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What's Normal?

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The U.S. Federal Reserve (Fed) has continued to stress all year that it has ended forward guidance and instead, policy will be determined by incoming economic data. And yet, Fed Chair Janet Yellen announced on May 22 that she would raise rates this year if the economy improves as she expects, and even went on to qualify the pace of renormalization—saying, that for many reasons—the federal funds rate would take several years to return to its normal, longer-run level. Then, with disarming but refreshing candor, Yellen added that she really has no idea of what will play out because “any specific projection I write down will turn out to be wrong, perhaps markedly so.”

All of these collective statements may sound like theatre of the absurd for the uninitiated, however, I personally think the Fed Chair’s take is realistic, and her perspective practical. We are living through a great economic experiment and there is no historical precedent for how it is going to end or extend. Plenty of interesting theories exist to explain this phenomenon, but nothing concrete. Any shift away from this pragmatic policy approach towards a rules-based view or ideology could be dangerous for the economy and could boost volatility. So far this type of policy shift has not happened in the U.S. although there has been considerable pressure. Correspondingly, the popular idea that volatility will increase this year because there is less forward guidance has not played out. Volatility probably won't increase unless policy turns anti-growth, which is unlikely for the foreseeable future.

There are many examples of mistakes made over the last few years when policymakers became less practical and more dogmatic, starting with the 2011 European financial crisis. The catalyst for the crisis was the European Central Bank (ECB) rate hikes which followed President Trichet’s doctrinaire but wrong interpretation on the meaning of low interest rates. More recently, China’s leaders “drank the Kool-Aid” on the need to rein in credit growth. The result of China’s policy misstep was a near collapse in private-sector investment spending—a predictable outcome for an economy with such a high savings rate and heavy reliance on its banking system for intermediation. Fortunately, with aggressive recent stimulus measures, the People’s Bank of China (PBoC) has shifted back to pragmatism.

The great financial experiment started in late 2008. Unorthodox policy managed to steer the world clear of catastrophe, but also set the global economy on an uncharted path. At the core of this unorthodox policy were the Fed’s efforts to accommodate an extraordinary demand for safe-haven financial assets (a shift in the demand for money) and to fill up the deflationary hole in household balance sheets created by the real estate and stock market busts. By and large, U.S. monetary policy has been successful. Chart 1 shows that the money multiplier is stabilizing after the post-crisis collapse, as fear drove savers and investors into low-yielding bank deposits and bonds. In addition, Chart 2 shows that household net worth—as a share of income—has rebounded back to pre-crisis levels due to rising asset prices. Given these positive developments, it is understandable why some members of the Federal Open Market Committee are itching to end zero interest rates.

