EPIC INVESTMENT MANAGEMENT

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Ready, Hike, Ease

In December 2015, the Federal Reserve ended a long-running zero-interest-rate policy by raising its Federal Funds target rate 25 basis points. A year later, the Fed doubled down with another quarter-point hike. This year the rate increases have accelerated, with two quarter-point hikes already effective and a third raise a distinct possibility.

In financial parlance, these short-term interest rate increases are alternatively referred to as "normalization", "withdrawal of policy accommodation", or more commonly, "tightening".

But a funny thing happened on the way to Fed tightening: financial market conditions have instead loosened.

Bloomberg US Financial Conditions Index June 2015 – June 2017
Initial Federal Reserve rate hike December 2015

The Bloomberg US Financial Conditions Index tracks the overall level of financial stress in our financial markets to help assess the availability and cost of credit. A positive value indicates accommodative financial conditions, while a negative value indicates tighter financial conditions relative to pre-crisis norms. The index includes three money market measures, four bond market

measures, and two equity-related readings. Excluding the equity components, the index essentially reflects spread compression or widening; that is, the cost of credit relative to a benchmark such as Treasury bills or notes. And as shown above, financial conditions have eased considerably since our central bank began raising short-term rates, with this measure approaching its post-crisis high.

Focusing on the US bond market, we see more of the same. Again using December 2015 as a reference point, high yield bond rates have fallen 310 basis points, investment grade bond yields have dropped 45 to 115 basis points, while yields on the 10-year Treasury are unchanged.

US Bond Yields 2015 – June 2017
High Yield (top line), AA rated (orange line), Baa rated (red line), 10-Year U.S. Treasury (lower line)

The ramifications for financial markets undoubtedly have been positive: investors favor easy money over tight, narrow credit spreads over wide, and low bond yields over high. Thus, asset prices have risen. That's the easy part. The difficulty arises in making sense of what has happened since the initial Fed rate hike of 18 months ago. Is this a new financial scheme, easing through tightening?

Here are a few theories:

The world is still flat.
Globalization is reflected not only in the price of goods and services, but in financial markets as well. With central banks in Japan and Europe continuing to pursue easy money policies, the effect is felt throughout the world. Referencing 10-year sovereign bonds, yields are still negative in Switzerland, are slightly above zero in Japan, and are near 50 basis points in Germany. France, Spain, and Italy -- no economic superpowers -- all offer bond yields below those of the US Treasury. Capital usually flows to where it is treated best. That still favors our markets, with yields relatively high compared to the developed world.

Awash in Liquidity

More than a decade ago, then-Fed Chairman Alan Greenspan introduced a peculiar expression to our financial lexicon. The 'conundrum', as he saw it, was the stability, and subsequent decline, of longer-dated government bond yields in the face of persistently rising short-term rates. One explanation was offered up by future-Fed Chairman Ben Bernanke: the world was awash in funds ready to be invested, and the force of this liquidity could overpower our central bank. The passage of time has only strengthened this case. Depending on when and whom you ask, there are some 50 trillion dollars of cash and equivalents in the global financial system, looking for suitable investments. A portion of these funds favor US Treasurys, investment-grade bonds, and high yield bonds. This drives interest rates lower and credit spreads tighter; which is to say, it eases financial conditions.

Fed Futility

Years from now financial historians and a self-reflecting Federal Reserve may conclude that a zero-interest-rate policy was never the easy-money palliative economists expected. After all, the price of credit does not measure the availability of credit; money supply never accelerated as inflation hawks feared, and economic growth has been persistently below norms of prior expansionary periods. It all adds up to the likelihood that ultra-low interest rates were in fact sub-optimal to both our financial system and economic vitality. With short-term rates now 100 basis points off their floor, normalcy is returning, and that normalcy includes healthier credit markets.

It should be apparent that these theories are intertwined, forming a stronger argument when considered in combination.

A natural query is "how long will this last?" History reminds us that central banks eventually tighten to a point of capitulation, where yields rise, spreads widen, credit formation slows, economies stall, and risk assets are re-priced. The critical question for today is this: should we worry about an inevitable correction if financial conditions are still improving? To date, the answer has been 'no'.

At the same time, we should remember that easing through tightening is an anomaly, and anomalies do not last forever.

