

Time for the Federal Reserve to “Get Real”

We have concluded that the Federal Reserve (the “Fed”) leaders have sounded like political candidates of late, flip-flopping on the issue of the timing and extent of interest rate increases for 2016. While the Fed’s thought process has certainly become more transparent under Bernanke and Yellen, this improved communication and visibility has also exposed the Fed’s struggle to accurately forecast economic growth and to communicate a consistent and credible plan for normalizing monetary policy.

What’s driving the Federal Reserve’s projections?

Markets were not surprised when the Fed finally took action and increased the Fed Funds Rate by a quarter percent in December. The Fed signaled such a move for the past 18 months. However, they also guided toward four additional rate increases for 2016 in their dot plot projections at the same meeting. The aggressively hawkish stance caused a sell-off of all risk markets, including Investment Grade and High Yield spreads, in late 2015 and early 2016. The “risk-off” trade lasted until the March Fed meeting, when the Fed delayed an expected rate increase and signaled a reduction in the number of 2016 increases from four to two. Why? They appropriately cited capital market volatility and a slowdown in global economic growth. In a March 29 speech to the Economic Club of New York, Fed Chairman Janet Yellen intimated that rates would likely need to be lower for longer. Perhaps we will now see only one 2016 rate increase instead of the two signaled just a month earlier, especially since the Atlanta Fed’s GDPNow estimate of 1Q16 GDP growth has declined to 0.4%?

While the effort to improve communication and transparency is welcome, we believe the Fed’s overly optimistic forecasts have served to increase market volatility in recent years. In our opinion, the Fed has consistently overestimated the strength of economic growth and underestimated the time to monetary policy normalization. We believe it is time for the Fed to “get real” and admit that the end of the debt super-cycle has led to an extended period of lower economic growth.

The chart to the right details the convergence of various economic performance metrics over the past 10 years. We believe this chart helps tell the story of an economy stuck in a slow growth mode for the foreseeable future.

What is causing persistently lower growth?

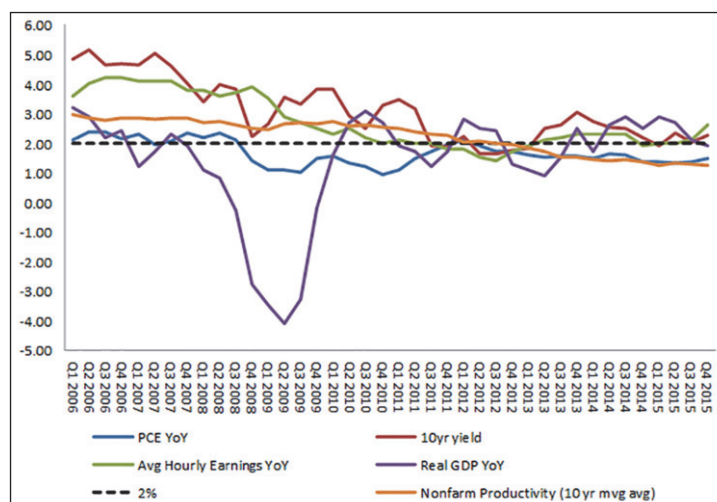
We believe part of the answer to this question lies in lower wages and lower productivity growth. Stagnant wages are both a cause and consequence of low productivity. Labor productivity growth has been on the decline globally and domestically for the past 15 years. When productivity growth is on the rise, employers can provide higher wages to employees resulting in a

higher standard of living as more value is produced per worker. Productivity driven wage increases do not result in inflation because firms do not have to raise prices to offset the cost of additional production. Why has productivity growth stagnated? A recent study by the Bank of International Settlements (BIS) suggests that the domestic employee base is not mobile enough to relocate to where the jobs are, nor are they being properly prepared for the jobs available. Why are these prospective employees immobile? Government programs designed to assist them actually chain them to their current residences, cities and states. These programs encourage people to buy homes (making them less mobile), reside where benefits are available (not where the employment opportunities are better) and locate in states that provide more generous benefits. Furthermore, falling wages and lower labor force participation can be the cause of lower productivity, as firms opt not to invest in productivity enhancing technologies when excess labor is available on the cheap.

The Federal Reserve’s attempt to spur economic growth has had the same effect as pushing on a string. Years of Washington gridlock and shortsighted fiscal policies cannot be neutralized or overcome by the Fed’s monetary policy alone. Washington could be a solution, as opposed to a problem, through a reduction in unnecessary regulation, an increase in the earned income tax credit, refinements to the Affordable Care Act and meaningful job training programs. In seven months, as we elect new political leaders, things may change...or maybe not.

