SEGALL BRYANT & HAMILL

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SBH NEWSLETTER

Thoughts on the Current Environment

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My partner, Jim Dadura, who has built a fine track record as co-manager of our Fixed Income team, reprises his favorite topic for the Quarterly Review with the third installment of “Frequently Asked Questions, Revisited…Again”[2] in the accompanying article in this edition of the Review. It doesn’t require a spoiler alert to merely observe that neither our fixed income strategies nor any of our equity strategies require us to make a forecast of the direction of interest rate moves, of the stock market, of the exchange rate of the dollar or of any other macro factor. As a result, we can always step back and ask what information is contained in the way such prices are playing out. What is the significance, for example, in the persistent price weakness of two of the most critical commodities in the world, money and oil? Indeed, while oil prices have rallied from their low of $26/barrel reached in the first quarter, the price of money continues to decline as interest rates in many countries move further and further into negative territory. How does this weakness persist in the face of data that suggest the U.S. economy may be showing sustainable strength? What implications are there for how portfolios ought to be structured?

I was briefly worried that the lack of stock market reports (I wanted a simple life, but not a poor simple life) might doom me to poverty, but soon enough realized that calculating asset price movements was absurdly easy. Rudimentary mathematical ability and a simple star chart were the only things needed.

- Iain Pears, Arcardia[1]

One possibility may be that 2016 is going to prove to be the mirror image of 2013 in this respect. In 2013, many stock markets had a great year: U.S. stocks rose more than 30% that year and international developed markets were up more than 20% (although emerging markets did have a hard time). This prosperity didn’t reach Main Street, however. The U.S. unemployment rate remained high at 7.4%, while average hourly wage gains didn’t break 2%. The various forms of quantitative easing (QE) practiced by global central banks boosted investors’ balance sheets but did little to help the “real” economy.

Just the opposite might well be the case in 2016. China’s woes and Europe’s malaise notwithstanding, the U.S. economy appears to be growing nicely, thank you. Growth in employment continues to run at roughly 222,000 jobs per month over the last 12 months, which has sliced the unemployment rate by roughly a third, to 5.0% as of March 2016, from where it was in 2013.

[1] Iain Pears, *Arcardia*. New York: Faber & Faber, 2015, p. 86.
[2] Please see “Frequently Asked Questions,” *Quarterly Review*, Second Quarter, 2012; and “Frequently Asked Questions, Revisited,” *Quarterly Review*, Third Quarter 2013. Copies available upon request.

The participation rate in employment continues to grind steadily higher, too. Growth in wages and salaries is at the highest rate not seen since 2009, according to the Federal Reserve Bank of Atlanta's Wage Tracker Index[3]. The value of residential housing, too, has been mostly restored, and even housing formations are back to pre-downturn levels. (The kids are finally moving out!) The stock market, meanwhile, had to stage an epic mid-quarter rally just to get to break-even for the first quarter.

If the recovery does indeed prove durable, the U.S. Federal Reserve (Fed) may carry through on its plan from December to raise interest rates several times during 2016. The markets do not believe this is the case, as evidenced by pricing in the futures market. Herein lies the issue for us. If the economy is getting stronger, this would imply that corporate profits might perk up by the end of the year, thus reversing a trend of the growth in profits slowing steadily towards the negative. It would, however, surely cause the Fed to act to raise rates, which should put a damper on the likelihood that price-to-earnings (P/E) multiples expand. Price gains would then be constrained to not much more than the growth in profits, which, if positive, will still be anemic. On the other hand, if profit growth does not materialize, perhaps the Fed does not have to raise interest rates as vigorously as feared and P/E multiples could expand, but that might do no more than offset the decline in profits.

At bedrock, of course, is the fact that global economies have not been able to deal with the unresolved burden of excessive debt loads since the Great Recession of 2008 to 2009. The debt burden, as we have frequently noted, has been largely shifted to the public sector from the private one, but it hasn't gone down. We have also noted that debt is inherently deflationary: debt today stakes a claim on tomorrow's economic activity, leaving the fruits of that activity unavailable to be used tomorrow. To deal with debt, there are four choices. Economies can tax wealth explicitly; can create or promote inflation, which is a stealth tax on wealth; can repudiate the debt; or can run austere spending patterns while the overall economy grows, which will, over time, reduce the debt burden to a manageable level. The path of least resistance, of course, is to promote inflation and hope (or pray) that it doesn't get out of hand. All of the global central banks have as their avowed goal an acceleration in inflation to a "moderate" 2% target.

