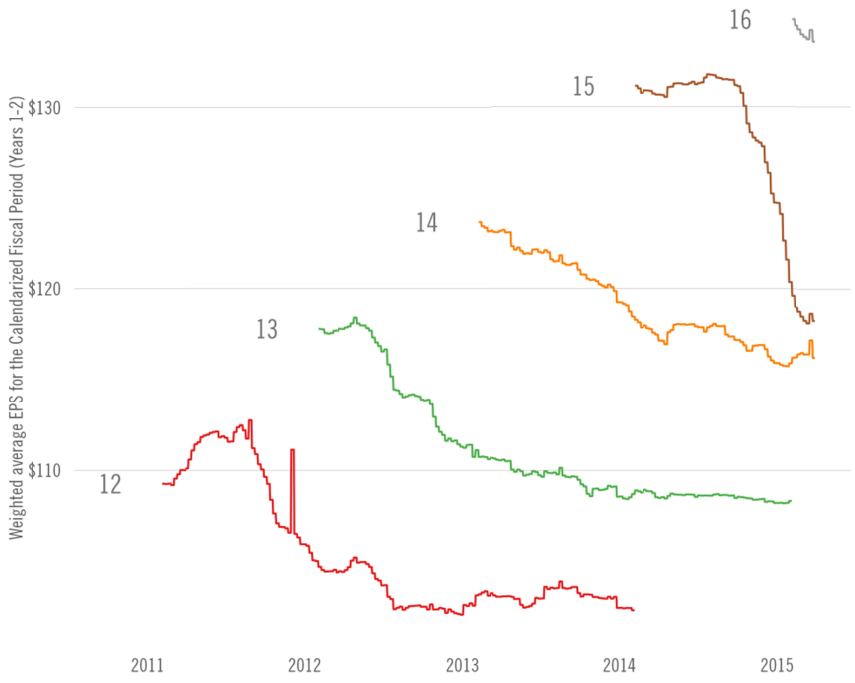
EVEN ANALYSTS AGREE!

As we have noted in the past on these pages, we place little weight on the prognostication of Street analysts. But we think their dramatic change in tune over the past few months is worth charting (see Figure 2). And the shift lower can't all be chalked up to a dramatic decline in the near-term outlook for Energy sector earnings, as, for an example, CEO mentions of concerns over dollar strength have been many. The upshot is that we should expect to see a deterioration in the earnings dynamic across a wide swath of domestic large-cap sectors over the next few quarters at least, further stretching already strained valuations.

FIGURE 2

S&P 500 Consensus Annual Estimate History

From 12.31.85 to 03.31.15.
SOURCE: I/B/E/S via Thomson Reuters



BELOW ZERO, STILL LAND UNKNOWN

As if the Fed decision-making process were our only concern, it's quite interesting that the conversation about sub-zero interest rates so quickly has shifted to, "What's the big deal?" On the contrary, we think the ultimate results of these extraordinary efforts are unknowable. Hopes rest so firmly on QE magic, yet their net effects remain indiscernible. And it's one thing when such powers act in parallel. How now to net out the impacts of divergent policies?

Meantime, global macroeconomic weakness, reflecting broadly weak growth at the regional level, will continue to pressure corporate fundamentals. In addition to the uncertainty related to monetary policy, geopolitical tumult, global currency volatility and the path of oil prices from here will further pressure corporate execs to exercise caution in investments, further compressing near- and medium-term growth.

The Innealta Investment Committee remains vigilant to these risks and others as we press further into 2015. Expanded equity market volatility has created a range of opportunities to add beta to our portfolios in those markets with sufficient fundamental support to warrant the exposures. As much attention is paid to managing the fixed income components of our portfolios to balance additional yield against incremental risk and the desire to maintain flexibility in light of additional potential opportunity.

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