PCM
PEAK CAPITAL MANAGEMENT

A Rock and a Hard Place: Quantitative Tightening

PCM Report May 2017 Volume 8, Issue 5

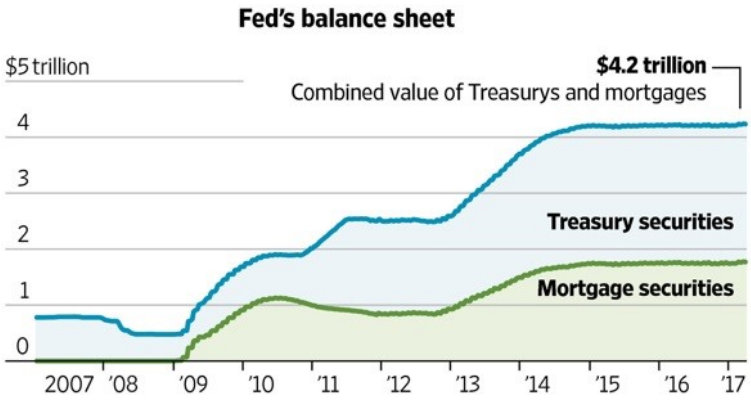
Do you recall the dramatic music in the original Jaws movie when the gal makes the ill-fated decision to go for a night swim? Like me, did you want to yell at the screen, "Don't do it!" because you knew something bad was going to happen? Watching Yellen and other Fed officials give speeches and press conferences lately I am certain I hear that same ominous music.

By all accounts the Fed seems to have won the battle against deflationary dragons and the fallout from the Great Recession. Unemployment has settled at a level that the Fed has long considered to be "full employment" and inflation has finally achieved their 2% target.

Pop the bubbly, let's party like it's 1999. 

Not so fast? Wondering why average wages today are lower than they were nearly 7 years ago (answer is the low participation rate)? Possibly, you are concerned that GDP has rarely achieved 2% growth during this "recovery" and that despite record high consumer confidence and business optimism the first quarter of 2017 appears poised to report an abysmal 0.5% growth. In other words, the Fed has achieved their targets but for many there is scant reason to celebrate.

The Fed has a dual mandate, full employment and stable prices, but finds itself with dual challenges. Not only does the Fed need to hike short term rates to normalized levels, they must also figure out how to pare their expansive balance sheet that swelled to over $4 trillion in late 2014. Reducing the Fed's balance sheet, referred to as QT or quantitative tightening, is probably the greatest challenge Ms. Yellen faces.



The Fed says they are in no hurry to sell assets on their balance sheet and will almost certainly choose to simply limit how much of the maturing bonds they reinvest. Many economists, however, are concerned that even a modest reduction in their mortgage bonds and Treasuries could result in dramatic changes in market conditions. We recall, painfully so, how the bond market reacted when Chair Bernanke announced the Fed was approaching the end of their bond buying program leading to the infamous Taper Tantrum. About 60% of the Fed's balance sheet is invested in U.S. Treasuries **(see chart)** that are predominantly short term paper maturing in 2018 and 2019. The Fed has purchased a large percentage of these bonds over the last 4 years to ensure yields would remain "accommodative." How much those yields will have to rise to incentivize investors to hold them is anyone's guess, but that adjustment will impact the excess liquidity going into risk assets like preferred stocks and high yield bonds.

> *"By all accounts the Fed seems to have won the battle against deflationary dragons."*

While the Fed claims to be absolutely apolitical, stating politics plays no part in their decision-making. My guess is they are secretly hoping the President is able to push through some of the fiscal policy initiatives he campaigned on and is trying to navigate through Congress. A corporate tax cut, for example, may help to offset the otherwise negative impact that higher borrowing costs may have on business investment spending.

Raising short-term rates has so far proved to have little disruption in the financial markets. The Fed has hiked 4 times over the last 16 months and both the 10-year and 30-year Treasury bonds have lower yields today than December 2015. We believe the Fed can tighten twice more this year without damaging the fragile growth in the economy. Selling $1 or $2 trillion in Treasuries and mortgage bonds is a much different issue. It is well documented that the excess liquidity created by QE (quantitative easing) drove risk assets like stocks and real estate higher as investors searched for yield or growth. QT is very likely to have the opposite effect by dampening demand for risk assets as it absorbs investor capital. How much that drives prices lower is anyone's guess but we would rather be at the front of the line when the rush for the exits start than stuck in the back.

