SEPTEMBER 25, 2015

"As I grow older, I pay less attention to what men say. I just watch what they do."
- Andrew Carnegie

EVERGREEN EXCHANGE

Tyler Hay, David Hay, Worth Wray

Tyler's Summary - Connecting the Dots!

- The Fed's decision NOT to raise interest rates last week was the single most important financial markets event of 2015.
- Investors have been worrying about inflation, but it's deflation that they should be worried about.
- The fact that the supposedly data-dependent Fed refused to raise rates with strong employment and stable inflation data suggests the committee believes something is deeply wrong with the global economy.
- Moreover, the fact that one voter called for European-style negative interest rates—not to mention Janet Yellen's refusal to rule out such a radical reversal in Fed policy—leaves the door wide open for additional easing.
- While most investors expect rates to rise and bonds to suffer in the coming quarters, the risk of deflation is far higher than most investment firms, or even the Fed, care to admit.
- Rather than selling safe-haven US Treasuries because of low yields, investors should consider buying for price appreciation.

Dave's Summary - No Exit

- Due to international risks, the Fed's job has become more challenging and complicated.
- Rampant global money fabrication has created deflationary—not inflationary—pressures, also making the Fed's mission more difficult.
- The Fed is now caught in a bind of feeling compelled to raise rates due to a decent domestic economy, but being afraid to do so because of market destabilizations concerns.
- Foreign central banks are also pressuring the Fed not to tighten and worries about another Chinese currency decline loom large.
- Because it has waited so long, the Fed may be forced to hike rates even as US corporate profits are weakening. If it doesn't, bubbles in various asset classes may continue to inflate, and then inevitably implode.
- The Fed lacks the tools to deal with the triple global threats of spreading currency devaluations, excessive debt, and widespread industrial overcapacity.
- It's likely that whatever Janet Yellen and her colleagues at the Fed do—or don't do—even more serious market turmoil is probable.

Worth's Summary - The "Global Mandate" Myth

- The Federal Open Market Committee's decision to delay a rate hike in September was shocking not because of the delay, but because of the way the committee mis-framed its decision.
- The Fed has NOT adopted a third policy mandate aimed at preserving global stability.
- Should the labor market continue to tighten and inflation expectations remain relatively anchored, a Fed hike is still likely this fall.
- By poorly communicating its concerns over the recent market turmoil, the Fed is setting up a number of fragile economies and nervous investors for an even larger shock if it moves ahead with a hike in the near future.
- Watch out for a stronger US dollar, a weaker Chinese yuan, a broad-based emerging markets exodus, a deeper sell-off in commodity markets, an outright global recession, and an ugly correction for major equity markets around the world. If US equity markets initially rally on a Fed hike, it may be a good opportunity to get more defensive.
- While market panics can be scary, they can be extremely rewarding for investors who are prepared in advance with large cash reserves and a long-term perspective.

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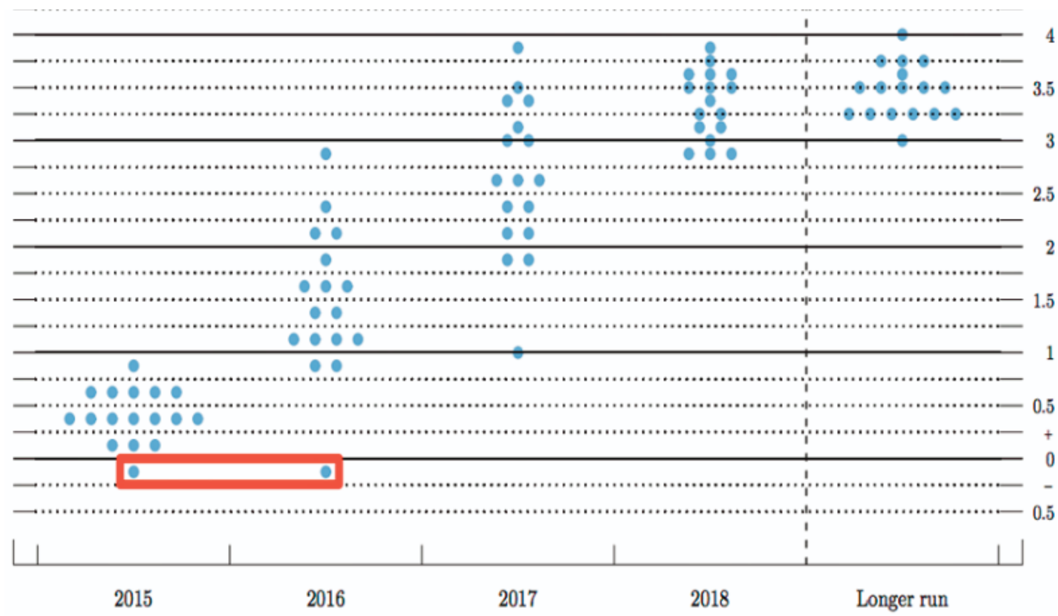
Connecting the dots! If you weren't watching what happened at the last Federal Reserve meeting you may have missed the biggest piece of financial news so far in 2015. Before I get into that, let me bring you up to speed. On Thursday, September 17th Janet Yellen and the rest of the Federal Open Market Committee met to decide if they would finally enact a long-awaited increase in the level of the Federal Funds interest rate, known more simply as the fed funds rate.

