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Monday, June 13, 2016

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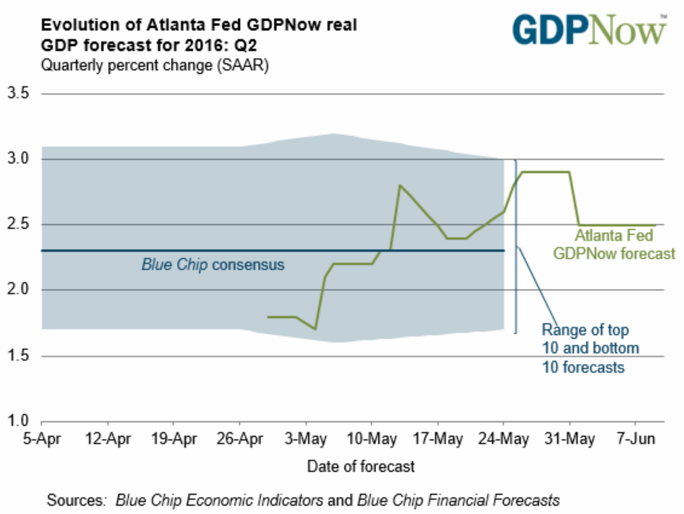
The Fed May Yet Surprise Markets

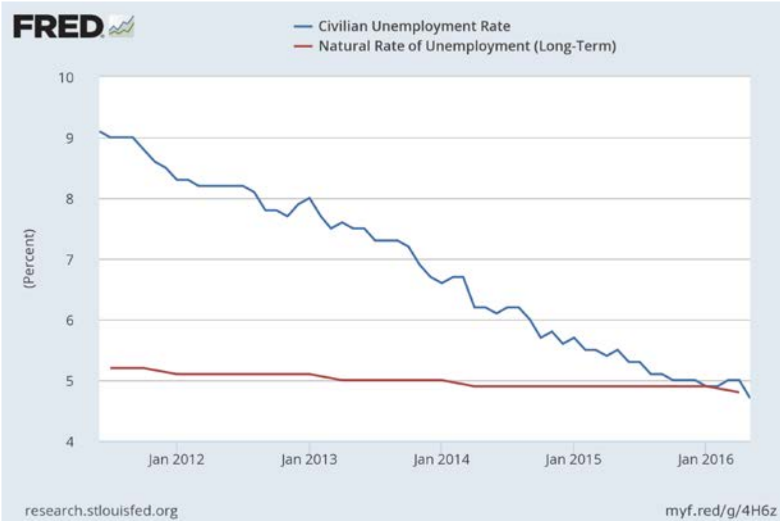
It's clear to us that market psychology is highly bifurcated. The economy is either terrible and headed for recession or the economy is in good shape and strengthening. There's no middle ground. In and of itself there's nothing wrong with that. After all, differing opinions is what makes a market. However, what has us concerned is the apparent lack of conviction among those adherents of either persuasion, which makes market sentiment fragile and vulnerable to sharp swings. As the major averages have floated upward to approach record highs, the low level of market volatility [as measured by the VIX] infers a level of investor complacency that appears unsustainable, in our view. **The rise in market volatility over the past few trading days may be early confirmation of our view.**

Last month we wrote that market participants had low-balled the probability of a June rate hike and the subsequent re-pricing of assets, even though our view has been that an increase isn't warranted given lackluster economic growth. We believed that commentary by the Federal Reserve regional presidents would unsettle markets ahead of the June 15th rate decision. While this proved to be a very accurate assessment initially, May's weaker than expected nonfarm payroll report put the kibosh on any thoughts of a rate hike. Fed Chair Yellen's dovish speech last Monday further emboldened market bulls that no rate hike is in the offing. We also note that excess bank reserves are no longer being drained as they were a month ago. **Yet we maintain that market participants may be too sanguine over the degree of reticence by the Fed to raise interest rates.**

Although the Fed will almost certainly not raise the Fed funds rate this week when the FOMC meets, investors could still receive an unwelcome surprise in Wednesday's FOMC statement. Fed speakers have been very vocal in postulating rationales to justify a rise in the Fed funds rate and have noted that one weak jobs report does not make a trend, especially when the dominant trend line is an unemployment rate that continues to decline to a level consistent with full employment. We believe that market participants have overlooked and are consequently unprepared if, for the first time in the current interest rate cycle, there is more than one dissenter among voting committee members. If the Fed wants market participants to take its intent to raise rates seriously, an increase in the number of members voting for a rate hike sends a signal and could readily move the needle to encourage pricing-in a rate rise sooner rather than later. Therefore, we would not be surprised, at all, if there was more than one dissenter among voting members. Investor angst will rise anew. The shock value would likely trigger a selloff in equities that could spread globally and cause a more meaningful correction than currently anticipated. **It will not be long before we all look back wistfully at this spring's extended period of low market volatility.**

