November 3, 2014

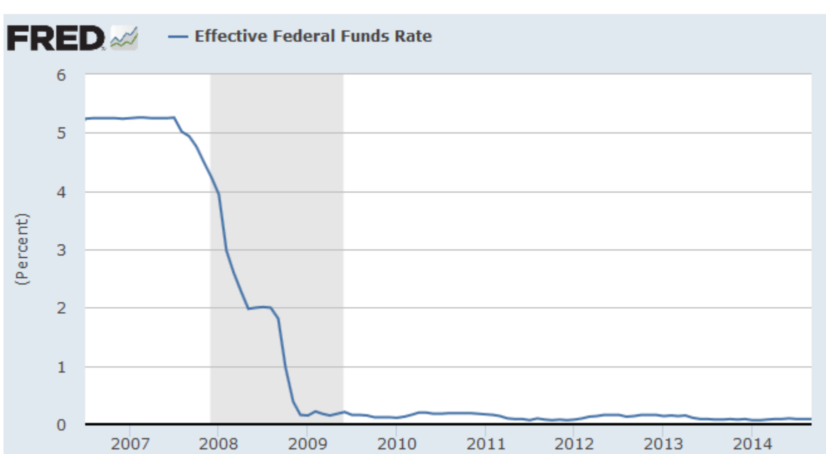
New Albany Investment Management

Market Insight: Going It Alone- A New Market Environment

It's official, quantitative easing (QE) has finally come to an end and so has the period of low volatility and easy money. With the bull market now in its 6th year and solid economic growth, it seems more than appropriate if not long overdue, for the Fed to step out of the market and allow prices of financial assets to float freely. On the one hand, this is welcome news because it is a vote of confidence from the Fed that the economy is healthy enough to actually function without support. On the other hand, it means a new playbook for navigating the financial markets where the 'natural' forces of the market will be the dominate factor instead of free money from the Fed which has always provided a 'floor' of support. So what will this new market environment look like and what should investors expect when it comes to returns? Let's take a look…

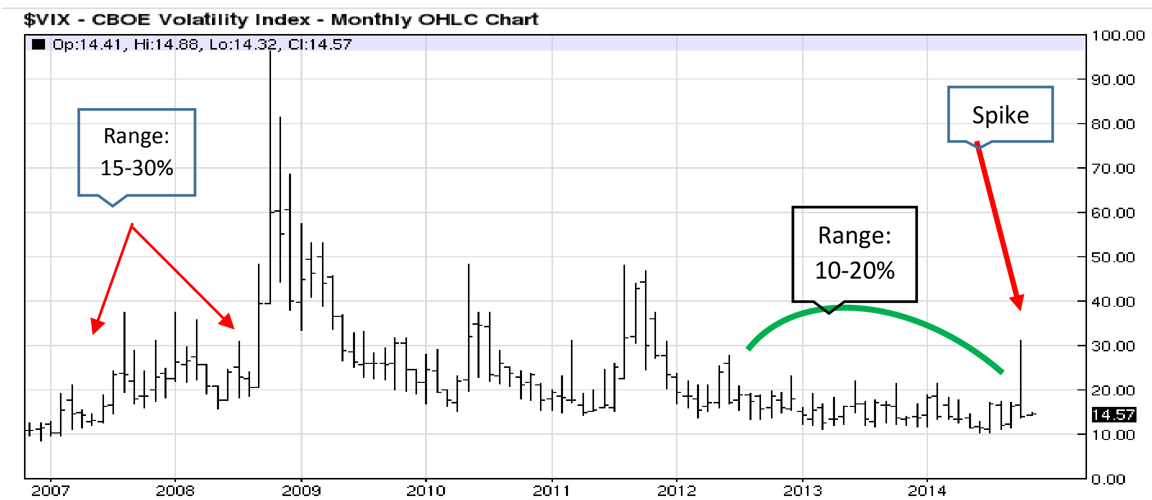
The Real Market Place: Free Markets allow capital to flow where there is perceived value. Expectations of changes in the future move prices today. For the last six years, the Fed has anchored interest rates both through market manipulation and policy statements. This action has been a great stabilizing factor to the markets in two ways: raising valuation and lowering volatility. Make no mistake, prices of all financial assets have benefited handsomely from cheap money AND the assurance of cheap money in the future. The following series of charts tell the story of how holding rates down has lowered volatility and raised stock prices.

