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Much Ado about Nothing

Fed watchers beware: Your efforts are fruitless! The growing throngs of word-parsing rate-niggling bombasts would have you believe that Fed Chair Yellen's first hike is the financial equivalent of the nano-seconds before the Big Bang. To suggest that a rate hike in September is different (or better) than a rate hike in June or July or October is misleading and irresponsible.

Do interest rates matter? Of course: They are an integral component of the way people value debt and money, profits and liabilities. Are they at a point where we need to worry about them? Absolutely not. In fact, an increase in rates may be one of the more welcome developments of the last six-year bull market; more on this later.

When interest rates go up, stocks often do, too

As we mentioned in our last letter, we believe that the Fed is doing its best to wrest power back from the markets by being less transparent and more opaque. Being “data dependent” is similar to saying that earth-bound animals are “oxygen dependent”—of course we are, but knowing this does not help one decode the behavior of a mule. Looking at the results of market activity after the “first move” of the Fed highlights no discernable pattern to suggest that early moves are bullish or bearish for the future.

J.P. Morgan has done a laudable job of plotting the correlation of the S&P 500 and 10-year Treasury bond yields and their subsequent moves higher: When rates are below ~5%, rate increases exhibit positive correlation with the S&P; so when rates go up, stocks do, too. Why would this be the case? Generally speaking, initial rate hikes suggest a heap of positive economic development and a more confident outlook towards future growth, with just a dash of inflationary anxieties.

Looking at the next few years, we don't see the Fed choking off the market with stifling interest rate moves, so it's quite likely that we'll see a roller coaster of rate moves that will give news outlets plenty of fodder to sell advertising space.



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First-quarter ups and downs

Speaking of roller coasters, thus far 2015 has seen its share of ups and downs. Comparing the beginning of the year to the end of the quarter, one would be forgiven for asking if anything significant occurred on the world stage. The S&P 500 returned -3.0% in January, followed by a strong 5.8% return in February, only to fizzle out and be down -1.6% in March; all told, the S&P 500 eked out a less-than-1% gain for the quarter (.95% to be exact).

As a whole, in the world of stocks, international outperformed domestic (U.S.), small exceeded big, and growth beat value. In fixed income, long-duration outperformed short-duration and high-yield surpassed investment grade. The asset-class winner on the quarter was managed futures (+11.4%) while small cap U.S. and international stocks ruled in equity land (+4.3% and +5.6% respectively). Commodities and emerging market debt continued to be the relative losers, down -5.9% and -4.0% respectively.

The U.S. Dollar's strength in context

Given the performance of the last two categories referenced above, it may not be surprising that the only (predominantly) one-way ride we've seen thus far is U.S. Dollar strength. The greenback continues to post positive returns relative to a basket of other-country currencies, with the USDX index +9.0% on the quarter. This marks the longest streak of consecutive up-months in the index (nine) since 1967; the greenback is up nearly 40% since its lows in 2009!

For context, the absolute level still falls well below the peak in the early-to-mid '80s when the USDX topped out about 50% stronger than today. We don't see a Volckeresque inflation-fight with gut-wrenching interest rate increases in the near-term future, so it's quite possible that we're due for a pause in this trend. Frankly, the dollar's move has taken some of the wind out of the wings of the interest rate hawks. All things being equal, if the perception of our potential interest rate increases slows, so too does the strength of our currency.

It is true that U.S. Dollar strength can be a drag on earnings here in the U.S., particularly for U.S. multinationals. We have seen a slowdown in earnings locally (-12% quarter over quarter from Q3 '14 to Q4 '14), but much of that



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had to do with last year's big drop in oil prices. For now, we believe the market can digest the impact to our trade deficits and net-import/export GDP calculations; if it helps pull Euroland out of its doldrums, perhaps we should be happy to shoulder a bit of the burden for the benefit of an improved tailwind to overall global growth characteristics.

