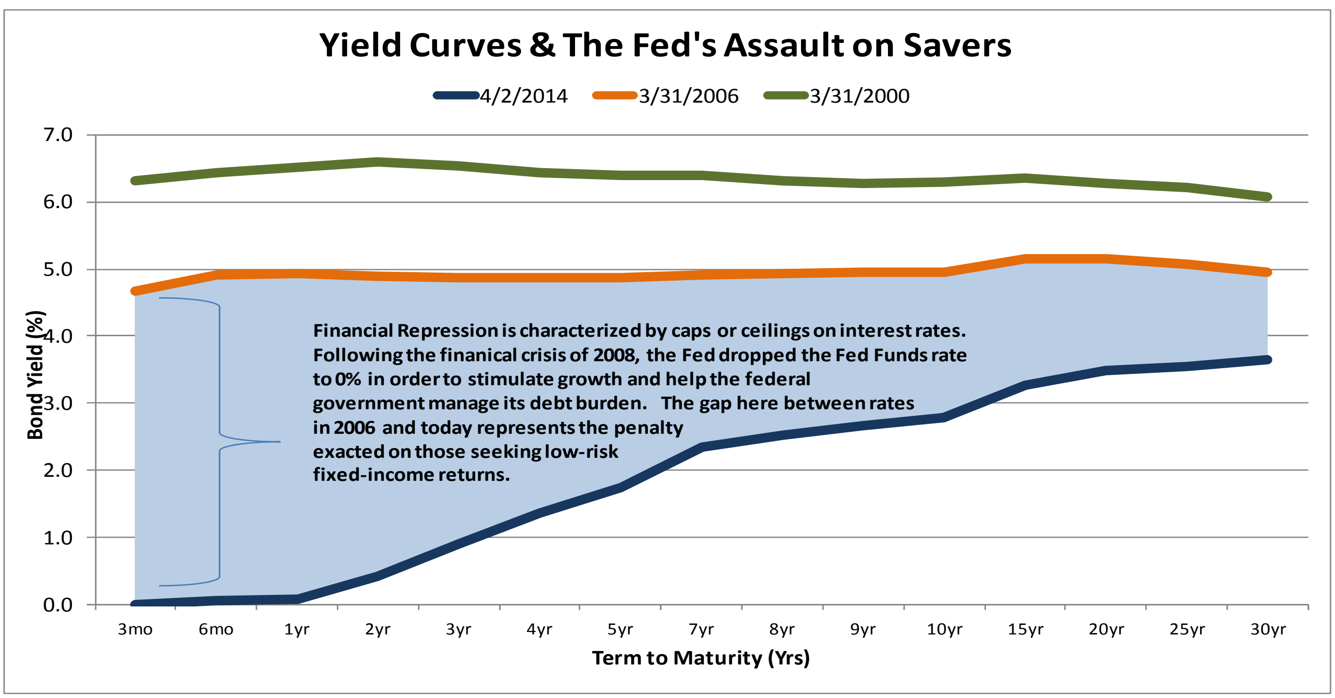
NOTTINGHAM ADVISORS
ASSET MANAGEMENT

THE FED'S LONG SLOW UNWIND

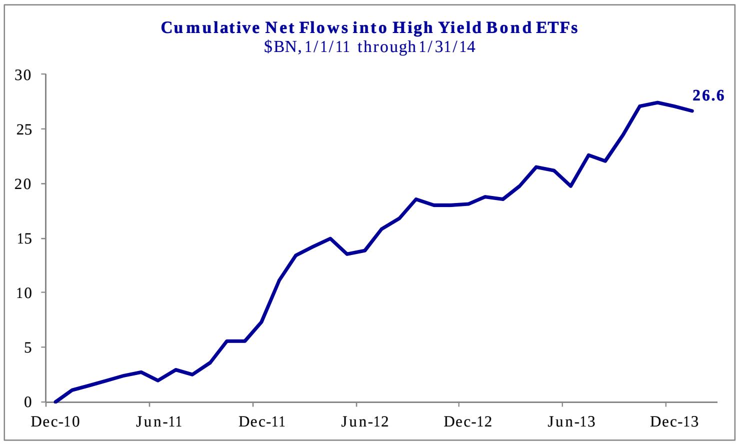
"It's frightening to think that you might not know something, but more frightening to think that, by and large, the world is run by people who have faith that they know exactly what's going on."
-Amos Tversky