#1 Chart of Federal Funds Rate: The Fed Funds rate is the rate paid by banks to borrow/lend money to other banks to settle their reserve requirements with the Federal Reserve. This rate is significant because it influences all other interest rates including CD's, Bonds, and Mortgage rates. The Fed cut the Federal Funds rate to zero in 2009. A zero rate forced all other market rates to drop and pushed investors to seek higher returns away from Bonds and into other riskier financial assets.

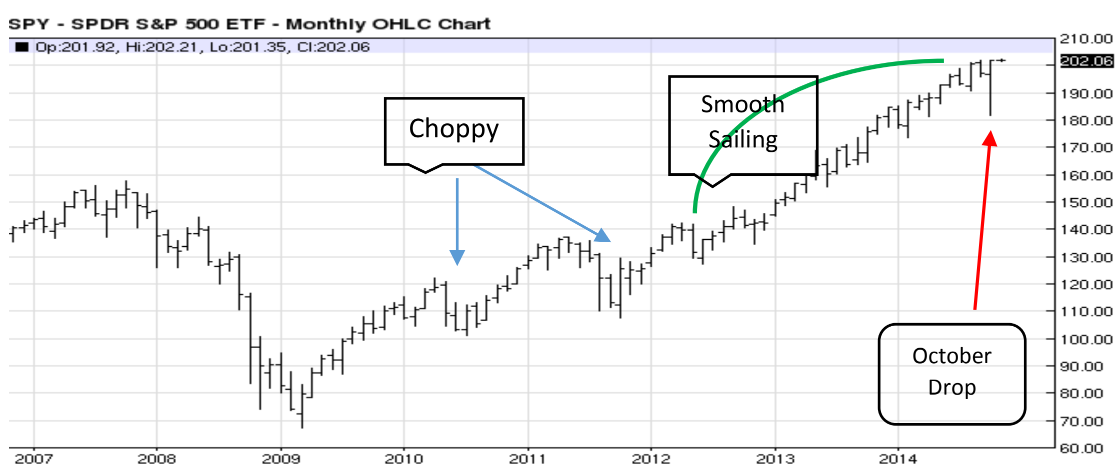


#2 Chart of the "VIX" which measures investors' expectation of volatility or price change of the S&P 500 (annualized). This is often referred to as the 'fear index'. Prior to 2008, the VIX ranged between 15-30% on the S&P 500. Volatility spiked dramatically in 2008 during the Lehman Bros. collapse and again in 2010 and 2011 when there was a scare of defaults. But each time the Fed stepped in with a huge dose of liquidity to calm the markets and volatility dropped. And since 2011, the Fed had promised to 'keep rates low for indefinite period of time'. This assurance of lower rates had the effect of increasing investors' confidence to take on more risk (because the perceived risk of default was removed) and volatility settled into a lower range of 10-20%.

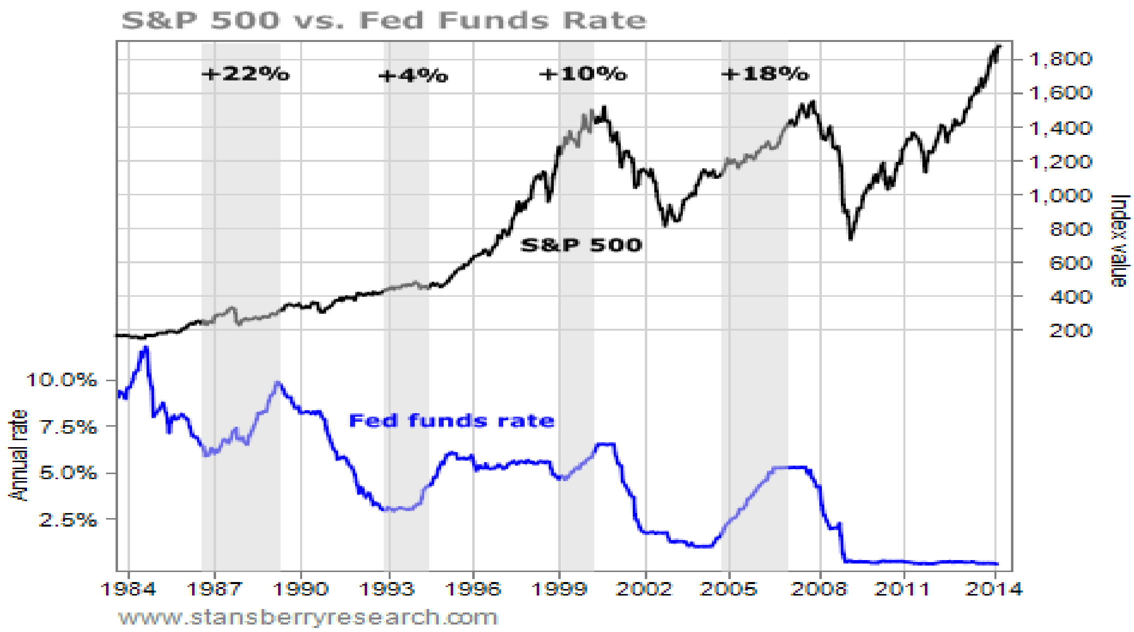
October marked the end of Fed intervention (support). During that month, global news was very negative and it is no coincidence the markets gyrated violently without the safety net of the Fed. Volatility spiked above its 2yr range, touching 26%, as investors realized they were on their own.