We have documented in past reports the dramatic reduction in Treasury holdings from both China and Japan. Treasury auctions since the middle of last year have seen very little participation from the countries who hold the largest amounts of U.S. debt.

As China steps up capital controls to curb outflows they are unlikely to resume their former appetite for Treasuries. Equilibrium can sometimes be difficult to achieve and if the Fed steps away from supporting Treasury prices we anticipate a domino effect will result causing stocks, real estate, and other risk assets to correct sharply.

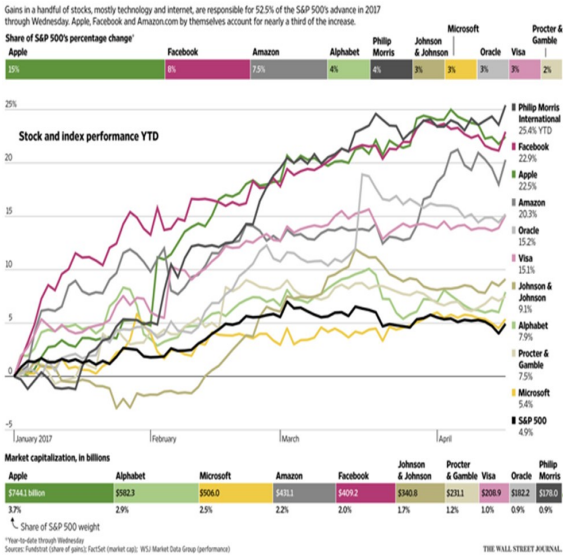
Time to Dump

In one of the more ominous data points on stocks today, Insider Selling has seen a sharp spike higher as corporate executives and board members are deciding it is a good time to cash in chunks of their companies stock. Insiders, those with the most intimate knowledge of the business and holders of non-public information, have sold more stock than they have been buying by a ratio of 6 to 1.

Maybe these insiders are needing cash for the down payment on their vacation home in Martha's Vineyard or to pay for their kids Ivy League tuition? It could also be that they are reading the tea leaves and believe taking profits today makes sense because the future is not as promising as sentiment surveys suggest.

- Insider selling data, according to FactSet, confirms that selling activity is exceeding buying across all major sectors of the markets, a bearish sign for the near term prospects of equities which remain near all-time highs.
- Past spikes of Insider selling have corresponded with pullbacks in the stock market although the actual size of the corrections has ranged from a modest 5% to actual bear market depending on the period analyzed.
- Possibly the strongest endorsement of the prospects for a company occur when Insiders are buying stock when the stock is near a 52-week high. While this appears rare in today's environment, there remains significant corporate buybacks of stocks near their recent highs.

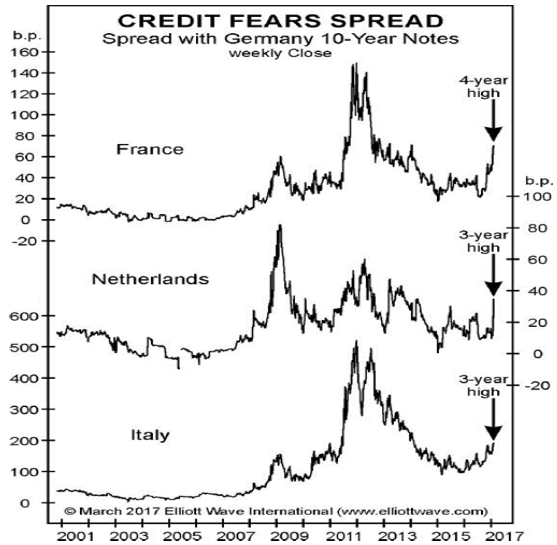
Top Heavy



The S&P 500 has become very top heavy in the companies that are driving performance. 10 companies make up approximately half of the S&P's gains for the year. For many, this is a common bellwether of a pending correction. This concern is even further exasperated when a single sector, technology in this case, is contributing so much to the return attribution The Wall Street Journal chart shows the percent weight of each of the companies in the index, the market capitalization of each company, and the year to date performance of each company. Apple has had the greatest impact at 15% of the performance attribution followed by Facebook at 8% and Amazon at 7.5%. All three returned over 20% year to date as of April 18th.

