PCA Perspectives

Permit Capital Advisors' Thoughts on the Investing Landscape

January 5, 2016

If you believe, as Shakespeare's *The Tempest* told us, that "what's past is prologue," then most market pundits and prognosticators have it wrong. The facts surrounding past Fed tightening cycles indicate that all of the hand-wringing and consternation about the potential damage to markets and the economy that rate normalization will create are largely misguided. That is not to say that there isn't a worrisome period on the horizon, but an examination of the behavior of economic growth, the stock market, and bond yields during more recent episodes of rate increases would suggest that investors need to go further out on the calendar before they are likely to see meaningful trouble.

In *The Tempest*, the sorcerer Prospero attempts to use illusion and skillful manipulation to restore his daughter to her rightful place. Inside today's Federal Reserve, Janet Yellen and company attempt to use forward guidance and the skillful manipulation of interest rates to restore the market and economy to appropriate growth, inflation and yield levels. However, until two weeks ago, the ability to boost the target Federal Funds rate was something that the Fed chose not to utilize for nearly a decade. Importantly, it was not for lack of opportunity to do so, because the economic and financial conditions that we've been faced with recently are similar to those that were present at the onset of other cycles in which the Fed decided to set policy rates higher. One question this begs is whether the focus of the Fed has shifted away from its three traditional objectives established by Congress: maximum employment, stable prices, and moderate long-term interest rates. Perhaps, in addition to those guideposts, the Fed's focus is now also entrenched in various macroeconomic and market forces as well.

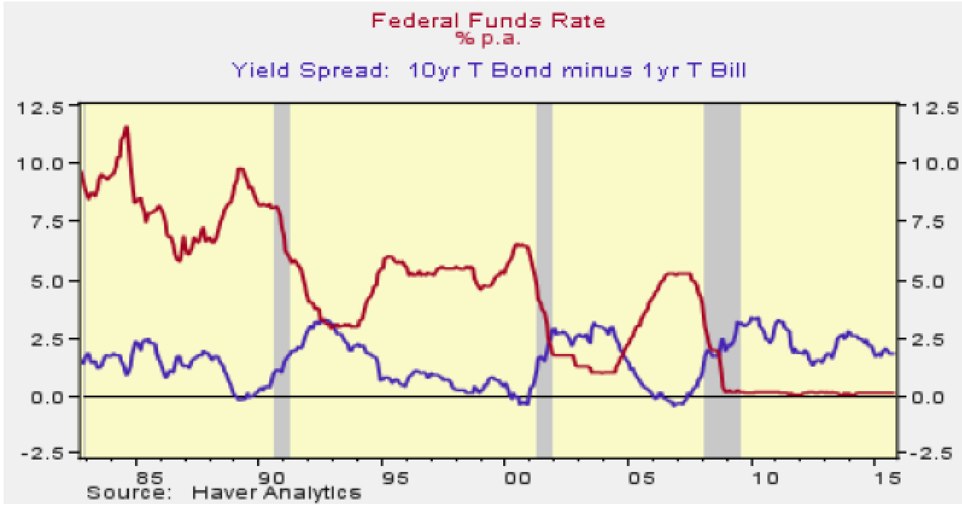
Monetary Policy and Its Market Impact

As we look forward to a new year that will feel the influence of shifting monetary policy winds, let's also look back in time to help better understand where market prognosticators may be ringing false alarm bells and what the Fed might be basing its actions (or inactions) upon, if it's not as straightforward as its Congressional mandate. There have been five rate increase episodes since the early-80s.[1] Each tells us something of relevance to the current situation, and when we look at the assemblage of clues in its totality, we begin to see the motivating influences weighing on Fed decisions. While the present has no perfectly aligned predecessor, there are similarities across the various episodes which should help us analyze where we go from here.

One of the responsibilities that we have as advisors in helping clients make appropriate portfolio allocations is what we describe as separating 'signal' from 'noise'. We wrote about this in the *PCA Perspectives* of August 2011, when the S&P 500 Index fell nearly uninterrupted over an eleven day period. This followed a Standard & Poor's downgrade of the long-term credit rating of this country for the first time in history. While that event was a painful (and noisy) one for market participants, culminating in a third quarter that saw the S&P 500 decline by 13.9%, when all was said and done, it wasn't a signal of greater damage to come. As evidenced by a fourth quarter that was up 11.8%, and a three year stretch from 2012 through 2014 that saw the S&P 500 up by an average of over 20% per year.[i] The strong stretch for equities was buoyed by a Fed that kept policy rates at or near zero and that continued to expand its balance sheet via Quantitative Easing through October 2014, and even today continues to buy mortgage and Treasury bonds to replenish its portfolio as holdings mature. We now stand at a point in history that marks the end of this extended zero interest rate policy and look out over the horizon at a range of outcomes that is both wide and worrisome.

