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Fearing Fear Itself

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The US stock market celebrated the 6th anniversary from its Lehman Brothers low last Monday, but the party was poopered by fears and foreboding.

- Fears of any Federal Reserve Bank interest rate alterations;
- Foreboding about dollar dominance and oil obstinacy.

In 5 of the last 6 trading days, the Dow Jones Industrial Average has closed higher or lower than the previous session by more than 125 points[1] – rare in a stock market tenderized with tranquility.

Fears of any Federal Reserve Bank interest rate alterations

The Fed meets this week, a 2-day dalliance from which will emerge a surgically dissected diatribe detailing the direction of their interest rate influence. Under the auspice of "stimulative monetary policy," the Fed has held rates very low for a very long time - attempting to instigate a virtuous circle of recovery by: cheapening the cost of capital which -> elevates an interest in borrowing that -> catalyzes capital formation while -> increasing economic vibrancy and -> ultimately resulting in the need to be less accommodative – aka: actually raise interest rates.

Economic data is mixed as it relates to the preparedness of the economy to raise interest rates, but the prospects of this posturing are increasing investor anxiety.

The Fed focuses on the data points of unemployment and inflation. It even embraces a snappy acronym that ties them both together: NAIRU, the Non-Accelerating Inflation Rate of Unemployment. And while the two measures co-exist peacefully within the acronym, the real world suggests otherwise.

The unemployment rate has fallen to 5.5%[2] from a post financial crisis high of over 10%, while inflation is non-existent….literally. On Friday, the latest reading of CPI (a price-gauge known as the Consumer Price Index)[3] actually dropped versus the prior month – attributable, some would say, to the savings we are all experiencing at the gas pump and the weather-driven discounting that has taken place in the retail world.

Janet Yellen, the Chairperson of the Fed, has characterized both price-dropping influences as "transitory" and has commented recently about the enduring strength of the US economy.

Let me be clear, I think that there is a zero percent probability that the Fed will actually raise interest rates this week. Zero. But I do believe that they will provide language and insight that will lead investors to embrace the immanency of a rate hike.

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Investors like low interest rates for two principal reasons:

1. They tend to be wealthier when they pay less in interest on things they buy with borrowed money. Things like houses, cars and of course, stocks.
2. The more effective the transmission mechanism (the Fed and banks) of getting currency into the economy, the higher the value of all assets (same houses, cars and stocks) denominated in that currency. Think about it: if the supply of dollars goes up, then the incremental value of each dollar declines on a per-unit basis, and the more dollars you'll need to maintain parity with prior purchasing patterns. Huh? That is a fancy way of saying that weaker dollars promote higher prices – by design.

The Fed wants inflation, or more importantly, it wants to avoid deflation. If the virtuous circle mentioned above were just that, then a broad-based drop in prices would jeopardize economic prosperity. The clear lack of price acceleration (the aforementioned negative CPI) has many investors worried about the timing of the Fed's announcement and any upward move in rates.

Those most adamantly opposed to a near-term rate move cite the following 4 factors and hope the Fed considers them strongly this week[4]:

1. Rates *can* still go lower: witness countries like Switzerland and Germany that actually have *negative* interest rates on their 10-year government debt;
2. The job market is weaker than it appears: cynics of the reported employment strength point to the weaker labor force participation rate – at 30 year lows of 62.8%[5];
3. The global economy is more challenged than the US economy: China has experienced slowing as have several European economies and the application of a more restrictive monetary policy in the US could have several adverse cross-border ramifications as so many countries depend upon demand from the Americans;
4. A strong dollar will make US exports more expensive: by raising interest rates, the Fed is extracting currency from the monetary system and raising the incremental value of each remaining unit (the opposite of the second reason mentioned as to why investors love low interest rates) which can reduce foreign demand for our goods and services at a delicate point in our economic recovery. This provides a sound segue to the second segment of volatility identification……

Foreboding about dollar dominance and oil obstinacy

Dollar dominance deals not only with the front-running of investor expectations on the directional bias of the Fed, but also the relative positioning of our home currency to that of other countries - particularly the European Union (EU) countries.

All foreign-exchange quotations are relative. This relativity is based on the "supply of" and "demand for" one country's currency compared with another's. The EU, via the European Central Bank (ECB), is embarking on a massive monetary initiative designed to bolster sagging (or in some countries, even negative) growth in the 19 member countries. By purchasing $60 billion/month[6] of government and corporate bonds, they are determined to flood Euroland with Euros and kick off a virtuous recovery circle of their own.

The stark disparity of the Fed's perceived intent vs. the ECB's action has popped the dollar's value vs. the Euro in a very

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steep trajectory contributing to the market's recent volatility. Investors have viewed the disparate monetary policy locomotives as transferring risk across the tracks – from the US to Europe, and the currency reflects such.

Given the prevailing skepticism of the US recovery's strength and the comparatively attractive yields on our government bonds, the promotion of a stronger currency seems analogous to punishing the least badly behaved student in a raucous classroom. And the market, doing what the market does, has preemptively staged a not-so-small and swift insurrection for the consequences of doling a maligned monetary policy.

Onto oil…Wow…under $45/barrel for West Texas Intermediate Crude oil….down from $98.57/barrel exactly 1 year ago[7]. So much has been written about:

- OPEC market manipulation;
- Shale formation overproduction and;
- Demand stagnation.

So I'll spare you the torture of another variation on the theme(s). What I will acknowledge is this: the persistently low price of oil is both a symptom and a cause of the overarching ailment for the markets – volatility borne from prospectively higher interest rates.

A symptom: Interest rates are a reflection on the availability of capital, itself a lever pulled by the Fed in its open market operations. Any predicted dearth of dollars makes them dear. The world oil market is denominated in such dear dollars, incrementally increasing the purchasing power of each, necessitating fewer per barrel.

A cause: The weakened price of oil is also reflection of the currency-neutral imbalance between supply and demand for the commodity. Like any laboratory experiment, stable conditions are preferred for assessing alternative outcomes. And whether it is one or a combination of the 3 bullet points above, adding a destabilizing stimulus, like higher interest rates, can skew the natural process of identifying a market-clearing price.

Therefore, I think that market volatility is going to stick around for a while.

I think that investors have become accustomed to rates that are well below historical trends. Altering course, or the mere consideration of it, is bound to be unsettling.

I think that when the Fed does raise interest rates, the world will survive. So much is built up – by the media, by the prognosticators, by the Fed officials themselves – that the act of policy modification takes on a binary property. However, it is anything but binary – not in its deliberation, implementation or outcome.

We'll keep in close touch as the capital markets, commodity markets and interest rate markets gyrate, all the while adhering to strategies that align with your long-term goals.

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[1] Source: Bloomberg Market Data
[2] Source: Bureau of Labor Statistics
[3] Source: Bloomberg Market Data
[4] http://fortune.com/2015/03/13/fed-raise-rates/
[5] Source: Bureau of Labor Statistics
[6] Source: Bloomberg Market Data
[7] Source: Bloomberg Market Data