After 5 years of nearly uninterrupted liquidity injections (aka "quantitative easing"), the Federal Reserve began the process last December of unwinding its extraordinary monetary support of the U.S. economy. After buying $85 billion of Treasury and mortgage-backed securities per month for the better part of the past few years, the Fed has been paring back purchases ("tapering" in investment parlance) by $10 billion per FOMC meeting, which puts a fork in QE by Autumn. The end to QE can't come quickly enough by our lights as the distortions to the price of risk assets everywhere, not to mention the penalty levied on savers, has created an entire investment conundrum, the ramifications of which are not readily apparent to many.

As any of you that have looked at a bank statement lately may attest, your liquid savings aren't earning squat ("squat" is a technical term meaning zilch, nada, nothing). A quick look at today's yield curve versus that which existed pre-crisis illustrates the challenge savers have nowadays. The so-called short-end of the yield curve, which consists of bonds maturing in the 1-5 year range, has traditionally been a safe-haven for risk-averse investors, including many retirees. These individuals could clip coupons yielding 3% to 4% or more and live off of a steady income stream without much risk to principal.



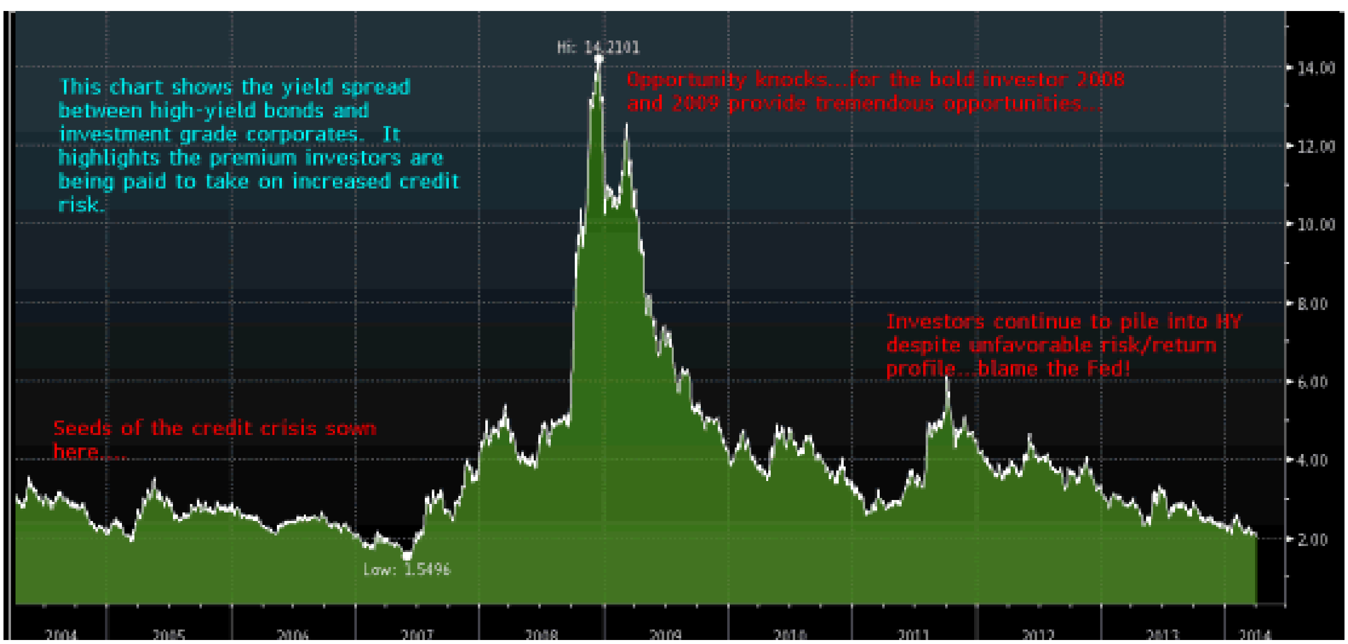
Today's environment necessitates that savers embrace an entirely different set of risks in order to maintain an investment return in excess of inflation. As we've discussed this at length in prior missives I won't go on about it here. The point is, QE has distorted the price of risky assets to the degree that many investors may not fully understand what can go wrong. Fed support has lulled fixed income investors into a false sense of complacency and only a return to market-driven interest rates will fix it.