[1] Because the Federal Funds rate was not the Federal Open Market Committee's key policy tool from 1979 thru the fall of 1982, we excluded the rate hikes between 1979 and 1982 from our analysis of rate hike cycles.

Chart 1: Federal Funds Rate



Source: Berenberg Capital Markets; Haver Analytics

Today, we think a quarter-point increase in the Fed Funds rate is 'noise', while the shape of the yield curve over the course of a tightening cycle is 'signal' (Chart 1). Looking back to those five most recent rate increase episodes illustrates why an increase in policy rates may be harmful, but doesn't have to be. It highlights the danger in the Fed "getting it wrong," and the benefit of supportive fiscal policy that exists alongside of tightening monetary policy. We consider "getting it wrong" to be a series of actions that results in an inverted yield curve, which is generally a harbinger of a recession. This was the case in the '87-'89, '99-'00, and '04-'06 tightening cycles. In each case, there was a recession in our economy within 18 months after the last rate hike.[ii] On the other side of the outcome range, in the '83-'84 and '94-'95 cycles the Fed navigated the monetary policy waters carefully and kept the yield curve upward sloping, while the fiscal support provided by politicians kept the economy growing at a healthy pace despite rising rates and tightening credit conditions. These are the types of signals that are important to recognize in the course of making long-term allocation decisions, as each recession provided investors with a bear market to deal with.

The circumstances surrounding each monetary cycle will look different, even if the blueprint followed by the Fed looks familiar—and this could be part of the problem. In April of 1987, when the Fed started to raise interest rates, real rates (those adjusted for inflation) were already high. Their motivation in this circumstance was to prevent the further decline in the dollar, which had begun in early 1985. Further complicating matters, there was a change in leadership at the Fed. When the tightening cycle started, Paul Volcker served as Fed Chair. By the time it ended in March of 1989, Alan Greenspan had taken the reins, and the yield curve was significantly inverted. When the Fed started to raise rates in July of 1999 it was maintaining a slightly schizophrenic public posture, as markets and the economy were rocking, but it was sounding caution about the unknown dangers of the "Y2K" impact. They were also sending strong signals to the market that they wouldn't allow the bond market to experience a sharp selloff, as it did in 1994. The result of these conflicting messages and actions was once again, an inverted yield curve and eventual recession.

The warning bells sounded by market behavior in 1994 make that rate hike cycle, which started in February and lasted for twelve months, an important one with respect to its impact on shaping future Fed behavior. Perhaps it was the aggressive decision to raise rates at a point in time that the economy had just started to accelerate from its malaise in the early-1990s, which led to the bond market selloff. Nonetheless, thanks to favorable fiscal policies, including the enactment of the North American Free Trade Agreement (NAFTA) and the deficit reduction legislation of the Clinton Administration, the economic expansion stayed on course. In this regard, the period was reminiscent of the early-1980s, when the hawkish monetary policy of Chairman Volcker was accompanied by the pro-growth tax and economic policies of the Reagan Administration.

When it comes to impactful periods in Fed decision making, however, the 2004-2006 cycle stands out. As the economy came out of a recession (that was at least in part sparked by the '99-'00 rate hikes) and deflationary concerns abated, the Fed signaled it would raise rates and then did so. Despite Fed Funds rate liftoff, long interest rates actually fell. In his semi-annual testimony to Congress before the Committee on Banking, Housing, and Urban Affairs in February of 2005, Chairman Greenspan puzzled over this dynamic and proclaimed that "the broadly unanticipated behavior of world bond markets remains a conundrum." 'Greenspan's conundrum', as it came to be widely referred, appeared to have been as much about poor memory as anything confounding, given the fact that the same thing had happened multiple times in recent history. Unfortunately, in this case, the result of lower long-term rates relative to the term structure of the yield curve was the continuation of the debt financed housing bubble and the explosion of leverage within financial institutions. We know all too well how that episode ended.

