September 2014

The New… Nightmare

Before the eponymous singer found wider fame as a solo artist, Alice Cooper was originally the name of the rock band of which he was the lead vocalist[1]. Legend has it that the name was picked for its innocuous and wholesome qualities, in (humorous) stark contrast to the band's image and music. It was in the early 1970's that the solo artist known today as Alice Cooper chose to adopt the band's name as his own.

'*Welcome to My Nightmare*' was the first track on the first solo album (of the same name) released by Cooper in 1975. Listened to in sequence, the album tracks were a journey through the troubling nightmares of a fictitious child named Steven.

Welcome to my nightmare
I think you're gonna like it
I think you're gonna feel you belong

A nocturnal vacation
A necessary sedation
You wanna feel at home 'cause you belong

Although Cooper's lyrics read more like a dark, hedonistic enticement, the concept of a series of interconnected nightmares, of embarking on a hellish journey that ultimately leads to an '*Awakening*' (actually the name of the last album track), there are stark parallels with the tenuous global recovery and regional stimulus programs ('*necessary sedation'*?) that face global markets. Welcome, to *our* global nightmare…

Fed QE ending, eventually…

With the US economy growing at an annualised 4.2% in the 2nd quarter and the unemployment rate falling to 5.9% in September (the lowest in 6 years), debate over changes to the US Federal Reserve's (Fed) forward guidance has increased, although consensus remains elusive. The real test for interest rates will begin when the Fed's preferred inflation measure, core PCE, gets closer to 2% (it's at 1.5% now, up from 1% in February). For the foreseeable future we expect slow improvement in economic data (payroll increases have averaged 225k/month in 2014, versus 194k in 2013 and 186k in 2012). Despite an improving consumer, private sector deleveraging will continue and put pressure on recovery in the near term. We expect modest acceleration in personal and business spending as housing and equity markets continue to support wealth, despite eventual increases in mortgage rates which will slow the housing recovery. However, inflation will remain under control, below the Fed's 2% target given the enduring slack in the labour market in the form of lower paid and temporary jobs. This will allow the Fed to remain on hold for longer than anticipated. We expect US Treasuries to continue to trade in a 2.00% to 2.75% range for the foreseeable future.

Europeans to follow suit?

Globally, other global deflationary risks still remain, particularly in Europe. The European Central Bank (ECB) will continue to play lip service to easy money and quantitative easing, even in the face of growing structural issues. The ECB will eventually reach their limit, but has ample political support to continue providing liquidity through the remainder of 2014 and probably 2015. European QE will balloon the ECB's balance sheet despite peripheral economies not reaching fiscal targets. Austerity will prove more difficult to implement over the long term, but we view this as a 2015-and-beyond problem, given the ECB's continuing support.

Markets are liquid, right?

A growing number of market participants – ourselves included – have spoken publicly about the worsening liquidity in bond markets and the need to factor this more directly into pricing and risk management. The heightened regulatory environment puts more pressure on bank risk-taking, capital requirements and in the end, *inventory*. This, combined with both asset class and manager re-allocations means transaction costs are moving up dramatically.

Large manager redemptions

Managers have learned to weather occasionally severe outflows as a routine and prudent practice of general portfolio and business management, whether driven by

[1] Alice Cooper now pays the band substantial annual royalties for use of the name.

fees, performance, corporate or personnel change, a shift to 'the next best thing', or a combination of all/any of these. However, it is hard to recall a time where such a confluence of factors was evident, and coupled with the massive scale of some businesses (almost in perfectly opposed symmetry with liquidity conditions), could these be the gathering clouds of a perfect storm…?

Turmoil if Fed hikes too quickly

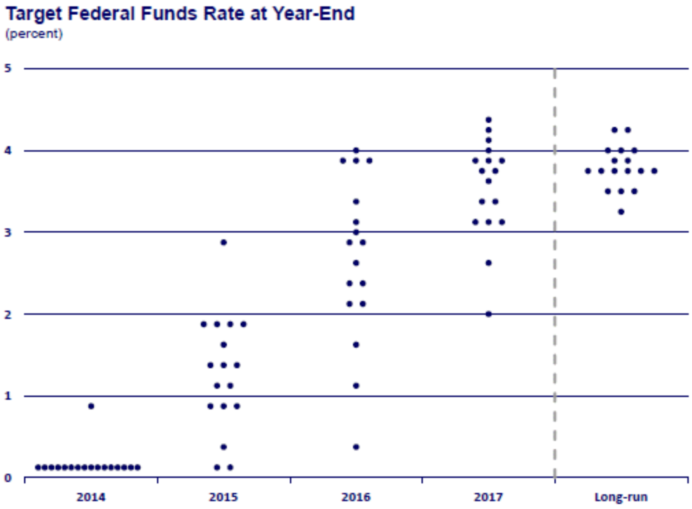
The Fed publishes its 'dot plot' (see chart below) after each FOMC meeting, to show projections of its 16 voting members. The dot plot represents the Fed's ongoing efforts to become more transparent with respect to its policies, recognizing the risks of the markets being caught off-guard. Each dot represents a member's view on where the Fed funds rate should be at the end of the calendar years shown, as well as the 'long run' – the peak for the rate once the Fed has finished tightening policy from the current ultra-low levels. Currently, average expectation is for rates to hit 1.27% at the end of 2015, 2.68% in 2016, 3.54% in 2017, and 3.79% in the long run.

More important than the absolute number is the direction of movement. Investors want to know whether the FOMC is leaning toward looser policy (reducing rates) or tighter policy (raising). In March for instance, a shift toward higher rates in the dot plot led to a short-term sell-off in both stocks and bonds – a reflection of investors' fear that the Fed may raise rates sooner than expected.

It's important to remember that the Fed remains data dependent, adjusting its policy based on economic trends, inflation, and global events. In the event of major developments such as a terrorist attack, a severe economic downturn, a sharp jump in inflation, etc., the members will shift projections from their current level. As a result, the longer-term projections on the dot plot carry less weight than those closer to the present.

It's also important to note that FOMC voting members change. Not only that, but there is no way to tell which dot belongs to which member. Investors don't have a sense of how much weight to attach to a dot that is an outlier for a certain period, nor do they know which dot belongs to Fed Chair Yellen. This doesn't stop market participants from reading into the averages generated by each new iteration. Each new release, after the Fed meeting, will continue to be a new source of market volatility.

It's been nearly 6 years (December 2008) since the Fed cut interest rates to zero, and embarked on its QE program, the latter of which is scheduled to conclude at the end of October 2015. However the eventual rise in rates is very hard for markets to predict, because of the many 'unknowns'. The further out you go the more unreliable forecasts become.



Source: September 2014 Summary of Economic Projections. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the appropriate level of the target federal funds rate at the end of the specified calendar year or over the longer run.

Can we prepare for the turning point?

We know that rates will eventually rise, and risk assets will eventually underperform. We just don't know when. So at Kapstream we're focusing on capital preservation; our cash and 'liquidity' bucket of government (and related) instruments remains at nearly 20% of our portfolios. You still get paid to take both the default risk and spread-widening risk of investment-grade corporate bonds, but at some point in the future you won't, and we want to remain prepared.

Midway through his 7th decade – and arguably having beaten the odds and survived if not thrived through a hugely colourful era of modern music – it could be said that these days Alice Cooper does indeed lead a more wholesome and innocuous life, per the irony intended in his *nom de guerre*, and that he has successfully navigated his own 'nightmares'. The test for us all today, and for the foreseeable future is how we do the same, until we reach our own '*Awakening*'.