The not-so-silver-lining of these issues is the potential for a pickup in Emerging Market Debt Default rates—particularly for debt denominated in U.S. Dollars. Imagine a foreign investor borrows \$1mm in USD in 2009. They take that money and convert it to their currency to invest in their business. When the debt comes due, they must convert back to the USD at the current exchange rate. In essence, a \$1mm loan taken back in 2009 now costs the borrower ~\$1.4mm (not counting interest payments!). The impact of these currency moves can be witnessed by the ~80% increase in Credit Default Swap (CDS) rates for Brazil so far this year. The bright side is that these types of concerns put pressure on EMD prices and may provide enhanced yield opportunities that more than make up for the additional currency risks.

With continued weakness in oil, one might expect that Russian CDS rates would be off the charts. While still relatively higher than Brazil's, the outlook for Russia's debt seems decidedly more positive, with their CDS rates down ~70% so far year to date. Putin is still too loose of a cannon for us to suggest we remove Russia from our wall of worries.

... While the verdict's still out on the Euro's health and the Yuan's hegemony

One can't talk about the strength of the U.S. Dollar without referencing the Euro (it makes up ~58% of the basket of currencies in the index). True, the European Central Bank (ECB) appears to be pulling out all the stops to fight deflation and has moved the Euro closer to par with the USD. Piling on, we see quite a few Euro bears suggesting that their currency cannot survive in the face of cantankerous nationalistic pride and populism movements. Indeed, since 2014, we've seen a number of Eurosceptic parties like Spain's *Podemos* ("We can") and France's *Front National* ("National Front") begin to make real strides in their home countries and the European Parliament.



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These countries could have a much bigger impact on the currency union than the recent bluster from Greece's *Syriza* party.

But if we look stateside, we see we're not immune to such populism; troubled economic periods beget troubled politics. Will 2012-2014 be to European politics what 2008-2012 was to American politics; in other words, a relative non-event? In spite of The Establishment's concerns, we've had a pretty good run. Perhaps it's Eurolands' turn? They've seen a pretty good start to the year, with small cap developed European equities outperforming all other equity classes in the 1st Quarter.

Before we get too complacent about long-term U.S. Dollar machismo, we should keep a wary eye on our East Asian counterparts. You may have noticed a competitive upstart to the World Bank and IMF, both of which are dominated by U.S. and Japanese interests: the Asian Infrastructure Investment Bank (AIIB). At last tally, 46 nations have agreed to join despite conspicuous caution against doing so from the U.S. and Japan. Several western/developed nations have joined the bank, including the UK, France, Germany and Italy. Note that the UK's Chancellor of the Exchequer has suggested that London will become the first clearing house for the Yuan outside Asia.

China has a long way to go before its political and property rights systems are up to Western snuff, but we cannot ignore the fact that they are likely to continue to flex their muscle and entice the emerging world to join their ranks as the alternative to the current developed-market construct. This could have long-term negative consequences for our ability to rely on U.S. Fed policy to save the day.

Are near-term U.S. economic prospects underrated?

One thing is for certain: We welcome the return of a marketplace that can rationally price risks. We have lived in a world where the value of an object has been obfuscated by manipulated borrowing (and discount rates) and limited consequences of failure. As investors, it's time to stop worrying about how the data will affect the Fed and get back to figuring out how the data will affect the market.



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To that end, the U.S. economy is still chugging along at a fairly robust clip. The Leading Economic Indicator index is still rising, up 6.2% year over year. Consumer confidence remains high, but not overly so. Headline Consumer Price Index (CPI) data has been flat to negative on the quarter, but excluding the decline from the energy (and food) component, it is still benign at 1.7% year over year. The unemployment rate is at 5.5% and the underemployment rate is at 10.9%; both are cycle lows. Labor force participation is still weak, but showing signs of bottoming. The market got in a tizzy over the latest non-farm payroll numbers showing a weak 126,000 new jobs in March (please reference the title of this quarter's market report to get a sense of our reaction to this single number).

We do expect a decline in profit margins at some point this year, but it should be noted that in the aggregate, analysts have been regularly underestimating the strength of U.S. profits. According to a recent Bloomberg analysis, analysts' expectations over the last five years were, on average, 5.1% lower than actual results. Profit share for the S&P 500 for the 1st Quarter is expected to be 5.8% lower than this time last year. Sounds familiar, doesn't it?

