Fed Caught in ITS Own Headlights

Table I: Global Equity Market Returns -%

	Mar. 2016	YTD
Russell 1000	6.97	1.17
Russell 2000	7.98	(1.52)
MSCI – EAFE	6.51	(3.01)
MSCI – Emerging	13.23	5.71
S&P 500	6.78	1.35

Source: Russell, MSCI and Standard & Poor's

The Federal Reserve realizing, they are paralyzed by its own actions have reversed course on raising interest rates in 2016. Investors immediately charged toward the risk trades and poured money back into equities. In one of the strongest months on record equities soured over 6%. At the end of March, the domestic large cap and emerging markets were in the plus column for the year. The credibility of the Fed is in tatters, which adds to the risk in the markets.

Economics and Policy

The Federal Reserve by its own admission has told the markets they are no longer U.S. data dependent. Instead they are more focused on China's currency manipulation, negative interest rates in Japan and Europe and the possibility of the United Kingdom leaving the European Union. Somehow the other economies are now posing significant risk to the U.S. economy to warrant a 180-degree turn in the Fed's position in interest rates. The Federal Reserve is now being reactive instead of proactive which heightens the risk in the markets and economy.

The actions of central bankers of pushing negative interest rate policies have increased the risk of deflationary headwinds, stronger currencies and sub-par economic growth that is the polar opposite of what is needed. It is quite apparent that monetary policy has failed. Fiscal and regulatory policies are in many instances hurting economic growth.

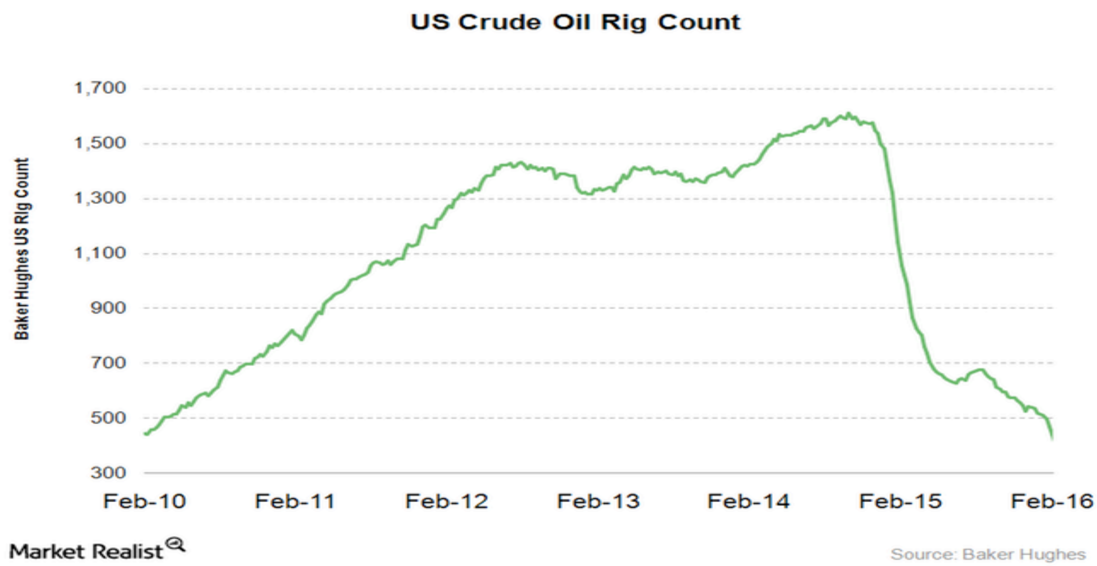
To add to the chaos at the central banks, the presidential election in the U.S. is featuring a race to the bottom ---by both parties. One party (Republican) is trying to build walls physical and legal, around its borders and economy. The other party (Democratic) is trying to buy every special interest group in sight. The real losers are the American taxpayers. The Republicans are blaming a wave of immigrants, the loss of manufacturing jobs and corporations moving offshore. The Democrats are blaming the producers in the economy, the wealthy and that old favorite villain, Wall Street. Rather than help expand growth and wealth politicians through ill-conceived policies want to punish one group to benefit another.

