KAVAR Canvas

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Put me in Coach, I'm Ready to Play!

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If interest rates were baseball players, and Janet Yellen, their coach, it's easy to envision the invocation of John Fogerty's snappy sports sonnet, "Centerfield."

Channeling the ringing refrain: "….put me in coach, I'm ready to play….today," several players in the capital markets line-up have begun repositioning themselves ahead of any official roster changes.

The overnight lending rate, set by the Federal Reserve's Open Market Committee has basically been benched – sitting stubbornly at 0.25% for almost 7 years running. Its inertia has been a stock market obsession, as identifiable signs of an economic recovery have not been paired with a commensurate rise in rates.

With a December meeting on-deck, the Fed has the investor crowd captivated as it prepares to step to the plate because fundamentally, interest rates influence other components of the domestic economy.

Notably, a change in the Fed funds rate tends to be positively correlated with the following:

1. Short-dated bond yields and;
2. The value of the dollar.

As both embed the strength and confidence of an economy that can:

1. Withstand higher borrowing costs and;
2. Ultimately become the beneficiary of greater foreign investment.

Corralling a clubhouse full of pining players has grown exceedingly difficult for Coach Yellen as the instincts of athletes tend to take over as the game goes on.

And in just the last 6 weeks, the dollar has risen over 5% against a basket of foreign currencies[1] and the 2-year bond yield has risen to 0.837% from 0.590%[2]. Essentially, the market is shaking off the Fed's pitches (or running through the Fed's signs) and exerting its emphasis in a pre-emptive fashion……front-running the Fed with anticipatory positioning.

As it indicated in the tradeable Fed Funds Futures contracts, (see below from Bloomberg), the market is "pricing in" an interest rate increase when the December meeting arrives. The market is taking the second verse of "Centerfield" to heart as it crows: "….don't say it ain't so, you know the time is now!"

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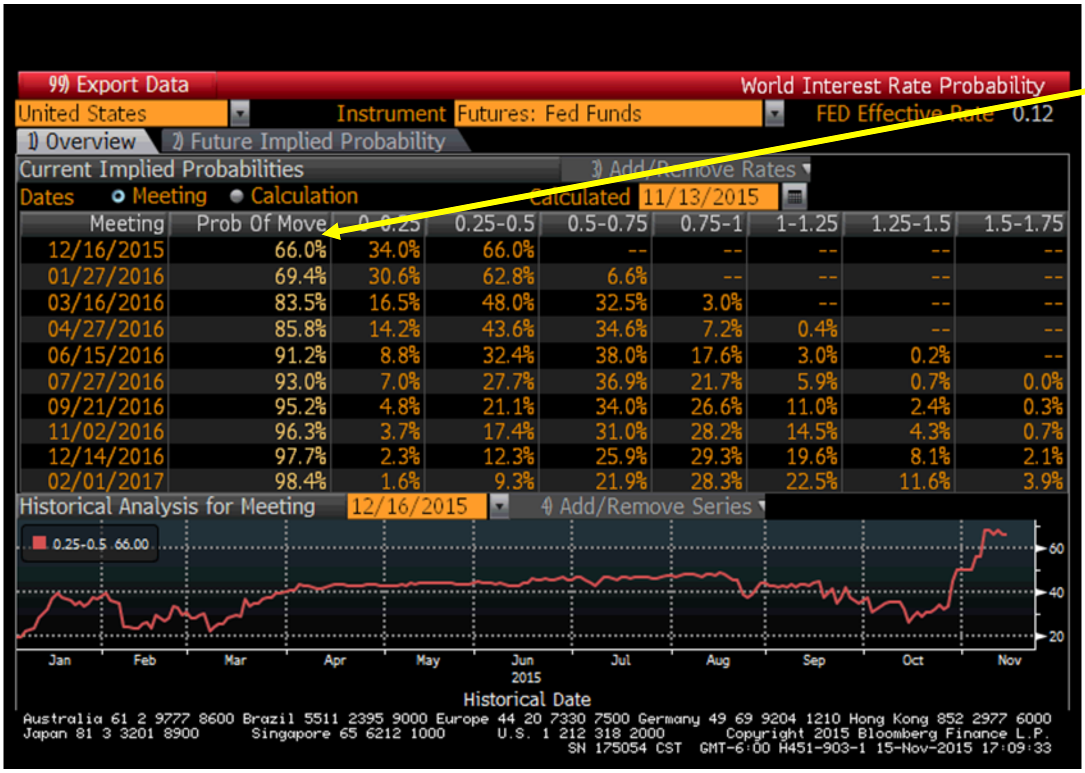