Chart 1: U.S. M2 / Monetary Base *As of 4/29/15*

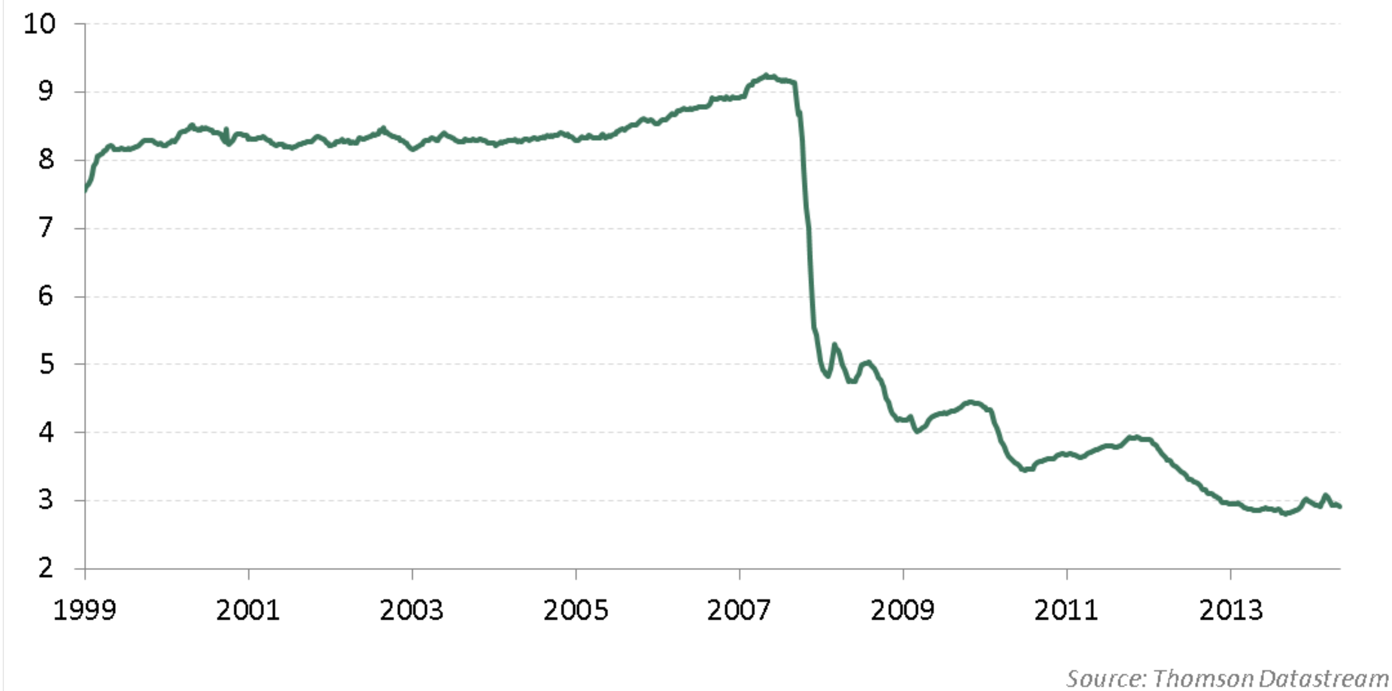
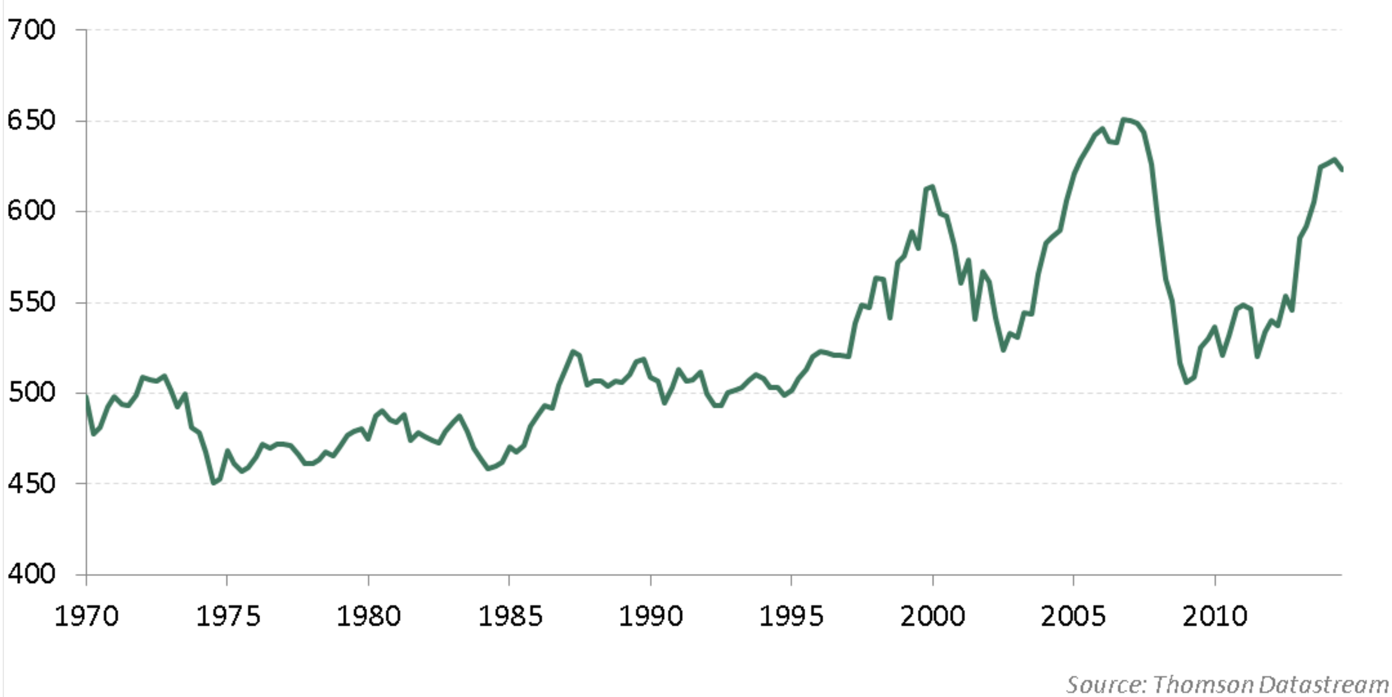