The poor policy proposals are creating concern globally. The concern is increasing as the current administration continues to mandate regulations and issues that have choked the very life out of the U.S. economy. Expectations for 1Q GDP are now less than 0.5%. Despite the happy talk from the administration, the U.S. economy is weak and sliding back to near recessionary conditions.

We hear every month about the number of consecutive months of job growth but the statements never include the very real fact that these jobs by a vast majority are minimum wage jobs. This invariably brings out cries for a doubling of the mandated minimum wage. This of course is just another tax on business that will then hire less people and/or cut current employees hours.

The crash in oil prices is having a major impact. The decline in oil should have a positive influence on the economy. Unfortunately, debt defaults and massive layoffs in the oil industry have greatly muted that impact. As seen in Chart I. below oilrig count has plummeted taking economic growth along with it.

Chart I.



Despite employment claims, red flags are beings raised in other parts of the economy. Retail sales fell 0.3% in March. Industrial Production fell 0.6% in March with mining and utilities hit the hardest down 12.9% and 7.7% respectively. Capacity utilization in March also declined 0.5% and is down 1.2% year/year.

The dark secret underlying the problem is the U.S. government has become an insatiable machine forcing taxes up at all turns arguing it is necessary to bring "fairness" to the middle class. High tax rates and regulatory explosions have over the decades decimated robust economies in Europe. Billionaires all over the world are seeing their private capital under government assault and are moving to where their capital is well treated. In the U.S., governments seem to be remedial economic students and have ignored that message. The lesson is being absorbed currently at the state and city level where "millionaire taxes" were going to solve budget gaps by making the wealthy pay their " fair share" only to see millionaires taking the next limo out of town. Maryland, Connecticut, California, Chicago among others have witnessed the wealth exodus. California's tax and regulations are crushing businesses. Over 250,000 California residents have moved out of state representing over $21 billion in adjusted gross income with Texas being the likely new home. Taxes, regulations, cost of real estate and a more favoable business climate being the primary drivers. More recent times have seen several hedge fund managers move lock stock and perfomance fee from high tax northeast states to more friendly business climes in Florida.

One additional issue that will also play into this political season of "fairness" and taxation is the $3+ trillion pension shortfall. Solving this problem will pit taxpayers who are already stretched and retirees who believe they are to be paid regardless of the fiscal condition of the government.

As baby boomers retire over the next 5 to 10 years bankruptices of cities will skyrocket. In states like Illinois, Arizona, Ohio and Nevada they will be faced with raising taxes or cutting vital services. Contributions to pension plans have been running around 7%. The gap wil force a rise in contribution to around 20%. Defenders of the status quo for pension plans argue that the 7% return assumption will fill that gap, noting that is the historical long term average. Of course, if that argument was true logically the pension gap would not exist.

A final issue falls in the "you can't make this stuff up" category. Recently the current administration is pushing mortgage lenders to offer loans to those with shaky credit and down payments as little as 3% down. Fannie Mae has also resurrected a subprime-lending program. Now we have a pretty good idea how this movie will end. The good news is it should not create another financial crisis like 2008 as banks have learned a hard leson. Unfortunately the fiscal punching bag is liable to be the taxpayer once again.

The one economic certainty is that taxpayers do not earn enough money to tax it all away to cover the insanity that is taking place. To quote the Iron Lady Margaret Thatcher, "you can run out of people's money" Unfortunately, governments and central banks have not yet subscribed to that fact.

