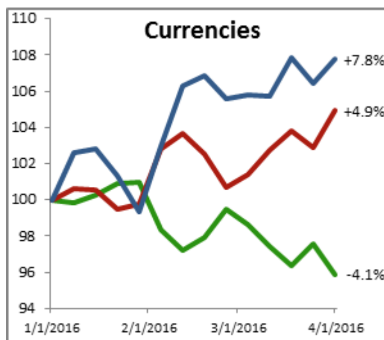
NOTTINGHAMADVISORS
ASSET MANAGEMENT

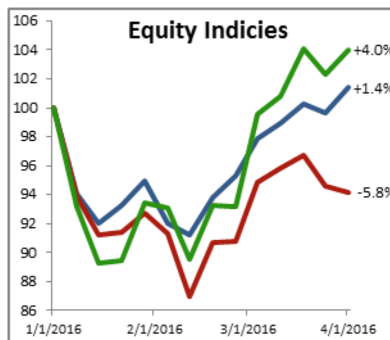
No Mas!
Discovering the Limits of Central Bank Intervention

"The difference between genius and stupidity is that genius has its limits."
-Albert Einstein

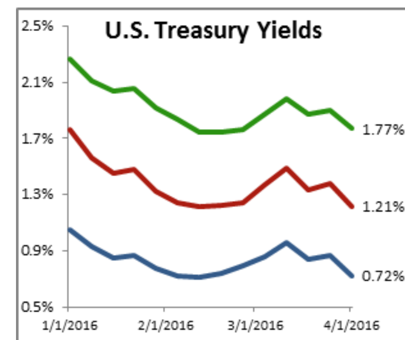
The first quarter of 2016 could well be remembered for any number of things – weird weather, Donald Trump, volatile markets – but for me, the time period will be remembered as the point at which central banks discovered the limits of monetary policy intervention. As we progressed from ZIRP (zero interest rate policy) to NIRP (negative interest rate policy), with the intent being to weaken currencies, stoke inflation and embolden risk-taking, market participants largely chose to move in the opposite, and unanticipated, direction. The result being greater uncertainty for investors, now that central banks have reached the limit of their effectiveness.



JPY/USD (Blue), EUR/USD (Red), DXY Index (Green)



S&P 500 (Blue), MSCI EAFE (Red), MSCI EM



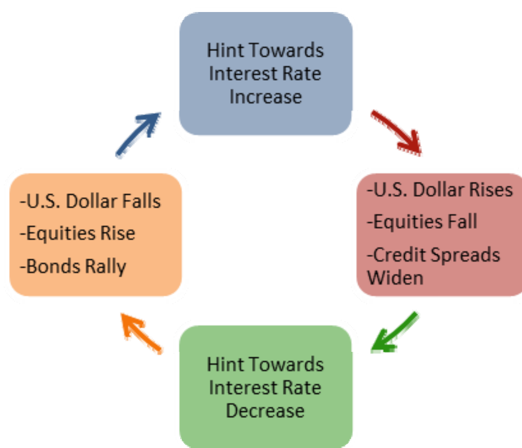
2 Year (Blue), 5 Year (Red), 10 Year

Since the Federal Reserve was created by Congress in 1913, it has exerted an outsized influence on global financial markets, not to mention the lives of everyday Americans. Its workings used to take place way behind the scenes, with periodic policy decisions being little more than tweaks to reserve requirements, open market operations and the federal funds rate. To say its inner workings were intentionally opaque might be an understatement.

The Federal reserve of 2016 is a far cry from days of yore. We now have open press conferences following most FOMC meetings, not to mention closely watched Fed Governor speeches every week. I don't think it would be a reach to say that the Fed has never in its history been so transparent and overt in its intentions or influence on financial markets. After all, the Fed did truly help save the financial system from collapse in 2008 and its policies since have helped return America to prosperity.

The trouble that we discovered in Q1, is that while America's central bank is trying to reverse course, foreign central banks are just ramping up further reflationary efforts (i.e. more QE!). So while the European Central Bank (ECB) and the Bank of Japan (BoJ) are furiously printing money to buy government debt (pushing interest rates lower – now into negative territory), the U.S.Fed is stuck trying to raise interest rates without roiling global markets. Good luck.