The scope of analysis regarding past Fed rate hikes is helpful to us as a reminder that we shouldn't make assumptions about imminent market direction. In fact, during the course of the five previous cycles we've discussed, the S&P 500 was in positive territory all five times. Further, we believe that it would be a mistake to assume that safety can be found in "staying shorter" with our bond portfolios. On the contrary, we believe that investors turning to short duration bond funds as a safe haven during a period of interest rate volatility are setting themselves up to fail. It seems likely to us that when investors receive their monthly statements and recognize that their "safe" investments are going down in value, they may exit those funds as quickly as they have poured money into them, turning fund managers into forced sellers at precisely the wrong time. Furthermore, we believe that it is important to think through the full array of evidence that markets and the economy present us with, as it is presented. History has shown that not all periods of rising policy rates are created equal, and importantly, those that do represent trouble for markets don't always announce their presence at the time of Fed activity.

Valuations and Technicals

While this recognition is an important consideration in the asset allocation process, it doesn't necessarily lead us to any obvious decisions. Beyond the role of monetary policy on markets, fundamental realities like earnings and valuations also help to determine eventual outcomes. Using the S&P 500 index as a market barometer, valuations are significantly elevated. The Cyclically Adjusted PE Ratio, also known as Shiller's PE Ratio, which we favor because it smooths out the volatility in profit margins and business cycles, registered at 26.1x as of December 24th (Chart 2). As recently as October, it was 27.9x, a level higher than all but 4.2% of months dating back to the late 1800s. Legendary value investor Benjamin Graham highlighted the rationale for favoring measurements that cyclically adjust for margin extremes by noting that good business conditions can be priced into stocks as if they are permanent, and stating that "purchasers view the good earnings as equivalent to earning power and assume that prosperity is equal to safety."[iii]

Chart 2: Cyclically Adjusted Price to Earnings Ratio for the S&P 500 Index

Source: www.multpl.com

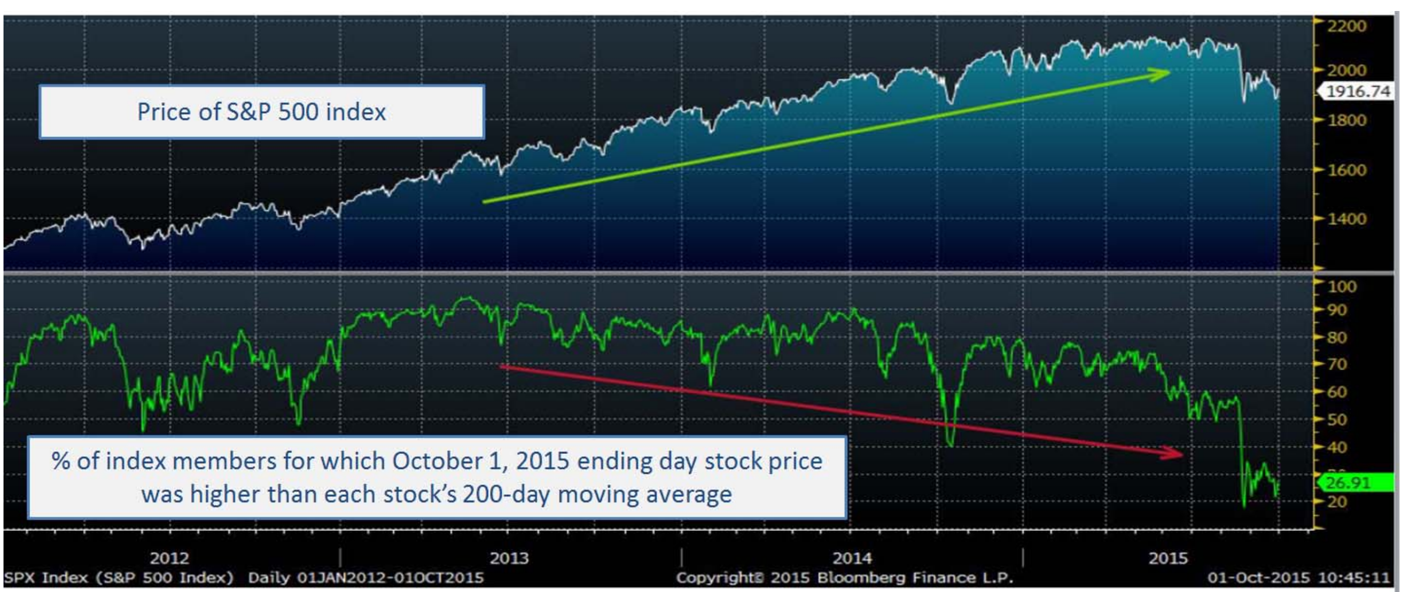
While we recognize that this metric is a poor short-term indicator of market performance, we believe that it is a reliable long-term tool for assessing future market results. To this end, the average S&P 500 return over the subsequent four years when Shiller's PE was higher than it was in October was down more than 10% per annum.[iv] In this respect, our framework for thinking about market valuations is aligned with how we think about macroeconomic variables like monetary policy. We are careful to avoid making assumptions about events that will unfold in the short-term, but mindful of meaningful shifts in asset allocation which should be made with a focus on the long-term.