No Way Out

The death of traditional retailing, also known as the Amazon effect, is accelerating. The prime victims, brick-and-mortar merchants, continue to register disappointing sales figures. Meanwhile, retail bankruptcies are reportedly at a record level for any year, just halfway through the calendar.

Among the casualties are shoe-store Payless, the ubiquitous if ever-foundering RadioShack, and what was once the hottest name in America's malls, Limited Stores. Adding insult to future injury, S&P Global Market Intelligence recently released a list of 10 publicly traded retailers they consider most at risk of default within the next 12 months. Some well-known names on the list include Sears Holdings, The Bon-Ton Stores, Bebe Stores, and Tailored Brands, owner of Men's Wearhouse.

Worthy of particular attention, Sears Holdings recently expressed "substantial doubt" about its ability to continue as a going concern. Those are far from comforting words, but then again, Sears is enduring perhaps the slowest collapse in business history, having reported annual losses for six consecutive years.

The problem in the retail business is two-fold: too many stores, and too much Amazon.

On the store front, consider the words of Urban Outfitters Chief Executive Richard Hayne.
"The U.S. market is oversaturated with retail space and far too much of that space is occupied by stores selling apparel," he said. "Retail square feet per capita in the United States is more than six times that of Europe or Japan. And this doesn't count digital commerce."

The 1990s and early 2000s saw too much new square footage, with thousands of stores opening, he added.

"This created a bubble, and like housing, that bubble has now burst," he said. "We are seeing the results: Doors shuttering and rents retreating. This trend will continue for the foreseeable future and may even accelerate."

Don't sugar-coat it, Mr. Hayne.

As for Amazon, according to a Deutsche Bank research note, e-commerce gained 140 basis points of market share in adjusted retail revenues over the past year, now accounting for 12.6 percent of sales. More impressively, e-commerce took 73 percent of the retail sales GROWTH in the past year. And over half of the total retail sales growth went to one company... Amazon.

This is no cyclical blip. Expect little relief, as the profit squeeze spreads from department stores, big box merchants, and mall-based retailers; to suppliers of apparel and hard goods, and to owners of regional malls and local shopping centers. For many caught in the downward spiral of this e-commerce vortex, there's just no way out.

Tidbits..

Treasury Department report calls for rollback of Dodd-Frank-inspired banking regulations.
Trump Administration floats idea of raising federal gasoline tax, stuck at 1993 levels.
Congressional Budget Office says 23 million Americans will lose health care coverage under GOP reform plan.
Trump Administration budget proposal targets 3.6 trillion dollars in spending cuts over 10 years.
Dream On.

Puerto Rico seeks bankruptcy protection, says it is "unable to provide its citizens effective services".
Puerto Ricans vote for statehood in non-binding referendum with meager voter turnout.

Obama Administration added 7,000 rules and regulations in its last two years, says Commerce Secretary Wilbur Ross.
Annual cost of complying with federal regulations estimated at 1.9 trillion dollars, says Competitive Enterprise Institute.

Chicago Board Options Exchange Volatility Index, aka 'VIX', aka 'fear gauge', drops to lowest level since 1993.

Global cyberattacks hit businesses and governments in 150 countries.

US takes formal steps to renegotiate NAFTA trade agreement with Canada and Mexico.
Federal Communications Commission initiates rollback of Obama-era net neutrality rules for broadband providers.

OPEC and other oil exporters agree to nine-month extension of crude oil production cuts.
Oil markets yawn, then tumble into bear market.

Ford Motors announces job cuts, including Chief Executive's ouster.
General Electric readies transition to new Chairman and CEO.
Uber's uber-brat Chief Executive steps down among misogyny-culture claims, talent exodus.

40 years after: Three Mile Island nuclear site to shut down in 2019, well ahead of planned lifespan.
More than half of US nuclear power plants are estimated to be unprofitable.
Economic reality supplants China Syndrome scare as industry's vulnerability.

Argentina, junk rated and having defaulted eight times in history, successfully offers 100-year bond.

Latest flash crash: price of ethereum, an alternative digital currency to bitcoin, momentarily plunges from 319 dollars to 10 cents, in one second of trading.

Large banks pass government stress test with flying colors, including approval of dividend hikes and expanded share repurchases.
A kinder, gentler regulator.

Source:
Bloomberg
Deutsche Bank
The Wall Street Journal