- Of the 10 companies driving over half of S&P 500 performance YTD, technology and internet companies drive over 40% of that performance (WSJ).
- The six tech companies making up the top 10 cited are weighted at 14.2% of the entire S&P while Information Technology made us over 20% weighting of the S&P 500 (WSJ and State Street Global Advisors).
- Financials make up the next heaviest sector weighting at nearly 15% yet the return attribution of the top 10 companies does not include a single financial name (WSJ).
- Phillip Morris is also noteworthy in driving S&P YTD gains with a YTD return of 25.4% (WSJ).

Signals from Europe—Widening Credit Spreads



Europe has been in the new a bit more frequently lately. It's fairly well known that the European banking system is in disarray. The hangover effects from the Great Recession and global credit crisis are quite persistent. We thought it would be insightful to show how current risk levels in Europe are changing, particularly in the bond market. The table below illustrates the credit spreads across various markets in Europe. Credit spreads show how much additional yield investors demand for taking on the risk of holding corporate bonds. Typically, the yield on corporate bonds is compared to the yield on investment grade government debt. A large difference in these yields generally suggests that investors anticipate greater uncertainty going forward.

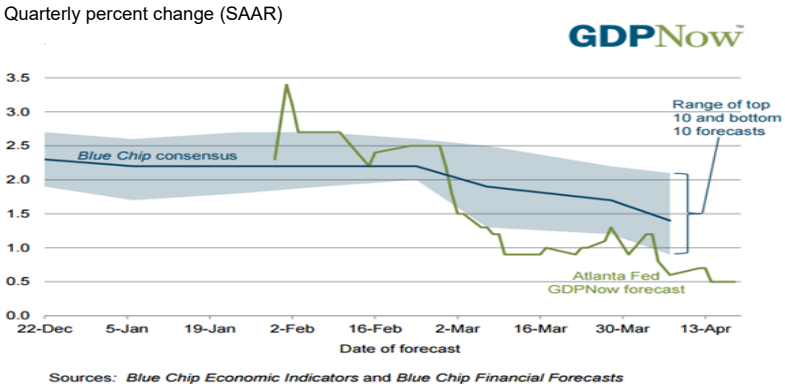
- The table to the left illustrates that credit conditions have deteriorated (i.e. they have widened out) across multiple countries in Europe, specifically France, the Netherlands and Italy. While still below the levels of 2011, the spread of corporate bond yields over German bunds has risen to multi-year highs. The perception of risk seems to be increasing.
- The widening of these spreads might in part be due to Brexit effects and the French election. Still, it could be an indication that there are underlying structural issues at play that could have meaningful ripple effects across the global bond markets. The concern is that these spread levels reach, or surpass, the heights seen in 2011, and what the ultimate ramifications would be if defaults begin to increase.

Macro View – GDP Slide

The Atlanta Fed's GDPNow model has caught the attention of many economists. The chart below shows that forecasts spiked above 3% in February. An abrupt slide began in March, dropping from 2% down to .5% in to mid April. Consensus forecast is downward trending, with the lowest range just below 1% and the highest forecast in the range just above 2%. The GDPNow model forecast for real GDP growth in the first quarter of 2017 is .5 percent as of April 18th (Atlanta Federal Reserve Bank). The forecast for first quarter real residential growth went from 12 percent to 12.4 percent (US Census Bureau). The forecast of the contribution of inventory investment to first-quarter growth declined from −0.71 percentage points to −0.76 percentage points after the industrial production release from the Federal Reserve Board of Governors.