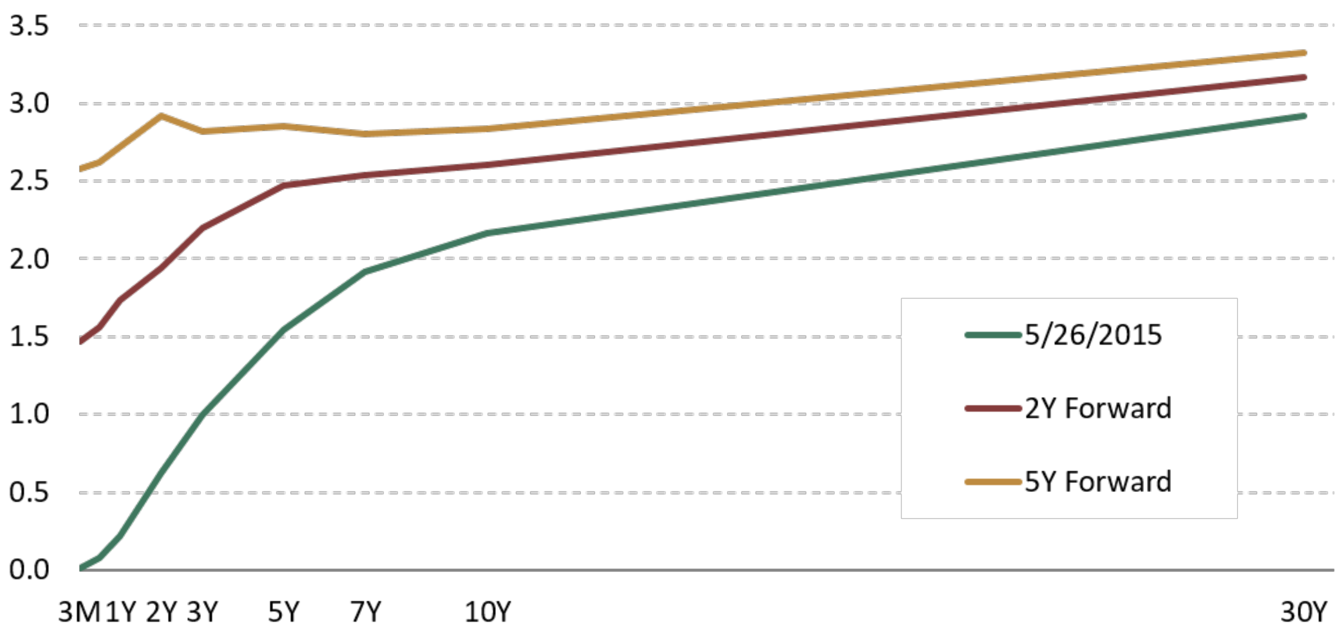
Chart 2: Households Net Worth *As Percentage of Disposable Personal Income; As of 12/31/14*



What now? For investors, the starting point for all this uncertainty should be an examination of what financial markets are currently pricing. The investment opportunity or risk always derives from where the surprises are in the outlook relative to what expectations are already priced.

Chart 3 shows the spot, 2-year forward, and 5-year forward U.S. Treasury yield curve. Long-term Treasury yields are not expected to change much over the next five years; however, the curve is expected to get very flat if the 2-year rate rises to 3%. The economic outlook implied by these prices is more of the same: relatively slow but steady nominal gross domestic product (GDP) growth. The historical term premium on long-term bonds would imply that “normal” for the fed funds rate might fall somewhere between 1% and 2%. In contrast, the Fed continues to believe that the terminal value is closer to 3.5% to 4%.