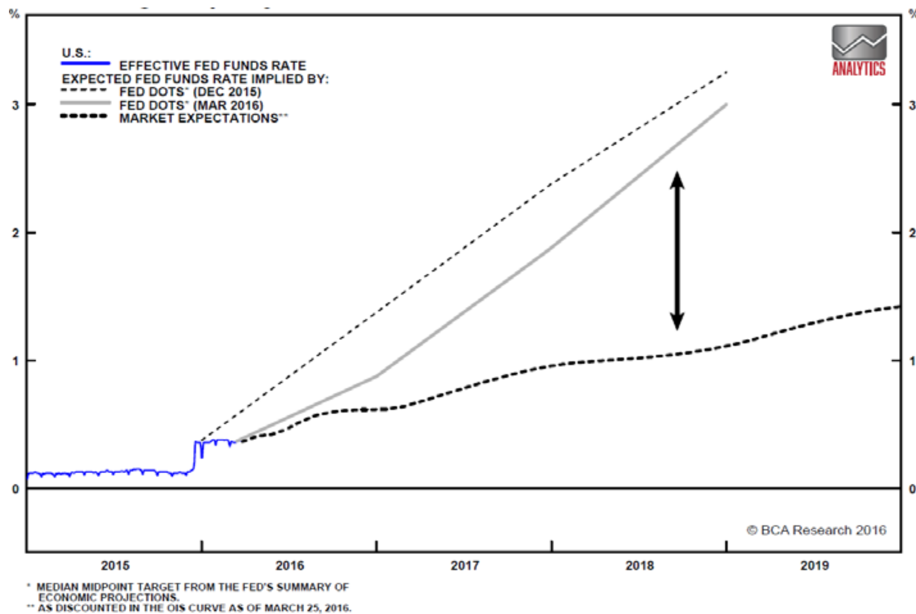
BCA Research has coined the problem the *Fed Policy Loop*. Each time Chair Yellen hints at higher interest rates (referred to as "hawkish rhetoric"), the trade-weighted U.S. Dollar spikes, triggering a sell-off in equities (especially emerging markets) and a widening of credit spreads (corporate borrowing costs increase). This then forces Yellen to back off (or turn "dovish"), lowering her outlook for economic growth, which leads to bonds rallying (yields head lower), stocks rally (despite no growth??) and the Dollar falls. Wash, rinse, repeat.



We saw this negative feedback loop play out throughout the first quarter. With economic data firming – 5.0% unemployment, low inflation, rising home prices – the Fed clearly would like to return to a more normalized interest rate environment. It's very apparent that markets are not quite ready. Moreover, the effectiveness of international central bank intervention is declining as we've reached the point of diminishing marginal returns. According to Bloomberg, 1/3 of the world's developed-market sovereign debt now has negative yields. Globally, deflationary forces remain intact.

Source: Bloomberg, Starting 3/31/2006, Ending 3/31/2016

What does this mean for investors? Volatility! Despite the markets protestations, U.S. interest rate will rise over the coming years. That's a safe bet. Our bet is that the rise will be modest, absent any inflationary scare. Modest doesn't necessarily mean smooth, however. Bonds are currently priced for a very low growth/low inflation environment (much as we're experiencing now). Equites are priced for a modest growth/low nominal yield environment (by way of higher than normal P/E ratios). Transitioning from ZIRP to "normal" without upending markets will require a difficult balancing act from the Fed. There is currently a great disconnect between what the Fed says it wants to do, by way of its "dot plots", and what the market thinks it's going to do (by way of the forward curve).



Each meeting FOMC participants chart their targets for the "appropriate" Fed Funds rate, based on their own views. Collectively this forms the Fed's "dot plot", which market forecasters compare to the current market expectations for rates. As evidenced here, quite a disparity currently exists. Clearly investors don't believe the Fed will tighten as aggressively as they've suggested. Somethings gotta give!

First Quarter Recap

After dropping nearly 10% to start the year, the S&P 500 closed the quarter up 1.35%. Much as the root cause of the violent 2-month sell-off was uncertain, the dramatic recovery remains as much of a mystery. Fear triumphed over greed, and then greed triumphed over fear. In reality, there are any number of narratives that could explain this short-term price action. It would seem to us, however, that given elevated P/E ratios (i.e. somewhat expensive stocks), a Fed initiating a tightening cycle (see above) and lackluster U.S. economic growth (2015 Q4 GDP rising just +1.4%), the sell-off makes more sense than the rally. It could be, though, that given our inherent risk-aversion and the defensive posture we've taken for much of the past year, the sell-off confirmed our bias more than the rally.