With apologies to the 14th century German cleric, Thomas à Kempis, central banks propose, but economies dispose. The central banks of the world have done everything in their power to generate inflation, but to no avail. When excess funds (relative to the true needs of the real economy) are created, it leads to something called "inflation" if those funds flow into the market for consumer goods and services. It's called a "bull market" if those funds find their way to the financial markets. Why one episode of money printing leads to "inflation" and another leads to greater "wealth inequality" is unknowable in advance. What is most disconcerting to us is that many central bankers not only think they know what the economies will do in response to their policy actions, but that they think they can design programs that will lead to precise degrees of inflation and keep it under control. Regrettably, their record on forecasting, especially given the resources they have, has been remarkably poor. It is no understatement to suggest that the risks of a policy mistake are rising sharply as central banks try more and more untested stratagems to get their economies onto a higher growth trajectory.

The actions of the markets in the first quarter are illuminating in this respect: markets are getting more volatile. The decline in the first part of the quarter was relentless and intense. It prompted only the second interim commentary we have written in 21 years. (On this basis, by the way, expect the next interim comment sometime in the second half of 2027.) Stock markets around the world were down sharply, commodity prices plunged and talk of another financial crisis and/or recession were openly discussed. On February 11, the markets turned, and by quarter's end, most of the gloom had dissipated. There was no similar decisive reversal in the underlying economic data, all of which still suggest an ambiguous recovery. Amid comments about the "powerful" spurt of the stock market, it's worth keeping in mind that the "plain old" 10-year Treasury out-earned the stock market for the quarter. The problems being discussed at year-end still remain unresolved, while new ones make their appearance, which they always do. It's likely that the volatility of the markets will stay higher for longer. In such environments, it matters even more to understand why one holds the investments that one does and what the economic and investment rationale are for them. The loneliest time for a portfolio manager (or the most stressful time for a client) is to be holding a position that the market is declaring to be wrong, wrong, wrong. In such rapidly shifting circumstances, Mark Twain's advice about the weather is always helpful: "If you don't like the weather in New England now, just wait a few minutes." Happy Spring.

Frequently Asked Questions, Revisited...Again

James D. Dadura, CFA
Fixed Income Portfolio Manager; Principal

Pushing on a String

Last December, after much anticipation, the U.S. Federal Reserve (Fed) raised the target for the short-term funds rate for the first time in seven years. Does this move mark the beginning of the long-awaited upturn in interest rates? We have written about interest rates for our quarterly newsletter numerous times since the economic expansion began almost seven years ago.

[3] Source: https://www.frbatlanta.org/chcs/wage-growth-tracker.aspx?panel=1

Each time, we presented different arguments that suggested interest rates could remain low for quite some time. As it happened, rates peaked not long after the recession ended, and have declined steadily since then, notwithstanding almost seven years of a rising stock market and a growing economy.