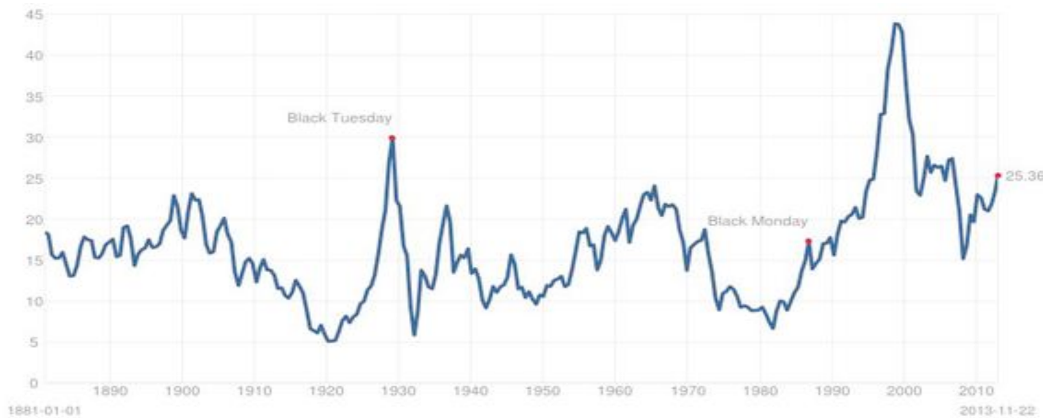
Investment Strategy

The U.S. investment markets pose an interesting problem to policy makers. On one hand the markets solid returns have exacerbated the wealth gap that is seen as unfair. On the other hand, if the Federal Reserve were to change its policies by reducing liquidity and raising rates, the decline in risk assets is likely to be swift and furious. As seen in Chart II, U.S. equities are not inexpensive and investor convictions are not running high.

For income investors the global bond markets will provide little comfort, as negative interest rates will dominate sovereign debt. High yield spreads have begun to widen largely due to the increased default rates in the energy sector. Other sectors may experience increased default rates as corporate earnings continue to decline in a lackluster economy.

Other external headwinds for the investment markets is the increased terror attacks which is spurring unrest caused by the mass exodus out of Syria. The cost of this flood of immigrants is crippling budgets forcing higher taxes and shifts in spending in many countries. In the U.S., in addition to the heated debate on immigrants, there are growing protests over "free tuition", "rogue police" and other social causes that are bringing presidential politics to a full boil. As U.S. voters head toward the two national conventions this summer the protests in the streets will reach explosive levels and riots may be a common occurrence. Tolerance, free speech and free exchange of ideas have died. The mere mention of certain ideas or names has given portions of our citizenry the vapors. Every opposing idea is met with name-calling and cries of bigotry, racism and the new favorite, acts of "micro-aggression". Simply put micro-aggression is merely an attempt forcing silence on someone because his or her opinion differs and you are fearful. It makes one wonder how our ancestors would react to this nonsense and what is happening to the country they fought to defend for the values that are now being crushed.

Chart II. Shiller P/E



These activities and violence is very reminiscent of the 1960s. For those needing a remedial history lesson, the 1960s were a tumultuous times as Civil rights protests, war protesters and protesters against traditional institution raged across this country culminating with a violent clash at the Democratic National Convention in Chicago. The causes have a tenuous link but the market action is disturbingly similar.

As we have stated in past comments, this Black Swan event may be finally upon us. We continue to view public equity markets with caution. Zero interest rates will float the hot air balloon at least in the short-term. Those same zero interest rates will make investing in bonds a very difficult chore. These rates are also allowing for decent returns in the real estate markets. Farmland continues to be a top performer despite naysayers claims that land values have peaked. Prices are being pushed higher as Saudi Arabia is buying U.S. farmland to grow hay to be delivered back home to feed cattle for food. As water, another investment theme, remains scarce, it allows the Saudi's to protect their dwindling supply. Food and water resources are a growing global security concern.

Precious metals also remain an attractive element for a diversified portfolio. Gold is no longer just a "fear trade". With negative interest rates, gold and other precious metals serve not only as a safe haven but also are an important part of the monetary systems. Central bank buying has increased dramatically and supply is not meeting demand for goods in Asia. Currently gold is an under-owned asset and has a low correlation to other major asset classes.

In the coming volatile markets, it is prudent to reduce risk asset exposure and live to fight another day as the economic turmoil is soothed by a Federal Reserve move that will act in the best interest of the whole economy and not just the market portion of it.

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