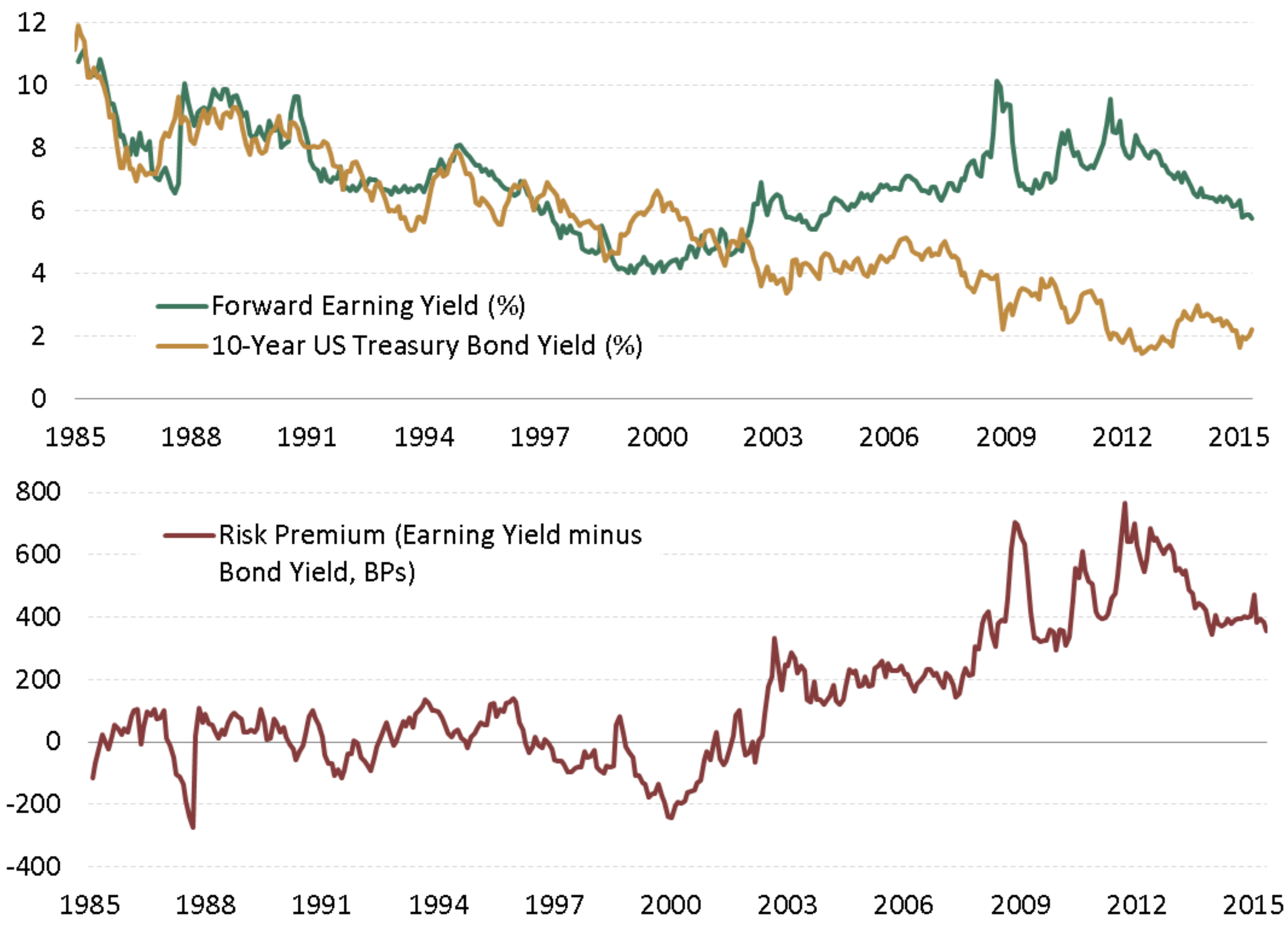
Chart 3: U.S. Yield Curve *Percent; As of 5/26/2015*



Source: Bloomberg (©2015, Bloomberg Finance LP)

As for the stock market, the U.S. equity risk premium is close to the lows of the post-crisis period but still substantially higher than most of the rest of history shown in Chart 4. In other words, investors have become much more optimistic than they were at the depths of the U.S. crisis in 2008/2009 and again in 2011. But their optimism falls well short of the levels that existed before the Lehman bankruptcy as reflected in the much lower pre-crisis risk premium.

Chart 4: S&P 500 Earnings Yield & Nominal Bond Yield *As of 5/25/15*



Source: Thomson Datastream

Last year's dollar rally was predicated on divergent expectations in global monetary policy. Since dollar strength is a substitute for rate hikes, the divergence in growth expectations has been substantially narrowed already as the scope for Fed renormalization has been delayed and flattened.

The key to returns hangs on the global economic outlook.

- **Will the U.S. economy rebound from this year's economic slump, and by how much?**
- **Will reflationary policy efforts in Europe continue to support economic growth in the continent?**
- **Will China's aggressive shift back to more pragmatic policy to support economic growth work?**
- **Similarly, will other emerging and developing economies (that currently compose roughly 60% of global GDP) follow China in reflating their respective economies and move away from a mid-1990s hang up with the level of their currencies?**

My expectation is that the unorthodox monetary policy in play around the world is likely to be more successful than the pessimists believe—and growth conditions will continue to improve, albeit slowly—over the next year or so. Reflation should get ahead of deflation, at least for a while. Pricing on the Treasury curve is not particularly anomalous: the low level of yields says more about the rest of the world than it does the U.S. The same cannot be said for German Bunds or Japanese Government Bonds (JGBs) where prices are extremely high and reflect very pessimistic expectations about the economic future. In contrast, emerging countries like India,

Indonesia, and even Brazil seem to offer tempting absolute and relative opportunities using a similar calculus. Equity investors should be mindful of the aggressive effort currently underway to pump up the global economy. For currency investors, policy divergence remains the driver.

Preoccupation with the timing of the Fed's first rate increase has become borderline obsessive. Arguably this is driven mainly by the same group of "Cassandras," who believe all economic progress made since the Lehman crisis is built on a pile of funny money that will collapse on the first twitch in the opposite direction from the Fed. Investors have been talking about another taper tantrum for two years. The information risk has been exhausted. A 25 basis point rate increase later this year is not going to change much and I believe the path to higher rates is going to be very slow.

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