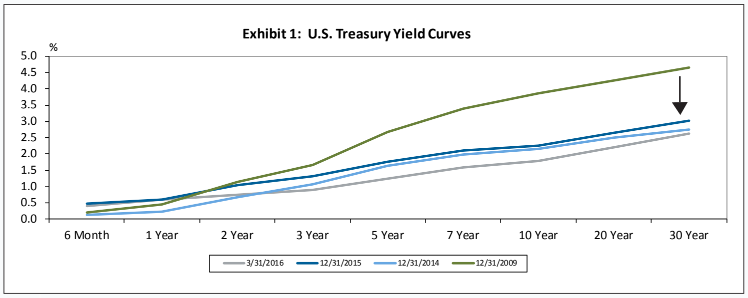

Exhibit 1: U.S. Treasury Yield Curves

Source: Bloomberg

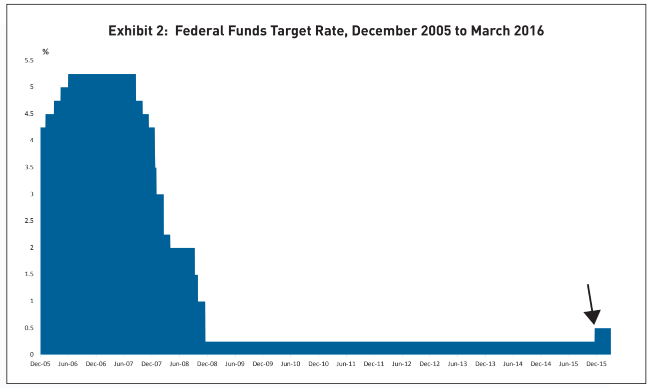

Exhibit 2: Federal Funds Target Rate, December 2005 to March 2016

Source: Bloomberg

Does this recent rate hike change anything? The bond market's response to this move was initially mixed: short maturity Treasury yields moved higher, and longer maturity Treasury yields moved lower. Three months later, and with a little reflection, yields on Treasuries all along the maturity spectrum are lower than they were when the Fed hiked rates in December, as shown in Exhibit 1. Based on the bond market's response, the level of interest rates clearly depends on more than just the Fed's monetary policy. We believe there are four key factors influencing the level of interest rates today:

1) The Federal Reserve Funds Rate
2) Supply of Government Debt
3) Global Interest Rates
4) The Economic Environment (and Historic Precedents)

The first factor, the Federal Reserve Funds Rate, is the short-term interest rate targeted by Fed monetary policy. The Fed dropped this targeted rate to a range of 0% to 0.25% in December 2008 during the financial crisis. They kept it unchanged for seven years until last December when they voted to move it higher to a range of 0.25% to 0.50% (see Exhibit 2). The Federal Reserve Funds Rate has a direct effect on short-term interest rates, but its influence on longer-term interest rates is often dependent on other factors.

One of these factors is the supply of high-quality government debt. The supply of U.S. government debt available to investors peaked in 2010 at $6.7 trillion. Since that time, available government debt has declined due to a variety of factors, including asset purchases by the Fed (quantitative easing, or QE), increased bank purchases to comply with new capital requirements of tougher regulation and greater constraint on new government issuance from sequestration and legislative gridlock. Today, the available supply of U.S. government debt is down to approximately $5.2 trillion, as shown in Exhibit 3.

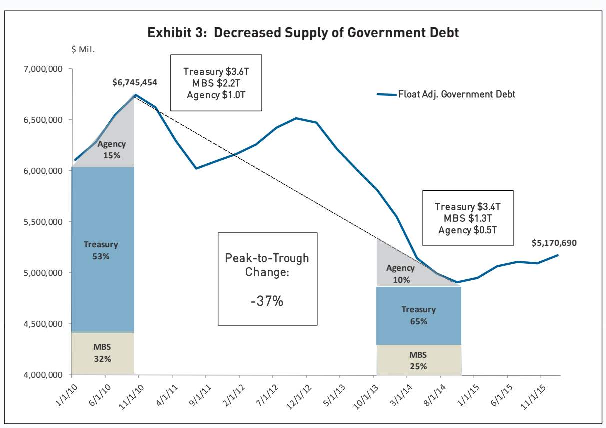

Exhibit 3: Decreased Supply of Government Debt

Note: Total outstanding U.S. government and agency guaranteed debt adjusted for securities held at the U.S. Federal Reserve and U.S. Depository Institutions.
Sources: St. Louis Federal Reserve Bank, Barclays

Basic economic theory says that a decrease in supply puts upward pressure on the price of a commodity. Keep in mind that in the fixed income world, an increase in the price of a bond pushes its yield lower. Another factor influencing interest rates is the level of yields for U.S. government bonds relative to those of bonds of other countries. Despite the fact that many of us have seen Treasury yields multiple times higher than current levels during our lifetimes, today's U.S. government yields are still much higher than yields in most other developed countries, as the chart below illustrates. In some instances, yields have even dipped below zero into negative territory, as shown in Exhibit 4 on the next page.