Source: Strategas

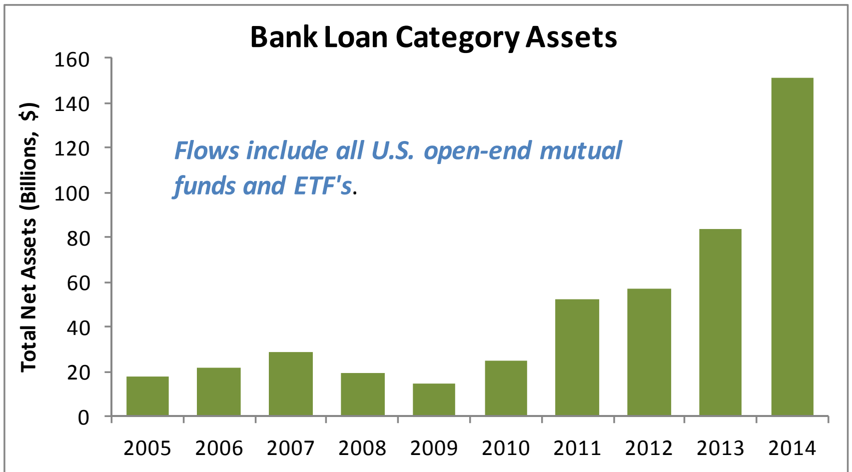
High-yield exchange-traded funds have seen tremendous inflows over the past few years. A combination of historically low interest rates on investment-grade debt along with very low default rates in the junk bond market has lured investors into this arena, despite low absolute yields on sub-investment grade debt and tight spreads. The quality of junk continues to decline as issuers currently hold the upper hand.

At Nottingham, we've favored credit over duration for the better part of the past five years. Our faith in investment-grade corporate and high yield has been well rewarded, much to our clients benefit. Looking ahead, however, we see numerous warning lights flashing. There are too many dollars chasing too little yield. The quality of junk bonds continues to deteriorate with more and more payment-in-kind debt and covenant-light bonds being issued. Investors aren't being compensated for many of the risks associated with the high yield space these days. In other words, junk bonds are getting "junkier".



Source: Bloomberg

The challenging part as a portfolio manager is actually having the courage to sell your high yield bonds and leveraged loans and swap into U.S. sovereign debt yielding next to nothing. As the legendary investor Howard Marks of Oaktree Capital Management observed, "Being too far ahead of your time is indistinguishable from being wrong." While we're convinced risk premiums on high yield and bank loans aren't properly rewarding investors given today's prices, the alternatives appear worse.

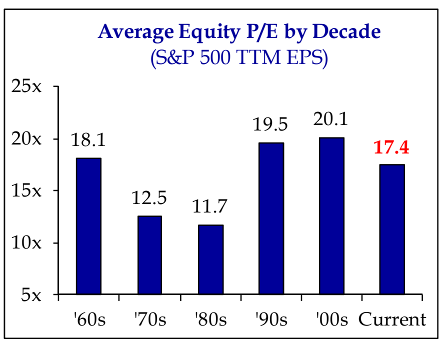


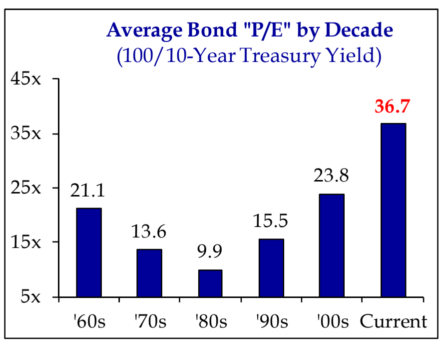
Source: Morningstar, Ex. MM & FoF

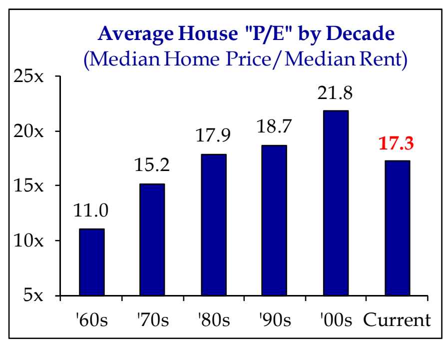
Flows into bank loans have increased 5x since the advent of quantitative easing. This once-sleepy segment of the fixed-income market is arguably the fastest growing subsector of the bond market. Like high-yield, issuers have the upper hand due to strong demand and the quality of bank loans is declining. Investors should proceed with caution!