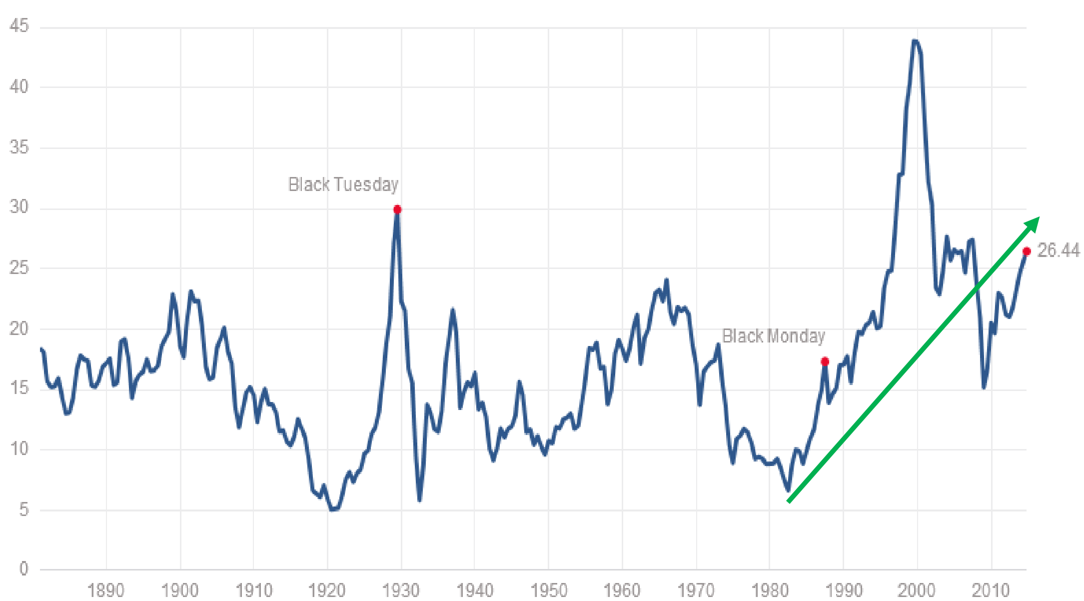
#3 Chart of the S&P 500. From 2009-2011 prices rose every time a new Fed easing initiative commenced but fell when it expired. Likewise, since late 2011, prices have steadily risen because the Fed's constant presence soothed investors' fears.



#4 Chart of S&P 500 and Fed Funds Rate: Rates have been falling since 1985 and have been a tail wind for stocks.



#5 Chart of Price Earnings Ratio. P/E is one measure used as a relative valuation of stocks. The chart below shows the historical Shiller P/E ratio since 1890. Since 1984, smoothing out the market shocks, the P/E has risen steadily as rates have fallen. Low rates have fueled higher valuations.



New Paradigm without the Fed: Exceptionally low rates over the last five years have benefited most financial assets, reducing risk premiums and increasing valuation. Investors have become complacent if not expectant of a 'safe' environment where volatility is low and returns are easy. And until this year, this has been a good bet as generally all asset sectors have risen in price. But this year, as the reality of the Fed withdrawing its support settles in, investors are once again beginning to pull back from riskier sectors and quicker to exit the market when the water gets rough. Thus going it alone, without the Fed's safety net, the markets will revert back to their 'normal' functioning state where global economies direct valuation and political factors impact fear/ confidence. This means volatility will be higher (back to its historical range of 15-30%), returns more trend like (lower) and more widely dispersed across asset sectors.

Investment Strategy: Portfolios are fully invested however early in the third quarter, risk was reduced in anticipation of choppy markets. Equity positions were further diversified across asset classes to minimize volatility. High yield exposure was reduced and allocated into investment grade short term bonds.

Please contact me with any questions or concerns.

Kind Regards,

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