Meeting	Prob Of Move	0-0.25	0.25-0.5	0.5-0.75	0.75-1	1-1.25	1.25-1.5	1.5-1.75
12/16/2015	66.0%	34.0%	66.0%	--	--	--	--	--
01/27/2016	69.4%	30.6%	62.8%	6.6%	--	--	--	--
03/16/2016	83.5%	16.5%	48.0%	32.5%	3.0%	--	--	--
04/27/2016	85.8%	14.2%	43.6%	34.6%	7.2%	0.4%	--	--
06/15/2016	91.2%	8.8%	32.4%	38.0%	17.6%	3.0%	0.2%	--
07/27/2016	93.0%	7.0%	27.7%	36.9%	21.7%	5.9%	0.7%	0.0%
09/21/2016	95.2%	4.8%	21.1%	34.0%	26.6%	11.0%	2.4%	0.3%
11/02/2016	96.3%	3.7%	17.4%	31.0%	28.2%	14.5%	4.3%	0.7%
12/14/2016	97.7%	2.3%	12.3%	25.9%	29.3%	19.6%	8.1%	2.1%
02/01/2017	98.4%	1.6%	9.3%	21.9%	28.3%	22.5%	11.6%	3.9%

66% probability of a rate hike in December

Source: Bloomberg

So if a rate rise looks to be a foregone conclusion, the question becomes - will higher interest rates and currency values overwhelm the markets since they have relied for so long on the Fed as the pinch hitter for organic economic growth?

I don't think so. And consistent with this metaphorical missive, I offer a corollary to our beloved 2015 World Series Champions, the Kansas City Royals, to explain why not.

This year's World Series victory was the team's first in 30 years. Last year's playoff appearance was the first in 29 years. To put it lightly, success had been sparse.

But in 2006, a new era was born in KC with the hiring of Dayton Moore as general manager.

Moore slashed payroll and personnel as he endeavored to rebuild a broken program from the ground up. He focused on reinforcing the farm system, sourcing more international prospects and exercising frugality in contract negotiations – favoring smaller bets on a greater number of players versus outsized bets on any singular solution.

In addition, Moore drafted players that possessed the covert essentials: not striking out, hitting singles instead of home runs and playing great defense. Fundamentally sound. The tortoises, not the hares.

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Success has followed the implementation of Moore's plan, 9 years in the making and a Commissioner's Trophy to show for it.

Some would say Coach Yellen has experienced similar success - 7 years in the making and a better job market and GDP rate to show for it.

Both are attempting to tame the cyclicality of their teams' prosperity by employing a discipline and prudence in calibrating their expected return prospects in a globally competitive marketplace that is less prone to the perpetuation of pricing power.

Both understand that what is given up in margin can be made up for in volume by combining innovation with productivity.

And lastly, both connote the benefits of balance in your portfolio/team construction: spreading risk and relying on the quantifiable and evidentiary capabilities of investments/players instead of their aspirational counterparts.

The Royals are establishing a new order as it relates to the dual fortunes of baseball – cost and success – and the Fed may be embarking upon the economic equivalent of the same.

I do feel confident that the market can tolerate the course reversal of interest rates as, frankly, it already has. The aforementioned underlying market movements are already telling the Fed, as sung in Centerfield's final verse, "…..it's a gone and you can tell that one good-bye."

[1] Source: Bloomberg Market Data using the ETF, UUP as measured from 10/14/15 – 11/16/15

[2] Source: Bloomberg Market Data, function: BTMM

IMPORTANT DISCLOSURES:
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