The Fed’s changing focus

One additional comment on the Fed before we close. Below is a Deutsche Bank graph depicting the number of times Janet Yellen used the words “China”, “Dollar” or “Global” in her last four outlook speeches. The global economy has become an

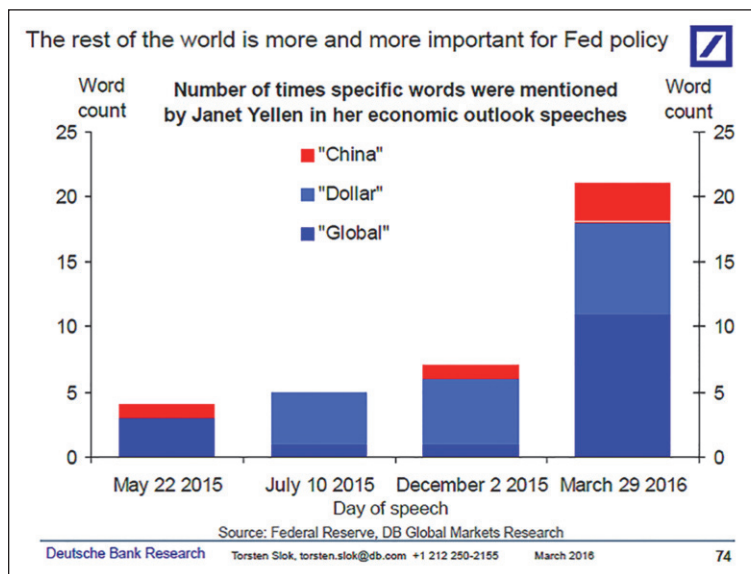


Source: Bloomberg

increasing concern to the Fed, particularly in the last three months. Historically, the US economy has been characterized by the Fed as relatively insulated with global economies having limited or “transitory” impact on the US economic outlook. The transformation of the Chinese economy from a manufacturing to a service-oriented economy has begun and the ripple effect of these changes are being felt in emerging markets and also in Europe. These ripples are increasingly becoming a concern to the Fed and may lead them to be a bit more dovish than they prefer. We believe the Fed would rather risk overheating the US economy by keeping rates lower longer versus driving up the value of the dollar and experiencing a corresponding detrimental decline in exports and an even flatter yield curve with rate increases.

Capital Markets and Performance

Market volatility was robust in the first quarter of 2016. As mentioned above, the quarter began with market uncertainty about Fed policy and projected rate increases, as well as uncertainty about slowing global growth, and lower oil and other commodity prices. All of these market worries created a “risk-off” trade and thus Treasury securities were the best performers in January and February. However, March witnessed a dramatic reversal as uncertainty and worry gave way to greed. The Fed reduced their rate hike projection to two instead of four, oil prices rebounded to \$40, and global growth maintained projections. Subsequently, the market sentiment pendulum swung back to risk-taking. Corporate securities, both investment grade and high yield, overtook Treasury securities as the best performers for the quarter.



For the first quarter, the Barclays Capital U.S. Aggregate Index returned a healthy 3.03%. The bellwether 10-year Treasury yield declined 50 basis points in the quarter to close with a yield of 1.77%. Overall, Treasuries returned 3.20% in the quarter but, corporate securities were the best performers with an impressive 3.97% return. Longer maturities performed better than shorter maturities and lower quality securities outpaced higher quality. The BofA/Merrill Lynch High Yield Master II Index increased 3.25% in the quarter.

Our composites had positive performance versus their respective benchmarks in the quarter given the extreme market volatility. As we have mentioned in our past quarterly commentaries, we have structured all of the accounts with an overweight to the corporate sector. This corporate overweight obviously helped our performance and we believe the best opportunity moving forward remains in the corporate sector for higher yield and spread tightening.

A publication we found insightful:

From BIS Quarterly Review 2016: Wealth inequality and monetary policy: “This feature explores the recent evolution of household wealth inequality in advanced economies by looking at valuation effects on household assets and liabilities. Using household survey data, we analyze the possible drivers of wealth inequality and the potential effect of monetary policy through its impact on interest rates and asset prices. Our simulation suggests that wealth inequality has risen since the Great Financial Crisis. While low interest rates and rising bond prices have had a negligible impact on wealth inequality, rising equity prices have been a key driver of inequality. A recovery in house prices has only partly offset this effect. Abstracting from general equilibrium effects on savings, borrowing and human wealth, this suggests that monetary policy may have added to inequality to the extent that it has boosted equity prices.” https://www.bis.org/publ/qtrpdf/r_qt1603f.pdf

Our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward trade-offs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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