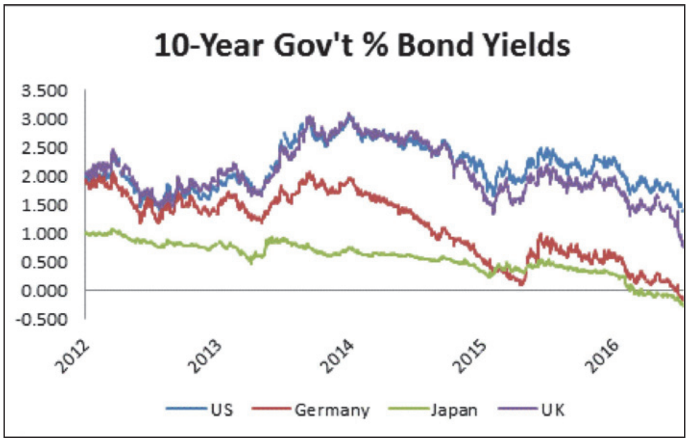
Lower for (even) longer....the Federal Reserve finally "Got Real"

Our last quarterly commentary was titled "Time for the Federal Reserve to 'Get Real.'" They made strides in this regard during the second quarter as they elected to keep rates unchanged and reduced their interest rate forecasts for 2017 and 2018. This took place following the report of weak job growth in May, but before the "Brexit" vote. We are currently amidst the fallout from Britain's decision to leave the EU, with Treasury yields reaching historical lows and the dollar strengthening against major currencies. We will address the Fed decision, Brexit, and our outlook for the economy and fixed income markets in the discussion that follows.

The Federal Reserve

The 10-yr Treasury closed at an all-time low yield of 1.369% on July 6 while Japan's 10-yr government bond yield entered negative territory. The previous low on the 10-yr UST yield was 1.388% in July 2012, when Operation Twist was underway, meaning the Fed was swapping short term debt for longer maturities, and QE3 was announced. Currently, however, the primary drivers of low yields are a quest for safety and ironically higher yields. 1.369% doesn't sound like much, but compared to 0.765% in the UK, -0.177% in Germany and -0.265% in Japan, it's a home run. The volume of global sovereign debt with negative yields is reaching such critical mass that its gravitational pull is wresting control of the Treasury curve away from the Fed.



Source: Bloomberg

The Federal Open Market Committee (FOMC) held rates steady in June and made few changes to its policy statement, as expected. The FOMC still projects approximately two hikes for this year. However, they did cut the expected pace of rate hikes going forward, implying three hikes each in 2017 and 2018, down from four each, and they reduced the longer run funds rate expectation by 25bps to 3.00%. In our view, that was a dovish concession. The FOMC's actual forecasts for economic growth changed very little from March to June and remain around 2.00% for the foreseeable future, but the outlook has become more uncertain. In her press conference remarks, Fed Chair Janet Yellen stated that the Committee had grown somewhat more uncertain about the neutral rate (the inflation adjusted interest rate which neither stimulates or restricts an economy operating at full potential), and that was an important factor in reducing the policy path. A lower assumed neutral rate implies fewer rate hikes needed to keep the economy from overheating.

The FOMC made no meaningful changes to its language around inflation expectations, claiming that "most survey based measures...are little changed, on balance, in recent months." During the press conference, Yellen said that realized core inflation had largely moved "roughly as one would expect with well-anchored inflation expectations," although she acknowledged that it is difficult to know what the appropriate measure of inflation expectations should be. Fed officials slightly revised higher the median core inflation projection for 2016, although both 2016 and 2017 still remain below the 2% target. In the end, inflation continues to trend below target and it sounds like the Committee remains fairly uncertain about the outlook. This uncertainty is one reason we expect the Fed to move rates higher only gradually, even allowing inflation to overshoot their target for a time.

Yellen made one thing clear during her recent testimony to Congress: there is much uncertainty in the Fed's forecast for the economy, inflation, and path of growth. Since 2012, the median dot projection for the longer run federal funds rate has plummeted from 4.25% to 3.00%, with 50bps of reduction so far this year. Yellen attributed much of the shift down in the dot plot to the aforementioned lower anticipated neutral rate. The neutral interest rate may be lower than previously assumed due to a number of factors including low productivity (see our Q1 2016 Commentary), slower population growth, and low global growth prospects, among others. Yellen has also recently acknowledged that rates might be depressed by "factors that are not going to be rapidly disappearing, but are part of the new normal." That sentiment is finally consistent with the market's understanding of the economy for the past several years. We believe it represents a significant change for the Fed, where denial of secular stagnation has been central to its forecast since 2009. The Fed finally decided to "Get Real."

While we appreciate the Fed's efforts to become more open and communicative, we believe it has somewhat undermined the Fed's credibility as the Board has consistently overestimated economic growth in recent years. Furthermore, consistently low growth and inflation, despite unprecedented monetary policy accommodation; have cast doubt on the extent to which monetary policy can stimulate real economic activity in the face of increasingly apparent secular headwinds. We continue to expect only one additional (and mostly symbolic) 25bps hike in the Fed funds rate in 2016, most likely in December. Furthermore, while Treasury rates could bounce off the lows as the fears of Brexit instability recede, we do not anticipate a significant or sustained increase in yields. Yields are likely to remain lower for (even) longer.

