Outlook for December, 2014: "Divergence…"

"Divergence" will be a key word to describe the events for 2014 when all is said and done: Divergence related to policy – both monetary and fiscal policy, divergence with respect to equity performance across the globe and divergence with regard to the role of government in society as well. These trends in the behavior of government, institutions and individuals is likely to create ongoing rifts in financial markets and stability.

Economic data continues to be ***positive*** in the U.S generally: Third quarter gross domestic product (GDP) was revised upward from a previous growth rate of 3.5% to 3.9% on a seasonally adjusted annual rate. In the past two quarters, the economy has grown by 4.25% which marks the strongest reading in more than 10 years. The run rate for fourth quarter (given its emphasis on the Christmas retailing season) will likely continue this trend as consumer spending gets a lift from lower oil prices and rising confidence in the labor market.

The ***U.S. labor market*** gained steam in November as employers added a seasonally adjusted 321,000 jobs during the month. Within the private sector, the strongest gains were in professional and business services (+86k), retail (+50k), health care (+29k) and manufacturing (+28k). In a separate survey, the ***unemployment rate*** held steady at 5.8% with the broadest measure of unemployment, the U-6, dropping to 11.4% from a previous reading of 11.5%. Over the past year, the measure has dropped by a full 2%.

There is no doubt that the ***labor market is improving***, but it appears to be in fits and starts. Still, some indicators like the labor force participation rate, are not where we would deem them to be "healthy". Further, increases in average hourly earnings (+2.1% in the past year) and hours worked remain quite muted implying little wage pressures in the pipeline. Until we see progress in these areas, upside pressure on wages will likely remain subdued.

The Institute for Supply Management's purchasing managers index (or ***PMI***) which is a general barometer for purchasing activity, dropped slightly to 58.7 from 59.0, marking the 18th consecutive month of expansion. Several additional economic indicators we follow support the idea that the U.S. economy might finally (finally!) be gathering steam.

The Federal Open Market Committee of the Federal Reserve decided to leave interest rates unchanged at its last meeting of the year in mid-December. The FOMC Statement accompanying the announcement did leave the ***"considerable time"*** language in place (to describe when rates would start to rise), but also ***"clarified"*** with the phrase ***"the Committee can be patient in beginning to normalize the stance of policy".*** At the press conference after the release of the Statement, Janet Yellen took trouble to explain what she (and her colleagues on the FOMC) meant by "patient" and we gather that this means that rates will not rise for at least the next two FOMC meetings (Talk about long term thinking!)

This brings up another interesting facet on the conduct of policy: Typically, both fiscal and monetary policy were set years ahead of time – so that businesses and consumers had sufficient time horizons to plan for their spending and economic activity. Now, with tax policy lurching from year to year and monetary policy lurching from month to month (since it is now "data dependent"), we are afraid that the ***"short-termism"*** that is so symptomatic of the ills in Washington DC also seems to pervade policy making!

When (not just if), the Fed does decide to increase rates – perhaps sometime in the fall of 2015, it will mark a stark contrast in the direction of monetary policy in the U.S. relative to those in Japan and Europe. In the past couple months we have seen China, Europe, and Japan push liquidity into the banking sector and telegraph that there is more to come.

It is very difficult to gauge ***China's economy*** given its opaque nature. The most recent estimates pegged 2014 growth at around 7.5%, but this might well get revised lower when all the results are in. Policy makers have signaled to markets that growth is slowing and they might be more "flexible" on some of these targets. Clearly, the economy there appears to be slowing, but time will tell whether the authorities are able to ***"engineer" a soft-landing*** given some of the excesses that have built up in the system - especially as it relates to real estate speculation in the larger metropolises like Shanghai and Beijing.

While the European Central Bank's President, Mario ("do whatever it takes") Draghi, has continued hinting at aggressive monetary easing measures, he has yet to bring much forth in that department. The ECB's latest policy meeting deferred any action until early 2015, but Draghi assured the market that quantitative easing is on the table should growth in the Eurozone lag and prices remain stagnant.

The Japanese population re-elected Shinzo Abe in a landslide this past weekend. But, his victory at the hustings was tarnished by the abysmally low turnout – with merely a little over half of those eligible to vote casting their ballots. Nonetheless, a "W is a W", as Derek Jeter the now retired Yankees short-stop (and baseball's ambassador par excellence) would say. It is going to be interesting to see what this means for policy reform going forward.

Currency markets are shifting under the backdrop of divergent monetary policy in the U.S., Japan and Europe. Volatility has increased as market participants are building in rate increases by the Fed over the next twelve to eighteen months. The Euro Dollar strip curve has built in expectations that the Fed Funds Target will rise from its current level to 84bp by late next year (Dec) and then increase to 1.35% by the following summer (June, 2016).

We suspect that this pace of increase is quite aggressive: The last thing that Janet Yellen and her cohorts at the FOMC are going to be accused of is nipping the nascent recovery in the bud. We suspect that the pace of rate hikes is likely to be slower than the consensus is currently building in. In addition, it is not at all clear to us that higher rates necessarily imply a higher currency. In theory, it does, but as we all know, theory and practice often operate in different realms entirely.

The ***steep decline in crude oil prices*** in the past few weeks has been startling: Global oil markets reacted quite negatively to OPEC not lowering their output targets in late November (most OPEC members do "cheat" on their output targets anyway – meaning they over produce). While it initially appeared to be an abundance of supply, it now looks like it is a demand (or lack thereof) issue as well. Nonetheless, we suspect that the sell-off in energy names could well create opportunities for a disciplined long term investor.

The widening in ***high yield spreads*** in response to the decline in crude prices also appears to be an ***over-reaction***: While energy names do form a significant proportion of companies in the high yield index (about 17%), we are not at all sure that a decline in crude prices (even a steep one at that) immediately implies a deterioration in credit quality of all high yield issuers. If anything, lower energy prices ought to ***increase*** margins for the other 83% of the index that does not produce crude oil or natural gas.

Divergence is the act of deviating from a path, practice, or plan. At times it may seem lonely to hold a diversified portfolio when, for the time being, large cap indices dominate midcap and smallcap, and domestic trumps international handily. But we have been here before, and we would counsel patience and long term thinking during these volatile times.

We would like to wish our regular readers a joyous Holiday Season to you and your families!

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