Evolution of Atlanta Fed GDPNow real GDP Forecast for 2017: Q1

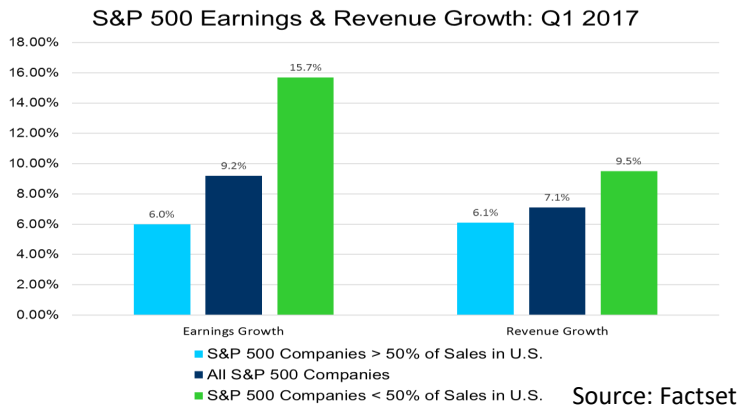
Quarterly percent change (SAAR)



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Taking Stock – Global Tailwinds

Factset is providing interesting data points around the revenue and earnings growth of US companies with less than 50% sales derived from the US. There has clearly been a headwind given an appreciating dollar. The wind may be in US company's sails, though, given growing global GDP growth. The chart below shows that first quarter earnings growth and revenue growth for US companies with less than 50% revenue generated inside US borders surpassed US companies with greater than 50% sales generated in the US. Information Technology and Energy are the largest contributors to earnings and revenue growth specific to the US companies with greater sales outside the US. For companies that generate less than 50% of sales inside the U.S., the earnings growth rate is 15.7% while the sales growth rate is 9.5% (Factset).



Source: Factset

Fixed Income – Mortgage Bond Uncertainty

One of the biggest impacts of the Fed's decision to start unwinding their bond holdings is going to be felt in the mortgage-backed securities market. Historically, the Fed never purchased mortgage-backed bonds and only held Treasuries. The Fed holds nearly $2 trillion in MBS paper today, a market that sometimes lacks liquidity and can see large swings in prices if sellers outnumber buyers. The Fed stepped in as a buyer of mortgage bonds in 2009 during the housing crisis and their buying has ensured that mortgage rates have remained very low since. Housing prices are strong in virtually every market across the U.S. so it may be premature to panic about the Fed withdrawing from bonds issued by Fannie and Freddie. The path of least resistance will be the Fed holding the bonds until maturity to minimize the impact outright sales might have.

Technical – Drying Up?

One of our favorite charts we track is the Baltic Dry Index which reports the cost of moving raw materials like grain, iron ore, or steel across seas by shipping companies. When capacity is tight, prices will rise as exporters compete for cargo space. Prices tend to fall when excess capacity on cargo ships is rising. The BDI has been a useful leading economic indicator to forecast short-term global economic expansion and has traditionally had a strong positive correlation with the MSCI World Stock Index. The BDI can be volatile as demonstrated by the near 75% gain from February to the end of March. The latest readings have been trending lower and if the index breaches its trend line it could be an early warning signal that global growth is beginning to slow. We often look for confirmation of a slowdown with emerging market performance.

Interpreting the VIX

Clint Pekrul, CFA

Most investors who follow the equity markets are familiar with the VIX Index (or more formally, the Chicago Board Options Exchange Implied Volatility Index). Simply put, the VIX measures the expected level of volatility, or the implied level of return variation, in the S&P 500 Index over the next month. It's derived from the level of volatility that is used to price call and put options on the S&P 500 Index, and is calculated and disseminated on a daily basis. Generally speaking, if the VIX moves higher, it's a signal that equity traders expect market volatility to increase over roughly the next 30 days. Likewise, if the VIX falls, then equity traders expect market volatility to fall over the next 30 days.

The VIX is expressed as an annualized standard deviation of expected returns. So for example, a VIX level of 10 means that future expected returns will vary around the average return by roughly 10%, up or down. Historically, the VIX has averaged about 15 going back to the early 1990s, suggesting that investors generally expect about 15% volatility in the S&P 500 Index. At times, however, the VIX can far exceed a level of 15. During the 2008 financial crisis, the VIX exceeded 80, or roughly five times its average level.

It's noteworthy, however, that the VIX does not necessarily measure the direction of the S&P 500, but simply the magnitude, or variation, of returns around the average daily return over the next 30 days (which is typically assumed to be zero). Therefore, it's possible to have a high reading on VIX and an upward trending market (i.e. upside volatility). But generally, equity volatility is to the downside.

