MV CAPITAL MANAGEMENT

Weekly Market Flash

Five Observations for a Post-12/16 World

December 18, 2015

Credit is due to the Yellen Fed for setting clear expectations and then delivering on them. Markets expected a 25 basis point increase in the target Fed funds rate, accompanied by an accommodative policy statement, and that is just what they got. “Monetary policy remains accommodative” was the key phrase in that statement, underscoring the reality that data trumps calendar when it comes to the size and timing of policy actions in 2016.

Nonetheless this is something of a brave new world, a definitive coda in the policy-driven economy of the past seven years. There are plenty of risks as well as opportunities in the year ahead. Here are five observations informing our thinking as we see out 2015.

#1 – Sell the Rumor, Buy the News

Counter-intuition was a theme in many asset markets in the immediate lead-up to and aftermath of the 12/16 announcement. Asset classes that typically fare poorly in rising rate environments, such as precious metals and high dividend stocks, were strong outperformers on the day. The dollar was mostly muted against other major currencies. Most likely, expectations were largely baked into prices well in advance of Wednesday and thus the news itself gave little reason for further action. If anything, the trading dynamic Wednesday afternoon was characterized by some holiday bargain shopping in recently oversold corners of the market.

#2 – Ignore the Short Term Noise

We expect to see higher than average volatility prevail through the remainder of the year, and we attribute this to little more than the residual noise following a major policy event. The S&P 500 opened Wednesday morning at 2043 and closed Thursday afternoon at 2041, with this net return of zero punctuated by an aggregate spread of three percent over the two day period. The two year Treasury yield is at a five year high, while the ten year still sits below its average over the same period. We do not see much in the way of meaningful trend signals coming from the market until this residual froth settles, and recommend riding out the volatility to the extent possible.

#3 – Inflation is the New Jobs

The big event on macro calendars for the past several years has been the jobs report – “where for one brief moment the interests of Main Street, Wall Street and Washington align” as the *Wall Street Journal* likes to say in its first Friday of the month live blog. We’re not sure that the mid-month Consumer Price Index report will earn its own following of econo-journalist fanboys and fangirls next year, but it should. Assuming that the prevailing employment trend doesn’t go into sharp reverse, we expect that prices will be the key variable influencing the size and timing of future Fed action. The FOMC policy statement released Wednesday made repeated mention of near-term and long-term inflationary readings and progress towards the 2 percent target. Although reasonably balanced, we give somewhat more weight to the possibility for a faster than expected pickup in prices (outside the volatile energy and food sectors). It may be time to dust off those TIPS for portfolio inclusion.

#4 – The Fed and the Spread

While the Fed has occupied the spotlight for much of 4Q15, the real action in 2016 may be less in future rate hikes than in risk spreads between Treasuries and other fixed income asset classes. It is always worth remembering that risk spreads have a direct effect on household financial decisions through mortgages, personal loans and the like. High yield spreads have taken a hit recently, in part due to another wave of commodity price slumps, but we would be more concerned about investment grade spreads as a wild card that could inflict collateral damage on other asset classes. The Office of Financial Research (OFR), an independent office of the Treasury Department whose annual Financial Stability Report should be required reading for anyone invested in global asset markets, calls out

"elevated and rising credit risks in the US nonfinancial business sector" as a key area of potential weakness. US companies have benefitted greatly from historically cheap borrowing costs in the past five years, serving up dividends and buybacks and other things investors hold near and dear. Those good times may be nearing an end.

#5 – Commodities: More Pain, but Stable

Speaking of commodity price slumps, we have listened to a number of quarterly earnings calls from energy companies over the past couple months. In expressing their views on 2016 the dominant theme is an impersonation of *Rocky 2*'s Clubber Lang: "My prediction? Pain". The supply-demand imbalances that have sent crude prices down to seven year lows this year will not work themselves out overnight. Nonetheless, the impact of US E&P downsizing should start to be felt and inventories should gradually recede from their recent record levels. Demand should improve as well, with China a likely buyer of more oil at lock-in price levels for its strategic petroleum reserves. While we do not see a return to fortune and favor for commodities in the near term, we also do not necessarily see commodity prices as a key risk story for 2016. In our most-likely scenario model we have modestly narrowed our crude price range to $40-55 from $40-60.

There are plenty more blips on our radar screen: emerging markets, corporate earnings, geopolitics and US elections – among others – are all in the mix, set to surprise, befuddle, delight or antagonize investors in the year to come. We will have plenty more to say about all of them. Happy holidays.

Masood Vojdani
President & CEO

Katrina Lamb, CFA
Head of Investment Strategy & Research

Investment Advisory Services offered through MV Capital Management, Inc., a Registered Investment Advisor. MV Financial Group, Inc. and MV Capital Management, Inc. are independently owned and operated.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by MV Capital Management, Inc.), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from MV Capital Management, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. MV Capital Management, Inc. is neither a law firm nor a certified public accounting firm and no portion of the newsletter content should be construed as legal or accounting advice. A copy of the MV Capital Management, Inc.'s current written disclosure statement discussing our advisory services and fees is available for review upon request.