Nottingham's income-oriented strategies still rely heavily on dividend-paying equity securities, although even these have seen their prices rise and yields fall. The so-called equity risk premium, the incremental return equities offer over risk-free debt, has declined over the past few years yet remains elevated by historical standards. The dividend yield on the S&P 500 currently stands at 1.95%, down from 2.30% just a couple years back. Given the five-year Treasury yield of just 1.70% and ten-year note yield of 2.70%, equities remain a viable substitute for bonds.

As the charts below would indicate, equities, while somewhat rich on an historical basis, remain quite attractive relative to both bonds and real estate. With Q1 earnings season set to launch this week, it's critical that corporate America comes close to meeting analysts expectations. While we firmly believe equity P/E multiples can expand from here, it won't take much to send markets materially lower should a large number of companies miss earnings. However, given the large number of firms guiding lower over the past 6 months, our bet is that the vast majority of firms reporting will have enough to beat these lowered expectations.







Source: Strategas

Despite the large move in equities last year, they still remain attractive fundamentally relative to bonds and housing. The P/E ratio of the S&P 500 is slightly above the 6 decade average, but not materially so.

"We are all born mad. Some remain so."
-Samuel Beckett

There are many days in today's investment environment in which we portfolio managers feel like kindred spirits to Beckett's protagonists Vladimir and Estragon, waiting patiently, comically, absurdly for the arrival of Godot (the Fed). While convinced that interest rates **must** rise, we can't yet seem to escape the specter of deflation that hovers over our collective shoulders. And, while Godot never shows (spoiler alert!), Fed Chair Yellen recently dropped a few hints that the Fed is at least on the move. For those portfolio managers that shortened duration in

2012 (i.e., us) in the name of prudence, the past two years have been a painful reminder that doing the right thing – or what you think is the right thing – protecting our client's capital, sometimes has an opportunity cost.

In 2012 we moved to shorten portfolio duration (reducing interest rate risk) and increase credit exposure (increasing default risk to earn greater yield). Now, we find ourselves maintaining our shorter duration while reducing credit risk. The result is a fixed income exposure that will protect our clients from sudden moves higher in interest rates as well as unforeseen spikes in defaults, while generating a yield just slightly in excess of inflation. In a nutshell, we are trading risk for return. And like Vladimir and Estragon, we may be waiting a while to be vindicated – although we're pretty certain that the Fed will actually show up!

With most of the world's central banks still highly accommodative, developed market equities globally continue to have a tailwind, with the path of least resistance appearing to be higher. The exception currently is the emerging market sector where a combination of heightened geopolitical risks and lower growth forecasts has spurred capital flight out of these volatile markets. Despite the most attractive fundamentals on our radar screen, we remain cautious, selectively picking our spots to add increased exposure.

With Spring in the northeast not quite having sprung yet, it's hard to blame anyone for seeming half-mad. Cold temperatures and cloudy skies can sap the vim and vigor out of even the heartiest souls. But, as with the expectations for the arrival of Godot, and higher interest rates, it's the prospects for (at this point longing for!) the arrival of Summer that keep us going. And, whereas Godot never quite made it, and higher interest rates might take a while, it seems inconceivable to us that temperatures around western New York won't hold steady above 60 sometime soon. So, if you're calling us one day and no one picks up, it's likely that we've broken 65 degrees here in Buffalo and the office is closed and we're out celebrating. But call again the next day and we'll be here, for the markets, and market forecasts, seem to change with the wind these days. We know our job and we vow to remain faithful and vigilant stewards of your capital. And we thank you for that privilege.

Happy Spring,

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President/Chief Investment Officer
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