There are many different ways to interpret the VIX. What is generally most important to portfolio managers and traders is not necessarily the absolute level of the VIX, but the rate of change in VIX. Most of the time, the VIX will spike in value around a market disruption (e.g. global crisis, natural disaster, geopolitical events, etc). Then, as investor fear subsides, the VIX will mean revert back to its longer term average level. Therefore, from a risk management standpoint, it could be helpful to reduce equity exposure as the VIX rises, and increase equity exposure as the VIX begins to fall, or mean revert. In theory, such a move could help us better manage drawdowns in our portfolios.

In practice, however, trading the VIX is incredibly difficult, simply because the VIX is a basically a coincident indicator (unless you are a very active trader). That is to say, by the time the average investor observes that the VIX has moved higher, the market event that triggered the move has already occurred, and any hedging will be timed incorrectly (i.e. you will be too late). To make matters worse, the VIX could begin to mean revert, or move back down, at precisely the time you attempt to put your hedge into place. So not only do you take the loss on the underlying equites in your portfolio, you might also take a loss on the hedge as well.

Another way to approach the VIX is to instead look at the term structure of volatility. Just as with Treasury yields, the VIX is measured across varying maturities. For example, there is a volatility estimate that goes out three months instead of just one month. The so-called three month VIX measures the same thing as one month VIX, except over a longer time frame (i.e. investors' expectation of market volatility three months out instead of just one). Usually, three month VIX is higher than one month VIX. After all, as you go out in time, expected returns become more uncertain. The market will generally place a risk premium on returns the further you go out on the maturity curve. As a consequence, a normal term structure is said to be upward sloping, much like a normal yield curve for interest rates.

There are points in time, however, that the VIX term structure can become inverted. In other words, the level of one month VIX will exceed the level of three month VIX, and the volatility term structure becomes downward sloping, rather than the more normal upward sloping term structure (in technical terms, a downward sloping VIX curve is said to be in backwardation, while an upward sloping curve is said to be in contango).

On occasion, the volatility curve will tend to flatten out before the inevitable spike in one month contract. We experienced this as recently as earlier this month and on a few occasions last year. While these more recent occurrences didn't result in major volatility events, it's still worth examining. Changes in the volatility term structure, in conjunction with other measures such as changes in credit spreads and in the yield curve, can be helpful in evaluating the current risk environment.

Q: Are geopolitics a risk to the markets?

This topic was hotly debated at our recently concluded summit in Sonoma, CA. John Mauldin was gracious to attend the Summit this year and share his thoughts on geopolitical uncertainty and the likely impact on portfolios from his lofty relational perch. While the elections in France, animosity with Russia, or dealing with a lunatic in North Korea dominate the headlines, I think John accurately points out that what is taking place in Italy might be the most concerning development. Nationalist candidate Marine LePen had a strong showing in the French election placing second among 11 candidates and making the scheduled run-off. Centrist candidate Emanuel Macron not only received more votes but will get the endorsement of nearly all of the top vote getters who did not qualify for the run off, making LePen a steep underdog (like Brexit and Trump, by the way). A victory by the Five-Star party in Italy could dramatically alter the glide path of the EU and the Euro currency. We have previously written our belief that the Euro experiment would eventually fail and the upcoming Italian elections could provide that spark towards ultimate demise.

North Korea is more of a regional threat in my opinion and is unlikely to lead to any sustained pullback in the markets. I view the instability of Kim Jong-un as a positive geopolitical factor in that it will likely force the U.S and China to cooperate on security of the peninsula and trade issues in general.

I assume you are referencing the events transpiring in North Korea. It's a dangerous place with an unstable and unpredictable regime. What makes the situation exponentially worse is North Korea's nuclear weapons capabilities. But honestly, I honestly don't think their threats are genuine. They know full well that if they did unleash their nuclear capabilities on the U.S., or any other country, they would literally be annihilated. Given the unfathomable – that is, a nuclear strike – President Trump would not hesitate to repeat the actions of Harry Truman against the Japanese. Ultimately, the regime in North Korea wants to retain power, which is what any authoritarian regime ultimately wants. They know that if they follow on their threats of a military strike, they will lose this power. So far the markets have largely dismissed the threats from North Korea, but if the threats turn into action, then expect a jump in volatility.