One of the reasons that short-term mispricings can continue unabated for a period of time is the impact of speculative forces on markets. The Fed's relentless and intentional encouragement of speculation since 2009 has meant that even periods of obvious overvaluation have been met with further advances. One of the characteristics of speculation is that it tends to be indiscriminate, so movements within markets tend to lack nuance, or distinction, when it is most rampant. This is often spoken of in the context of market internals, which measure how money is flowing into the market, i.e. in indiscriminate fashion or in a way that favors particular sectors or styles. Certain market dynamics are useful to analyze because they can help determine if eventual developments are nearing, and market internals are one such dynamic, since they can help identify when speculative forces are waning.

Noted market analyst John Hussman refers to market internals as a "hinge" that can be used to identify turning points. Recently we've seen weakness in market internals, indicating that speculation may indeed be subsiding. In part, this weakness has manifested itself in the form of a particularly narrow market. This can be identified in the 2015 performance of the stocks within the S&P 500 index, which returned +1.38% on a capitalization weighted basis but -2.20% on an equal weighted basis.[v] It can also be seen in the dichotomy between the trajectory of the S&P 500 price index and a chart illustrating the percentage of its constituents trading above their 200-day moving average (Chart 3), a technical indication of market internals. It is when you combine lofty valuations with deteriorating internals that warning signs flash brightest.

This is what is worrisome about both markets and the economy right now—there is really no room for error. No room for error in markets, as measured by valuations, or profit margins, or market internals, and no room for error in the economy, as measured by growth, or monetary stimulus. Slower growth, which isn't strong enough to reduce the debt overhang or put an end to deflationary pressures, makes economies more vulnerable to negative shocks. These shocks could stem from a policy mistake, such as those that the Fed may be heading towards, or from a geopolitical event.

Chart 3: Important Signals Diverging



Source: "The State of Credit Markets" by Bowery Investment Management and BTIG; Bloomberg; Permit Capital Advisors, LLC

On that note, it doesn't appear that the threat of terrorist attacks on developed market soil is going away anytime soon, as the collapse of authoritarian regimes in Iraq and Libya, and a similar threat in Syria, has created pockets of instability where terrorists can plot their next move, and ISIS militants who have been recruited from western countries and who are losing the conventional ground war in Iraq and Syria may be likely to head home.

If there is a shock to growth within the developed world, monetary policy will have limited ability to soften the blow. In the emerging world, the problem is similar, even if the cause is different. In many of those countries, monetary tools haven't yet been exhausted, but weak exchange rates constrain policymakers from easing aggressively because they raise the cost of servicing elevated levels of foreign currency debt. This balancing act, when layered with a prolonged period of underperformance, makes an analysis of likely fortunes within emerging market equities difficult, leaving us in a position where we think a neutral weighting is appropriate.

High Yield Corporate Debt

Within some markets, the outcome of this analysis guides intra-asset class positioning as opposed to simply a 'more' or 'less' proposition. High yield debt is one such segment of the market. There is a lot to like about high yield right now. Since the summer, the Credit Suisse High Yield Index credit spread over comparable Treasuries has widened out from 400 basis points to 760 basis points.[vi] Incidentally, this can also be seen as an indication of risk for equity investors, as high yield spreads have often been a leading indicator with respect to stock market weakness. This dynamic becomes even more pronounced when spreads are viewed side by side with the shift in trailing 12-month P/E ratios over the same period (Charts 4 and 5). Within high yield, there is an ongoing decision to be made to invest in bonds versus loans. High yielding loans (also known as leveraged loans or floating rate loans) can be attractive when short-term interest rates are rising, as they possess a coupon that adjusts, or floats, in the direction of those rates. Another decision to make, depending upon where we are in the cycle, is how much credit risk to take. This can inform where we invest on the below-investment grade spectrum ranging from defensive high yield, which focuses on BB- and B-rated credits, to distressed securities. Currently we think there are attractive opportunities in high yield (though not yet in distressed), though we recognize the risks that are outstanding and recommend an active approach to the space.