The Impact of the Brexit Vote

(Contributed by John Stoltzfus, Oppenheimer & Co. Market Strategist)

If there was a lesson that stood out to us as a result of the referendum on Brexit last week, it was that the gunboat of populism has a much deeper keel than anybody expected.

For all the warnings that British voters heard from political leaders, corporate spokespeople, policy experts and denizens of the markets around the world about the risks of a pro-Brexit vote, it was the frustration of a large enough segment of the population that felt disenfranchised from the status quo of cross-border economic realities that defeated the "Bremain" camp and pushed the fifth largest economy in the world into a process of unwinding the intricate

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and highly complex cross-border agreements that have joined a region of the world for over 40 years.

For the immediate future, not knowing how the outcome of Brexit will unfold increases the levels of uncertainty that markets will have to contend with on a day-to-day basis for the foreseeable future. The good as well as the bad news surrounding the process of the UK's exiting the EU is that it will likely take place over a two-year period and perhaps longer due to the complexities of the agreements that will have to be unwound or altered to reflect a new order.

The length of the process would seem to reduce the chance of rash decisions making the situation worse, while the longer the process takes, the more complex, unwieldy and challenging it may become. Beyond the singular unwinding that has only just started for the UK and its trading partners on the continent, the precedent being set is likely to increase the likelihood of other member countries making a break for the door and away from the union. Among the countries considered to be prospective candidates to consider an exit in the future are the Netherlands, Spain and Italy.

From our perspective on the radar screen we feel it is important to recognize that the vote was a political event with likely economic repercussions for the UK and the European Community. It wasn't the other way around (i.e., an economic event with political repercussions). Ironically though, it may well have been the uneven economic outcome of politically driven economic agreements that tied highly disparate political, social and business cultures together but led to the current disillusionment with the EU. In the days that have followed since the vote it has remained clear that a "let them eat cake" response by the EU to the situation is not an option.

It appears to us that the US economy, with 70% of its growth anchored by the consumer, won't be severely impacted by what is happening across the pond. However, the dollar's resurgent strength as a haven currency evidenced after the Brexit could have a negative impact on revenues and earnings of US multi-nationals if the dollar continues to move much higher. Abroad we expect concerted action by central banks will help to quell roiled markets sooner than later.

In the UK the BOE is talking about perhaps another rate cut. In our view, Brexit could reduce UK 2017 GDP to 0.2%. The BOE may introduce a 50 bps rate cut in July and perhaps add as much as £50B GBP in quantitative easing purchases (QE) to offset the possible damage done to the UK economy by Brexit.

Low interest rates for longer will extend the process of normalization stateside. Concerted efforts by central banks in Asia and across the pond should help to offset challenges to the economic recovery's progress in Europe.

The outcome of the Brexit referendum and its effects on the markets worldwide last week remind us of the words attributed to the late Yogi Berra, "It ain't over 'till it's over."

A publication we found insightful:

As noted previously, 70% of the US domestic GDP is generated by U.S. consumers. In May, the Fed published its third annual "Report on the Economic Well-Being of US Households." It provides important information about how individuals and households are faring in the economy. Topics covered include income, savings behavior, economic preparedness, access to banking and credit, housing decisions, car purchases, education and human capital, student loans, and retirement planning. One interesting tidbit; 69% of adults report that they are "living comfortably/doing okay" compared to 65% in 2014 and 62% in 2013. However 31% or approximately 76 million adults are "struggling to get by" or "just getting by."

http://www.federalreserve.gov/2015-report-economic-well-being-us-households-201605.pdf

Capital Markets and Performance

Investors sought out the safety provided by the fixed income market during the second quarter of 2016 given the uncertainty of the Brexit vote and the uncertainty surrounding slowing global growth. These worries have induced a "risk-off" trade and thus brought U.S. Treasury yields to historic lows. Subsequently, the Fed will not be able to tighten in the near term and U.S. interest rates will simply be lower for a longer period of time.

In the second quarter, the Barclays Capital U.S. Aggregate Index provided a return of 2.21% which brings its year-to-date return to a very healthy 5.31%. The bellwether 10-year Treasury yield declined another 30 basis points in the quarter to close with a yield of 1.47%. Overall, Treasuries returned 2.10% in the quarter and 5.37% year-to-date. However, corporate securities were once again the best performers returning 3.57% in the second quarter and 7.68% for the year. Longer maturities performed better than shorter maturities and lower quality securities outpaced higher quality. The high yield market has also witnessed strong performance. The BofA/Merrill Lynch High Yield Master II Index returned 5.88% in the quarter bringing its year-to-date performance to 9.32%.

Our composites had strong performance results versus their respective benchmarks in the second quarter. 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 continues to benefit our performance and we believe the best opportunity moving forward remains in the corporate sector. 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. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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