Syria is another source of geopolitical risk. Trump recently ordered the airstrikes that grabbed the headlines. My take is that conflict in the Middle East will be a never ending quagmire. History tells us a great deal about getting involved in conflicts in this region. But, the mistakes of previous administrations (hindsight is always 20/20, I guess) and wars with no aim or final objective, will likely mean we continue to spend trillions on these efforts. That's a strain on our GDP at home.

Q: Will robots hurt economic growth?

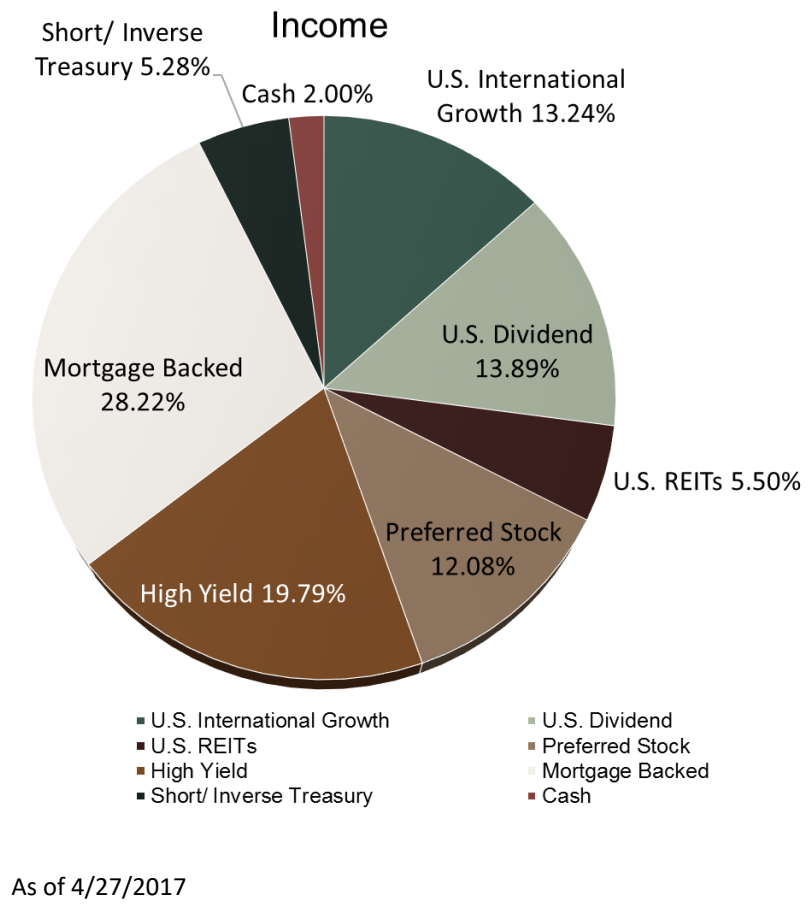
That may occur in the short term but longer term automation and robotics will expand the economy and provide even greater opportunities for American workers. Robots and automation work when you have a high volume task with low variability and the unit cost of automation can be quantified as lower than the unit cost of human labor. The drive to dramatically increase minimum wage across the nation is having the opposite intended effect. Instead of benefitting people in entry-level jobs, many of these jobs are being replaced through automation. At $10/hour, for example, McDonalds probably keeps cashiers in their restaurants. At $15/hour, plus the cost of employment taxes, worker's comp, health insurance, etc. the actual cost may be closer to $20/hour. Many McDonald's operators are making the decision to install kiosks to take orders and payments instead of minimum wage workers.