Chart 4: High Yield Spreads

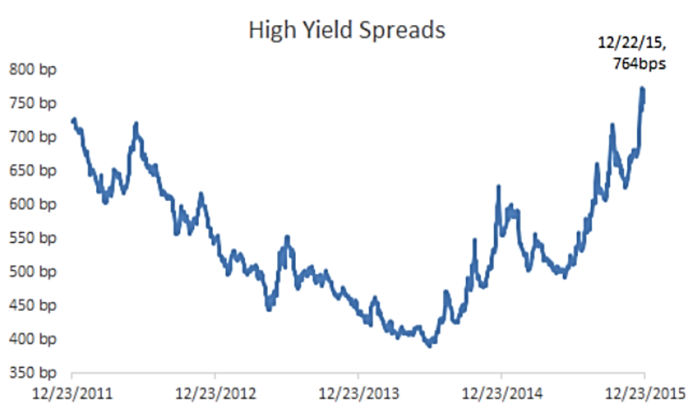


Chart 5: S&P 500 Trailing 12 Month P/E Ratio

Source: Advisor Perspectives article "High Yield vs. Equities—Is This the End of the Run for Equities?" by Heather Rupp of AdvisorShares

Domestic and International Stocks

Within the universe of equity investing, caution is certainly the operative word. This doesn't mean that we are going to eschew equities as an asset class, but we are going to tread carefully and selectively. For example, there appears to be a compelling case to be made for value equities on a number of levels. Value indices meaningfully underperformed growth indices in 2015, to the tune of 9.5 percentage points, with the Russell 1000 Value Index producing negative performance of -3.8%, while the Russell 1000 Growth Index was +5.7%.[vii] This isn't necessarily a surprising development, as historically there is an early-cycle bias towards value and a late-cycle bias favoring growth. Importantly, this results in the value style being a relatively safer bet during a bear market, but an underperformer during a bull market's final gasp. This may be a favorable tradeoff for value investing at the moment, as well as a way to more securely stay meaningfully invested in equities. One additional consideration with respect to reducing the risk inherent to equities during turbulent times is a shift towards more active and less passive exposure. While we discussed the notion that equities don't summarily fall during periods of monetary tightening, there is a correlation during such periods between outperformance of active managers relative to indices and more restrictive monetary conditions.[viii]

We also think that emphasis should be placed outside the U.S. as it pertains to developed market equity investing. Once again, as we discussed with clients a year ago at this time, markets in Europe and Japan appear more attractive than those within the U.S. In the just completed year, both markets fared well in local terms, though euro area indices were down slightly in U.S. dollar terms, as the dollar strengthened meaningfully relative to the euro. Once again, the case for the U.S. to underperform is influenced by unfavorable relative prospects pertaining to monetary policy, valuations, and profit margins. What may be different this time around are the improved prospects for those markets to hold ground in dollar terms, as we believe any future currency movements may be muted. Neither the euro/dollar or dollar/yen rates seem to offer compelling cases for dramatic adjustments, even with the disparate state of central bank activities. Fed and European Central Bank (ECB) monetary policy decisions should come gradually, and it appears to us that the U.S. economy is more likely to disappoint than exceed growth expectations while the opposite is likely true in Europe. In Japan, with the yen recently hitting an eight-year low relative to the dollar, the Bank of Japan (BoJ) appears reluctant to ease much further, likely placing a floor on the exchange rate.