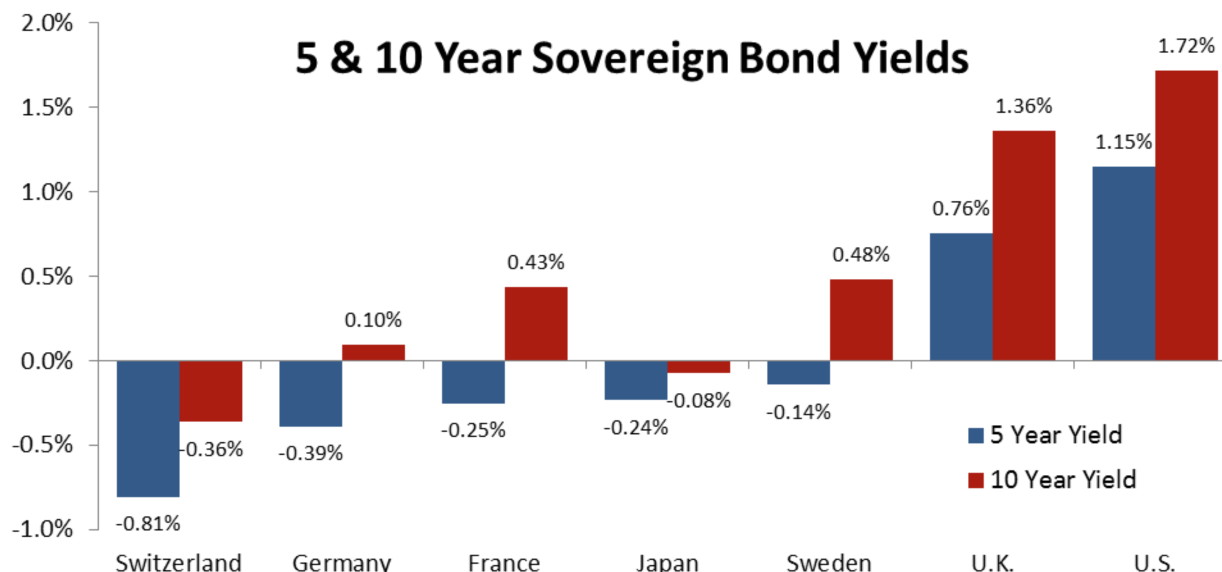
Small and mid-cap stocks rallied strongly in March, closing the quarter up 2.65% and 3.78% respectively (see our March *Monthly Market Wrap* for more detail on all asset class returns). After lagging large caps the better part of the past year, their fortunes appear to have turned. The same can be said for value, which has lagged growth over the past few years. Nottingham had been favoring growth up til the 4th quarter and with that trade profitably unwound, we're looking at what kind of value bias makes sense in this environment. Our low-volatility overlay has proven to be a home-run as of late.

Wouldn't you know it, though, that we chose to de-risk some of our portfolios right before things turned up! Our aversion to anything emerging markets has only been growing the past 2 years and we've been steadily paring back our exposure. Today we really only have a modest position in EEMV, the iShares MSCI EM Minimum Volatility ETF, having dumped more core exposure in February. And while our timing probably could have been better, the reward/risk tradeoff still looks poor in our eyes.

Developed market stocks, as measured by the MSCI EAFE Index, dropped -2.86% in Q1. Despite a drastic increase in the ECB's quantitative easing operation, growth in the Eurozone remains as punk as in the U.S. (Eurozone Q4 GDP was +1.6%). Now, with decidedly negative interest rates across much of the EU and the prospects for a "Brexit" looming (the UK is angling to leave the European Union), the prospects for a strong economic recovery remain suspect. Japan, after being one of our favorite (and most profitable) trades for the past 2 years, has seemingly slipped back into the deflationary spiral they've been battling for the past 2 decades. The early positive response to Abenomics has abated and with the BoJ now firmly on board the NIRP train, growth is slowing (Q4 GDP down -1.1%) and the Yen is rallying. The Nikkei 225 index fell -11.24% during Q1, chasing away many early advocates, including Nottingham.

Turning to bonds, the rise in equity volatility (the VIX nearly doubled during Q1), slow global growth, ZIRP and the Fed's dovish embrace (see the Fed Policy Loop above), gave a bid to fixed income across the board.

Despite closing the quarter off its lows, the 10-year Treasury yield fell from near 2.30% to start the year to close the quarter at 1.77% (it's 1.72% as I type). Clearly, the market doesn't believe earlier Fed calls for 3 or 4 interest rate hikes in 2016. As of today (4/8), the futures market is assigning a 17% probability to a June rate hike, 35% to September and a 50% chance for a hike in December.



Source: Bloomberg, As of 04/08/2016

As mentioned above, nearly one-third of global bonds sport negative yields (think about that for a moment: I'll give you $10 today, and you give me back $9.75 in 3 years – deal?). This makes the tiny yields in the U.S. market look positively robust when compared to other sovereign debt. And, there's the prospect for a rising Dollar when hawkish Fed rhetoric heats up again. As central bankers everywhere discover the limits of ZIRP and NIRP, one can only cheer on the U.S. Fed to push ahead with a rate normalization strategy. After all, about the only thing that hasn't been tried since the '08 recession has been capitalism.