The frustration of the members of the FOMC to raise interest rates is palpable. Last month's weak payroll report notwithstanding, the labor market has continued to strengthen while inflation shows signs of creeping higher toward the Fed's target of 2%—and maximizing employment and controlling inflation are the twin mandates of the Fed. **The Atlanta Fed currently forecasts a return to higher growth in the current quarter of 2.5%.**





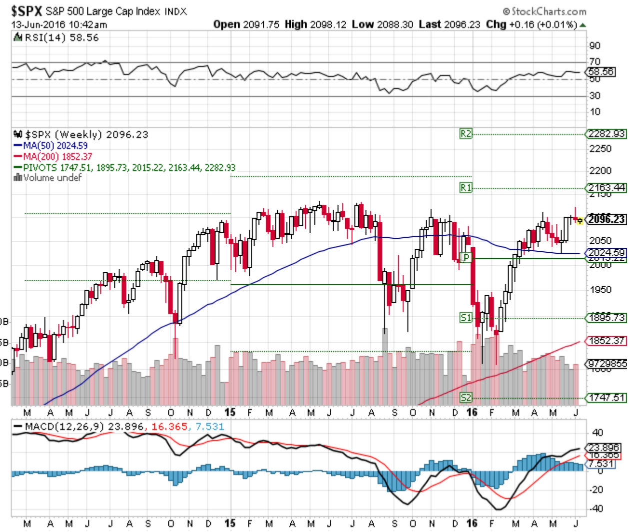
The decline in the unemployment rate to the natural rate of unemployment (full-employment) sets the stage for additional upward job mobility and higher real wages—adding support for those in favor of raising interest rates.

Global bond yields plumbed new levels on Friday when concerns over global growth re-emerged after the World Bank announced that it was cutting its global growth forecast from January yet again—this time from 2.9% to 2.4% for 2016 and from 3.1% to 2.8% for 2017. Global bond yields continue their descent with German, UK and Japanese 10-year bond yields all trading down to new record lows. The German 10-year bund came within one basis point of ticking into negative yield while Japanese 10-year bond yields are already negative. US Treasuries benefited from the search for yield by global investors as the yield on 10-year Treasuries fell to 1.64%. Given the repeated reassurance by Janet Yellen that the increase in interest rates will be gradual, the press of foreign money into US Treasuries seeking yield is probably a bigger determinant for the direction of domestic bond yields than the Fed near term. **We continue to believe that bond yields will surprise to the low side.**

The Fed may be hoping that the market will do its work for it even as it keeps the Fed funds rate unchanged, but this would be wishful thinking. If the Fed believes that an increase in voting member dissenters to keeping rates unchanged will provide a smooth glide path to signal to markets that a rate increase is coming, they will likely be proven wrong as upward pressure on bond yields builds [initially] on the short end of the curve if market participants begin to doubt the certainty of no rate hike but just as quickly fades. The negative impact is likely to be greater and more long-lasting on stocks than bonds for the reasons outlined earlier. **The weekly chart for the 10-year bond yield looks ready to break lower technically and yields are a long way from support.**

As we suggested back on May 10th, the stock market remains vulnerable to correction after its recent run-up (As we write this, the S&P 500 intraday is virtually unchanged from its closing level on May 10th). Earnings have now declined four quarters in a row and current second quarter earnings will almost assuredly make it five. Additional headline risks include election-related news, Brexit, terrorism, and policy missteps (to name a few) over the next several months. **A modestly more defensive portfolio tilt still appears the prudent course of action.**

The market has a nasty way of whipsawing investors whenever something is viewed as a virtual certainty and investor confidence remains fragile as sentiment vacillates between "risk on" and "risk off". The recent return of market volatility is not an aberration.



We suggest broadly trimming US equity exposure. Those long-only investors that desire to maintain equity exposure rather than raise cash should consider swapping into consumer staples (food and beverage sub-sectors) and health care (pharma and devices). We also anticipate that European equities' usual seasonal period of underperformance could be accentuated through the June 23rd UK referendum on EU membership (we expect UK voters will vote to remain in the European Union), which should present a subsequent buying opportunity for many European blue chips.

We also suggest taking profits and reducing near-term exposure to commodity export-dependent emerging markets. If market participants begin to anticipate an earlier rate hike than currently reflected in the futures market, the resultant likely boost to the dollar will hit commodities and emerging markets.

Treasuries remain the safe-haven of choice. Foreign investors continue to be attracted to US Treasuries and investment-grade corporate bonds as the spread between similar securities in Europe and Japan remains compelling. We prefer the mid-section of the yield curve.

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