Outlook for March, 2015: "What Patience?"

News wires and analysts were in a tizzy over the Federal Reserve removing the word ***"patient"*** in describing its approach towards raising interest rates in the future at the recently concluded FOMC meeting last week. While it has become quite a parlor game of sorts to guess when the first rate hike is likely to occur, our longer term views on capital allocation, in conjunction with our client's financial goals, are not swayed by such shifts in the posture of a few policy makers, even if it is indeed the Federal Reserve.

The ***US labor market*** continues to improve: The Labor Department's non-farm payroll report pegged a gain of 295,000 jobs in February (on a seasonally adjusted basis) and the unemployment rate fell two-tenths to 5.5% from 5.7% in January. Within the services sector, leisure and hospitality added 66,000 jobs, followed by trade, transportation, and utilities (+62,000) and education and health services (+54,000) for the month. The only segment to contract was mining, which reported a net loss of 8,000 jobs for February.

These job gains mark ***one of the strongest stretches*** of job growth in the past two decades; quality, however, is much to be desired. The U-6 measure - a more robust barometer of the unemployed and takes into account job quality from the standpoint of workers involuntarily working part-time even though they want full-time jobs - stood at a still high 11.0% in February, down three tenths from January's reading of 11.3%.

As we've mentioned before, ***wage growth remains subdued*** for much of the economy. Average hourly earnings were up a mere 2.0% in the past year. The move by Wal-Mart (arguably one of the largest employers in the country) to pay even its part-time workers at $10.00 per hour – well above the required minimum wage, might be starting a trend in higher wages, but we shall see if there is much follow through on this. In fact, the latest job openings and labor turnover survey ***("JOLTS")*** - a separate survey - reported roughly 5 million job openings, representing the highest level since January 2001, an indication that employers are having a tough time finding qualified workers.

The Institute for Supply Management's purchasing managers index showed a manufacturing sector that is expanding, but at a slower clip than the previous two months, coming in at 52.9 in February. Notably, the ***labor strikes at West Coast ports and weather disruptions*** have caused short-term dislocations, but aren't likely to persist. The bigger long-term risk is that the stronger dollar will likely impede international trade – particularly making US exports less competitive relative to those of Europe and Japan.

So far this year, ***retail sales have lagged expectations***, as predictions for increased consumer spending due to lower oil prices have yet to come to fruition (although we may yet be in the early innings). In February, retail sales declined by 0.6% (m/m; y/y: 1.7%), following on the heels of declines in January and December. Instead of presumably spending the "savings" from the gasoline pump, consumers appear to be paying down debt.

While the consensus expectations are for the Fed to begin raising rates later this year, the real question is not if, but when and by how much. Unfortunately for the Fed (Janet Yellen can thank Ben Bernanke for this as well) their noble goal for transparency has painted them into a corner. In theory, transparency is a positive, but in practice, we would argue that it can have unintended consequences. One of which is the inability to make impartial decisions. Instead, transparency brings public scrutiny and increased pressure from all stakeholders.

As predicted by the market, the FOMC did in fact drop the term "patient" in their public statement. However, the committee made a point to reassure the markets that they would not increase rates at their next meeting in April, and instead signaled that the federal funds rate would rise only "…when [the Committee] has seen further improvement in the labor market and is ***reasonably confident*** that inflation will move back to its 2 percent objective over the medium term." In laymen's terms, they appear to be in no rush to hike rates and the trajectory for such increases might also be shallow (despite the use of such fancy words like "lift-off" to describe the first hike).

The Fed's ***smorgasbord of data*** are likely signaling slower economic growth in the first quarter partially due to severe weather (déjà vu ala 1Q 2014?), falling industrial production, and diminishing international competitiveness for US companies due to a sharp appreciation in the US Dollar. Indeed, we would not at all be surprised if the Fed were to increase rates at a slower pace than what is currently built into the Fed Funds Futures strip (which implies a rate of 0.625% by end of December 2015).

The European Central Bank's quantitative easing program began earlier this month and already we are seeing bond yields plummet and investors push out the risk curve in search for additional returns. In the extreme cases, interest rates have actually gone ***negative*** – which implies that borrowers are getting paid to borrow money by the lenders. In fact, many of the valuation and risk management models along with banking systems are having to be retooled to handle negative rates, with media outlets dubbing this similar to the "Y2K" problem around the turn of the last century.

Global equity markets appear to be pausing to digest all this news from policy makers - the Federal Reserve, the European Central Bank and the Bank of Japan. With all three central banks continuing to ***expand their balance sheets*** we are afraid that from an economic and policy standpoint we clearly are in uncharted waters. The potential for a policy related accident (especially since it is now becoming fashionable to talk about ***"macro-prudential policies"***) is higher and we do worry about the implications for "risk" markets.

On the fixed income side, longer-term bonds have continued to outperform their shorter-term counterparts as yields have fallen, and in some places dramatically so. The ***ECB's quantitative easing program*** has caused European sovereign debt yields to continue their decline. Germany's 10-year is the closest to the psychologically important floor of 0.0%, with a current yield of 0.27%, representing a sizable 166 bp (a basis point is one hundredths of a percent) spread relative to US Treasuries.

In a world where the market for US Treasuries is the ***deepest and most liquid of all capital markets***, this anomaly of a positive spread relative to European benchmark government yields makes very little sense. Either markets are giving too much benefit of the doubt to the ECB for its inflation fighting credentials or US Treasuries yield more as a result of expectations of rate increases by the Fed. Regardless, European bonds will likely suffer large losses in the years to come or U.S. Treasury rates will likely decline going forward.

Crude oil prices remain ***quite volatile***: Despite a short rebound in prices earlier this month, crude prices seem to be plumbing new lows again as a result of excess supply and fears of declining global demand. Clearly, the precipitous decline in prices since last summer has been a story of excess supply. With falling prices, we have also seen falling drilling activity – with the Baker Hughes Rig Count now at 1,069 rigs in the US – a far cry from the close to 1,930 rigs that were deployed in October 2014.

Despite all the cross-currents plaguing global markets we still feel ***equities remain the asset class of choice*** (for now) and while we are cautiously optimistic, we worry about the risk of a policy mistake and the implications of such a mistake for capital markets. We do believe that your ***portfolios are appropriately positioned*** for the environment we foresee over the next twelve to eighteen months.

We apologize for the delay in publishing the Monthly Outlook this month – Spring Break and other activities conspired to delay our writing this month.

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