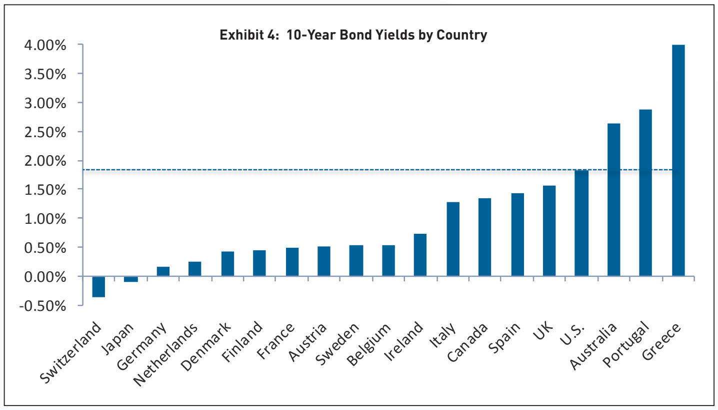

Exhibit 4: 10-Year Bond Yields by Country

Note: Data as of March 31, 2016
Source: Financial Times Markets Data

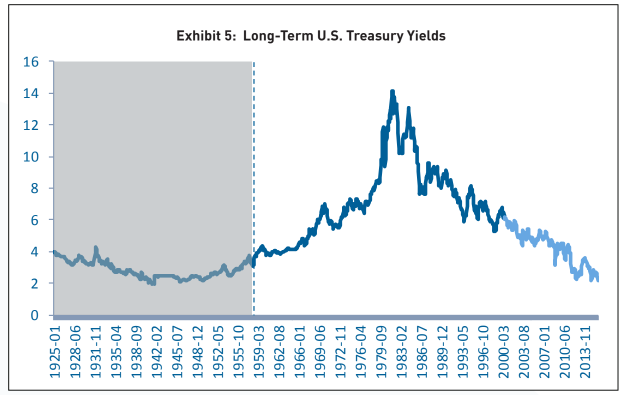

Exhibit 5: Long-Term U.S. Treasury Yields

Note: Data through Feb. 28, 2016. Yields from Jan. 1925 to June 2000 represent yields on Long-Term U.S. Treasury Bonds. Yields from July 2000 to Feb. 2016 represent yields on 20-Year Treasury Constant Maturity Bonds.
Source: U.S. Federal Reserve

According to Bloomberg data, as of February 2016 more than $7 trillion of bonds around the globe had negative yields, meaning that if investors hold these bonds to maturity, they would receive less capital in return than their initial investment. In this context, U.S. government bond yields look relatively attractive and will have a hard time moving markedly higher.

The fourth, and arguably most important, factor affecting the level of interest rates is the economic environment. The Great Recession did a lot of damage to our economy and financial system. No downturn had been this severe since the Great Depression of the 1930s. For this reason, we have frequently made the case that it is important to broaden the most commonly viewed history of interest rates that dates back to the 1950s to include the period of the 1930s. We do so in Exhibit 5.

By expanding the historical perspective on interest rates to include the area to the left of the dashed line, it is apparent that there is precedence for interest rates to stay low for a long period of time. Importantly, long-term interest rates stayed low for at least a decade from the early 1930s until beginning to gradually rise in the 1940s. That period of time marked the beginning of U.S. economy's slow recovery from the depths of the Great Depression. It was a period of low, but generally positive, GDP growth and inflation averaging a little over 1%—a period of time not dissimilar to our slow recovery from the Great Recession. In this context, it should be no surprise that rates are similarly low today.

MARKET BAROMETERS
AS OF MARCH 31, 2016

	Dec 31, 2015	1Q16	Mar 31, 2016	Low	High
Dow Jones Industrial Index	17,425.03		17,685.09	15,660.18	17,716.66
S&P 500 Index	2,035.40		2,051.50	1,815.40	2,055.20
Russell 3000 Stock Index	1,206.10		1,211.17	1,067.34	1,212.44
Russell 2000 Stock Index	1,135.89		1,114.03	953.72	1,135.89
Russell Midcap Growth Index	738.40		740.17	636.09	740.17
Barclays Cap Aggregate Index	1,916.49		1,974.60	1,916.49	1,974.60
Barclays Cap Muni Bond Index	1,136.69		1,155.71	1,136.69	1,158.68
Gold (Price/Oz) London AM Fix	1,062.25		1,233.60	1,062.25	1,274.10
Goldman Commodity Index	2,170.61		2,116.44	1,860.66	2,210.78

Source: Bloomberg

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