A brief read on ex-U.S. economies

Outside the U.S., the data is a bit of a mixed bag. Most data points around inflation and producer prices in the Eurozone point to some form of contraction, and unemployment numbers are still stagnant with the headline rate stuck in the 11% range. That said, consumer confidence is improving along with retail sales, autos, and capacity utilization. Purchasing Manager Indexes ("PMI") statistics are primarily accelerating with the notable exception of France. Credit growth and investor confidence are improving as well.

Emerging market countries have been showing some signs of deceleration, but are still growing strongly relative to developed nations. A U.S.-centric investor may have missed the fact that in spite of worries about China's true growth rate (7%? 6%? 5%??), China's Shanghai Composite index was up approximately 16% in the 1st Quarter and almost 90% over the last 12 months. This echoes the notion we've mentioned in previous quarterly letters, that an economy and its market are not joined at the hip.



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.... And in conclusion, some reflections on hedging

Given the U.S. bull market's sixth year, and the broad concerns we hear about the market being "due for a correction," we thought we'd take a few minutes to address the concept of hedging. We believe that hedging strategies and techniques should only be employed as part of a systematic approach to risk control; i.e., not designed to mitigate all short-term noise from the market. If a portfolio has a specific spending requirement, these techniques may be more important—to be as certain as possible that there will be enough corpus to support necessary spending and cash flow from the portfolio.

Portfolio returns are subject to an iron law:

The compound return of the portfolio will be approximately equal to the average annual return of each portfolio component (summed together) minus ½ the variance of those combined returns. Unless returns are absolutely stable and predictable, the compound return will always be less than the sum of the returns of the portfolio components.

In basic terms, money compounds faster when returns are more consistent.

Every asset or technique must also face several tests: *Is it likely to increase annual returns? Is it likely to reduce portfolio variance (i.e., be a "diversifier")? Will it reduce the portfolio return variance (which we use as a proxy for risk) by more than it may reduce the average annual returns?*

Below, we offer some questions you should ask before determining if a hedging strategy (or what type of hedging strategy) is appropriate for you. Rest assured, for the assets we manage for you at Halbert Hargrove, we regularly address these questions on your behalf.

- Where are the primary risks in your portfolio? Even in many well-diversified portfolios, the substantial majority of return volatility comes from the stocks ("equity risk") in the portfolio. This risk may stem from a shift in economic growth expectations or investor risk aversion that affects the market views of



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many assets at the same time.

- What is it that causes an owner to be risk averse? Vesting cliff? Liability payments? Fiduciary concerns? Tracking error?
- Will the overall expected volatility of the portfolio exceed the capacity of the portfolio owner to hold on?
- What is the appropriate time horizon used to make such judgments—and are those judgments aligned to the strategy? Is hedging a tactical tool that is used “only when needed” or a more strategic deployment of risk management tools that ebb (or flow) based on the direction in which the tide appears to be moving? Time horizon is important, since markets, especially in the U.S., have tended to be mean reverting.

Downside protection has costs; else everyone would hedge and the relationship between risk and return would approximate a straight line. In the simplest of terms, “There is no free lunch.” It should also be noted that there is no “standard” model to hedging. Without proper context and understanding by the end user, it is better to do nothing. It can be assumed that over long periods of time, proper diversification and rebalancing can help lower portfolio volatility and allow an investor to sleep at night.

To that end, when we build portfolios, we expect to include assets that zig when other assets zag. They may do so given: their characteristics as an investment (i.e., stocks vs. bonds); their lack of vulnerability to market influence (i.e., reinsurance); their ability to profit from variance (i.e., Variance Risk Premium strategies); or their ability to side step (or profit) from market declines (i.e., Managed Futures and Moving Average strategies).

In the context of the strength of the last two-year bull market concentrated in U.S. equities, these approaches may have cost upside return. Given an appropriate time horizon and long-term perspective, we expect that they will influence what really matters: the compounding growth of your money.

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