Given this global backdrop, treasuries, high-quality corporates and high-grade municipal bonds seem to make the most sense to us. Despite pitifully low yields, these assets offer investors stability in their portfolios as well as liquidity in the event cash needed to be raised quickly. Oftentimes in investing, boring can be beautiful. Speaking of which, good old U.S. TIPS (treasury inflation-protected securities) staged a very nice rally in Q1, which Nottingham participated in tactically, only recently unwinding that trade. Although we've by and large eliminated our position after a quick 5% gain, TIPS remain in my opinion a decent inflation hedge going forward for fixed-income investors.

Looking at Q2 and Beyond

Our comfort with the start of the year sell-off has quickly been displaced with angst at not having been more aggressive at the bottom. We drew a line in the sand, if you will, at 1,800 on the S&P 500, where it made sense to us from a valuation standpoint to begin reinvesting some excess cash. Wouldn't you know it that the market briefly touched 1,810 before beginning its rapid ascent back above 1,900. Call us greedy, if you will, but successful investing requires discipline and patience. I'm pretty certain we'll have another opportunity, perhaps by summer, to scout out some bargains for the portfolios.

The timing may even be sooner if first quarter earnings reports are as dismal as many analysts are estimating. Corporate earnings season begins soon with Alcoa reporting after the bell. Expectations are quite low across the board for corporate America, and revenue and EPS declines are inconsistent with today's equity market valuation. Forecasts for Q1 GDP are rapidly trending toward 0%, and its likely we'll see Y/Y earnings declines from many companies.

The thesis around the temporary “rough patch” though, is that the job market is strong, housing continues to improve, and fiscal policy could add +0.5% to 1.0% to GDP this year via tax cuts and spending changes. Whatever the argument, the key factor remains global growth, which has been declining, but could very well be bottoming here as central bank intervention finally kicks in. We’ll see.

In any event, volatility should remain with us into summer, given some of the major uncertainties lying ahead. The Fed rate-hike schedule, the potential for “Brexit” and the questions around the candidates for the U.S. Presidency are just a few, but in our minds, most profound of these uncertainties. It’s difficult to handicap any of these outcomes at this point, but all should weigh heavily on markets over the coming months.

Despite our call for lackluster asset class returns in 2016, should the U.S. avoid a severe recession over the next year, we could see growth pick up enough to reward patient equity investors. Bonds should struggle to generate anything more than their coupons as the Fed unwinds QE, but again the stability and liquidity they provide should be enough compensation for investors. For now, boring is beautiful.

	Domestic	International	Fixed Income
Bullish	-U.S. Quality Large Cap -U.S. Minimum Volatility -U.S. High Dividend	-International Developed Multi-Factor (JPIN)	-Short/Inter Term Treasuries -TIPS -High Grade Munis -High Quality Corporates
Neutral	-U.S. Mid & Small Cap -U.S. Dollar -REITs	-Japan -China	-High Yield
Bearish		-Emerging Markets -Commodities	-Int’l Sovereign

Source: Nottingham Advisors, Inc.

Conclusions

The past year and a half have probably been as challenging a time to add significant incremental value to client portfolios that I can remember. Large drawdowns in various sectors (energy, EM, materials) combined with the escalation of experimental monetary policy have rendered the benefits of diversification moot. Why own EM, or developed international for that matter, given its underperformance versus the U.S.? Tactical trades designed to add incremental return (alpha) to portfolios turn around overnight as historical correlations reverse thanks to changing investor sentiment. We think we’ve navigated these turbulent waters reasonably well; of course, we will always strive to get better.

Nottingham’s strategies benefit clients in various ways: 1) by using index-funds oftentimes, our portfolios tends to be very tax efficient; 2) thanks to our long-held obsession with costs, our portfolio solutions are amongst the cheapest offered; 3) everything we do is transparent, for better or worse, and our clients always know not only what they own, but hopefully why, as well; 4) the diversification inherent in our strategies protects our clients from debilitating drawdowns; 5) and lastly, our strategies are designed to perform well over time, typically matching the timing of our clients long-term goals and objectives.

By starting with the Investment Policy Statement, we make sure the portfolio strategy(s) matches the objective(s). We then focus on the things we can control – costs, timing, research – rather than the things we

can't control – market returns, Fed actions, tax rates. And, by maintaining continued contact with our clients and advisors partners, we look to provide a world class investing experience for all involved. That's the hope anyway, as it is a promise of ours.

Successful investing is rarely linear. Gains come in fits and spurts. Typically, when least expecting it, markets will rally whether you're completely ready for it or not. Patience, in the intervening periods, is a must. 2015 was one of those periods, and I think 2016 might be one too. As I mentioned before, my caution surrounding today's market prospects is only exceeded by my optimism over the coming years. As an investor, make sure you're comfortable with your plan. If not, call us to discuss. The next decade is going to be pretty exciting in my opinion, and the prospects for decent investment returns look strong. Nottingham Advisors looks forward to traveling that path together with you. Thanks again for your faith in us.

Larry Whistler, CFA
President/Chief Investment Officer
April 2016

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