Sovereign Bonds

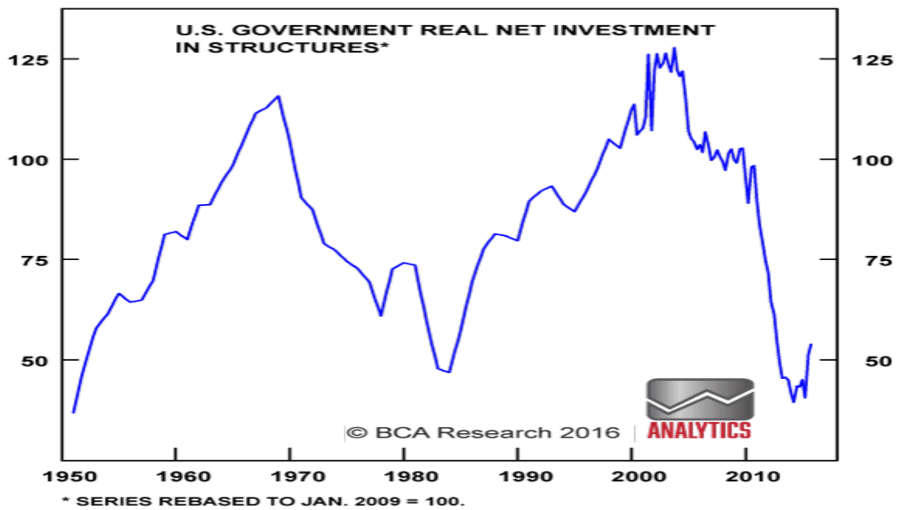
Our work is centered on an effort to enhance the likelihood that portfolios will meet the long-term goals established by our clients. In some cases, this means going against market sentiment to establish or hold positions that might seem out of favor. Right now, that includes maintaining both portfolio duration and our allocation to global sovereign bonds. The macro environment continues to be very bond friendly, with a combination of excess global savings and easy monetary policy on top of low inflation in the developed world. Low inflation seems to be something we can count on, supported by a current generation of central bankers, who appear to be focused on that objective. Not surprising, since most of them cut their teeth as monetarists during the '70s, when inflationary fires were raging. Borrowing from the underpinnings of our global equity strategy, foreign bonds would also likely be buoyed by actions taken by the ECB and BoJ. The ECB's decision to extend its Quantitative Easing program will mean a decline in the number of euro area bonds available for private investors. The BoJ purchases of government bonds should also exceed net issuance, keeping yields suppressed in both cases. The benefit to these allocations comes not only from absolute returns these bonds may generate, but also from their low historical correlation to U.S. equities (which in the past actually fell during periods of stock market stress), making them a good potential hedge against some of the downside risks we've outlined.

Alternative Opportunities

There are other opportunities stemming from current conditions that we are capitalizing on, ranging from merger arbitrage to infrastructure investing. Against a backdrop of relatively wide merger spreads and strong M&A activity, merger arbitrage investing, as thought of traditionally, affords investors the opportunity to deploy capital into a strategy that by our expectations should deliver reasonable returns with a fairly narrow range of outcomes.

The infrastructure opportunity is one for which we believe we are situated in both the right time and the right place. Natural gas is poised to become the primary U.S. energy source before 2025, with a significant and growing percentage of production coming from shale gas (up to nearly 60% from 10% in 2007[ix]), and a significant percentage of that coming from our neighboring Marcellus shale. Despite this production boom, in the U.S. in 2014, government infrastructure spending in net terms (after adjusting for depreciation) hit the lowest level since 1950 (Chart 6). Even after a modest revival last year, the level is still extremely low. Given the lack of room to maneuver on the monetary policy front, the U.S. could utilize fiscal spending on sectors like infrastructure if the economy weakens.

Chart 6: U.S. Government Real Net Investment in Structures



Source: BCA Research

The execution of this strategy can be implemented through public market instruments, such as master limited partnerships (MLPs), which have been beaten down to what we find to be attractive levels, or private investments, which require a give-up in liquidity in exchange for a potentially greater upside. Importantly, the ongoing conversion within the U.S. economy from oil to natural gas does not appear to be negatively affected by low energy prices. Equally importantly, as investors, we need to rise above the focus on temporary ups and downs across asset classes that plague most market participants and remember to use near-term pessimism to our advantage. While this discipline can be challenging at times, we have the utmost confidence that it will ultimately result in differentiated portfolios that offer long-term value recognition.

Thank you for your interest in Permit Capital Advisors, LLC. Please feel free to call us with any thoughts or questions.

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[i] Source: Bloomberg

[ii] Berenberg Capital Markets, "Economic performance around Fed rate increases," November 6, 2015

[iii] Hussman Funds, "On the Completion of the Current Market Cycle and Beyond" by John Hussman, December 30, 2015

[iv] The Leuthold Group, "Perception Express," December 8, 2015

[v] Source: AJO Partners

[vi] Advisor Perspectives, "High Yield vs. Equities—Is This the End of the Run for Equities?" by Heather Rupp of AdvisorShares, December 31, 2015

[vii] Source: Bloomberg

[viii] Strategas Research Partners, "Finding True North in an Odd Business Cycle," July 2015

[ix] Forbes, "Marcellus Shale Drives the U.S. Natural Gas Revolution," December 13, 2015