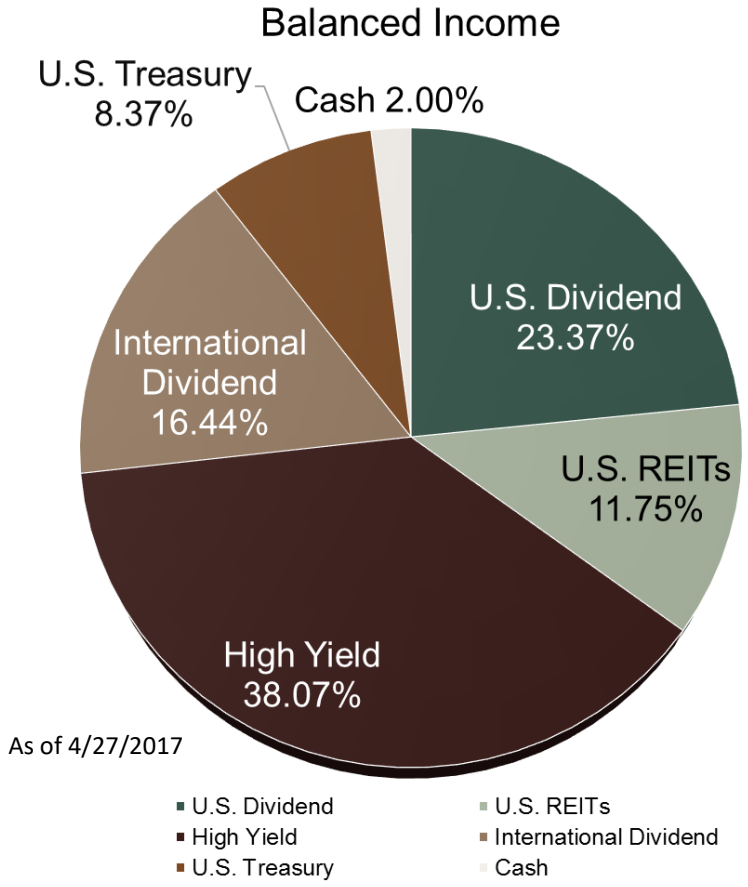
Automation is surrounding us even if we don't recognize it. People use FitBit instead of a trainer, we use Siri for everything from restaurant reservations to directions (been into a map store lately?). Google glass can allow a worker to perform a task where the instructions are displayed in front of them without taking their eyes off the task. The development of exoskeletons might be the most exciting breakthrough. Workers in factories can be fitted with a robotic shell that enables them to lift heavy objects without risk of injury. The road may be bumpy but in the end robotics will improve our lives.

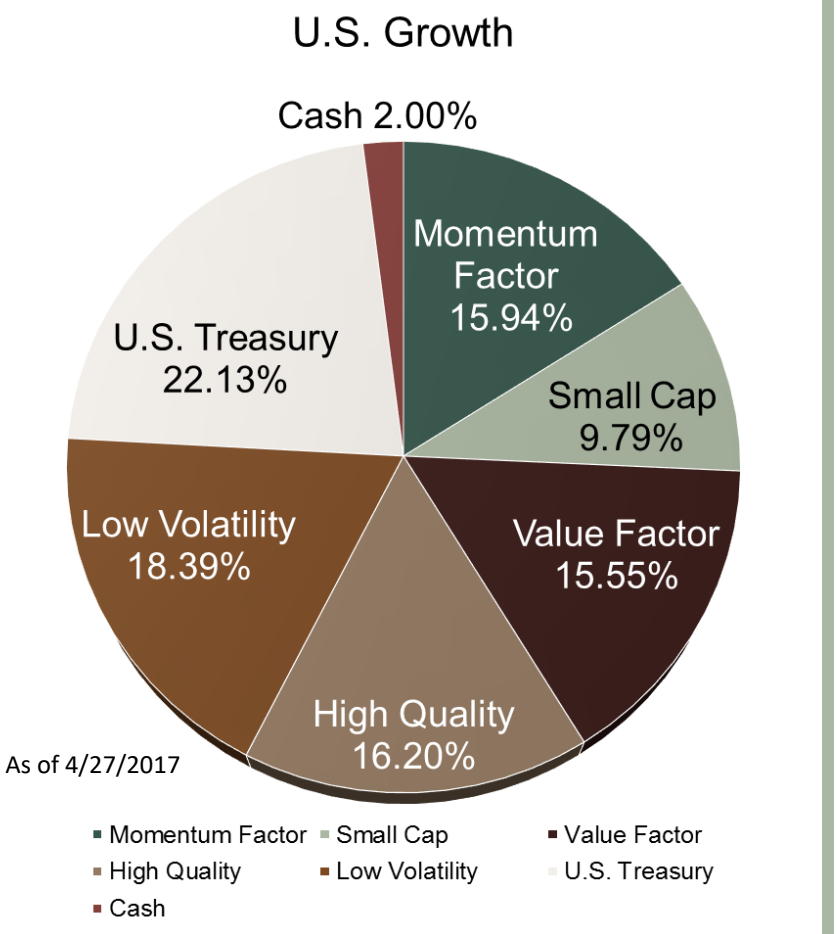
Well, to a large degree, robots have been taking over for quite some time. The question is to what degree will automation disrupt the labor force? Longer term, technological advancements are a fine thing. What was once repetitive work, or work that was done with a great deal of inefficiency, has been automated. Some industries today will no longer exist in a decade. Simply going through history, advances in technology have displaced entire industries, and often times, it's to the betterment of society as a whole.

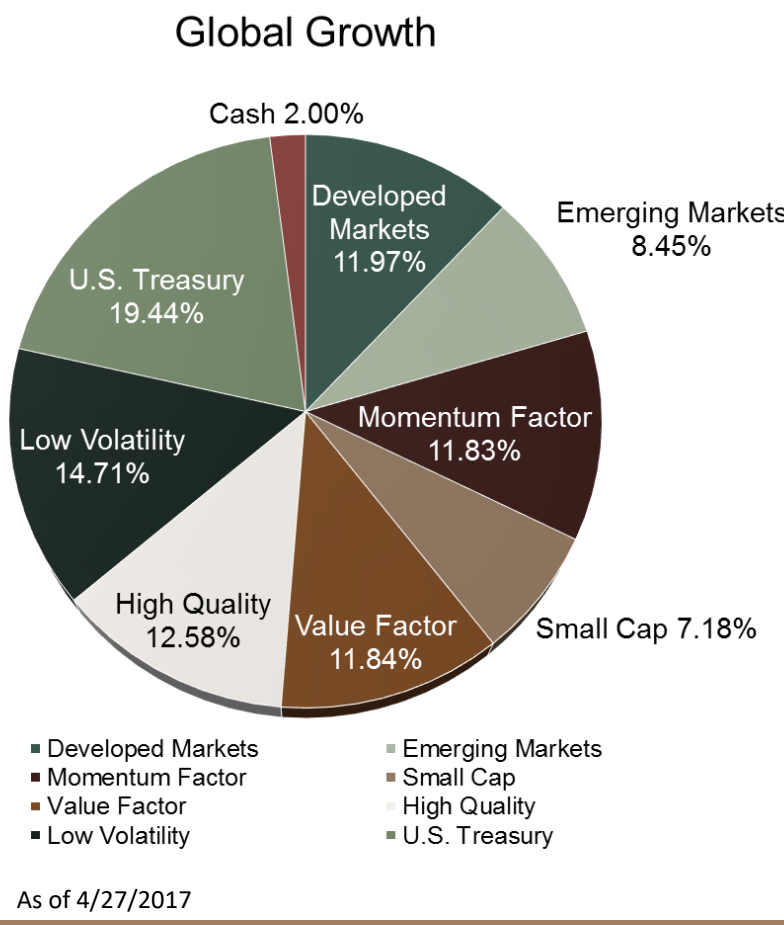
Shorter term, these advancements are disruptive as workers are displaced. Furthermore, advancements in technology generally impact all industries to varying degrees. They must either learn a new skillset, or accept new work at potentially a lower wage. There's a saying going around-either you learn to program a computer, or learn to sweep the floor around the computer. Think about the technology of driverless cars that's occurring now. How many hundreds of thousands of jobs will be eventually eliminated (i.e. truck drivers, cab drivers, etc)?

What I think is more interesting are advancements in artificial intelligence, where IT systems will learn and adapt on their own. That area of innovation is incredibly exciting. There's no telling what the labor force will look like 50 years from now.









PCM

PEAK CAPITAL MANAGEMENT

15455 Gleneagle Dr., Suite 100

Colorado Springs, CO 80921

Phone: 719.203.6926

Fax: 719.465.1386

Email: info@pcmstrategies.com

Website: www.pcmstrategies.com