Here's how it's supposed to work with regard to interest rates and the Fed. The fed funds rate historically serves as a key lever for the Federal Reserve to jump-start or cool the economy. Because the fed funds rate is used as the starting point from which many other interest rates are set, it has an enormous impact on the overall cost of borrowing within our economy. In the past, when the economy has been strong, the Fed would raise interest rates, making the borrowing of money less desirable and thereby moderating economic growth. On the other hand, when the economy is struggling to grow or contracting outright, the Fed is supposed to cut interest rates low enough to entice borrowers to take on more risk or invest in productive assets like factories or computers.

Countless people have opined about what should be done, but there are 17 members of the Fed (including the rotating regional Fed presidents) who will actually decide where rates go from here. Below is a visual diagram, released at the meeting, showing where different Fed officials would like to see interest rate levels over the coming years.

FIGURE 1: APPROPRIATE PACE OF POLICY FIRMING - MIDPOINT OF TARGET RANGE OR TARGET LEVEL FOR THE DEFERAL FUNDS



Source: Federal Reserve/Business Insider

The dots reveals some compelling and bizarre information. First, and most obviously, it tells us that almost all members are signaling that they want to see rates move consistently higher over the next few years. But this isn't news; they've been saying the same thing for the last few years. Past dot plots have repeatedly shown the outlook for the current year's rates being held at or around zero followed by fairly steep increases. Notice the red box, which indicates something fascinating: One member actually voted for negative interest rates. To clarify, this means you pay someone to lend them your money—more on that later.

Since the Fed has been posturing to raise rates and then postponing any action for going on three years, readers may wonder why I said earlier that their decision to not raise rates was the single biggest financial development of 2015. Here's why I think what happened should have caught every investor's attention: Investors are certain we are close to the beginning of rate hiking cycle, but I'm not so sure. Let's consider the context. First, markets were prepared for a hike. Also, the Fed had said that they were taking a data-dependent approach to a hike. The data has looked pretty good. Employment looks decent. Prices, or inflation, looked stable. With markets braced for a rate increase and the Fed's two criteria looking stable, a hike seems a very viable choice.

If you add in the fact that the Federal Reserve realizes that having rates at essentially zero puts them in a vulnerable position, a raise seems even more logical. Instead, what did they do? They elected to not increase rates, and I think that this is pretty alarming.

Are they worried the economic earthquake that's occurring in China could send a financial tsunami hurling towards the United States? Are they concerned that the strong dollar is choking the US economy and that further lay-offs from companies like Hewlett Packard and CAT are the tip of the iceberg? Are they frightened markets have been shaky of late and that a rate hike could turn restless investors stampeding toward the exits? Are they afraid that the collapse of the US energy sector has serious ramifications yet to be felt? I'm not sure which is holding them hostage, but whatever they are nervous about is a very big deal. If you think this is too dramatic of an interpretation, stay with me.

As I mentioned earlier, there was one Fed official who voted for negative interest rates. While many have dismissed this official, who we don't know by name since voting is anonymous, as largely a symbolic protest to the rest of the voters, I'm more skeptical. In the subsequent press conference where Janet Yellen took questions from reporters, she was asked about the vote for negative rates. Dismissively, she said that it wasn't seriously discussed, but what she said next is what I think is crucial for investors to hear. She went on to say that while negative rates seem silly, they couldn't be ruled out. Here's a direct quote where she goes into some detail.

> *I don't expect that we're going to be in a path of providing additional accommodation.* **But if the outlook were to change in a way that most of my colleagues and I do not expect, and we found ourselves with a weak economy that needed additional stimulus, we would look at all of our available tools. And that would be something that we would evaluate in that kind of context.**

Granted, Mrs. Yellen said she doesn't think we are on a path where this will be necessary, but she made it a real option should the economic environment warrant it. Here we are seven years after the financial crisis and at a press conference, where many expected the announcement of the first of many rate hikes, and we are talking about the possibility of negative interest rates. Now, let's put these two things together. We have what many thought were the conditions in place for a rate hike, but the Fed passed on the chance. Then, a member of the Fed voted for negative rates. Finally, Janet Yellen put the possibility of negative interest rates in play if "we found ourselves with a weak economy."

If I understand her correctly, we won't have negative interest rates unless the economy becomes weak. But the economy is not weak, apparently. It's also fair to assume the economy isn't strong since they declined to raise rates again. So one would infer the economy is perceived to be somewhere in the middle but headed in what direction? And while I'm not sure which direction we may be headed, what I do know is that most investors have set their minds on a rate hike. Meanwhile, I think that the opposite is emerging as a real possibility. If the weak global economy was to see further deterioration, a foray into negative rates in the US is a potential Fed response.

Incorrectly, I think that most investors are being told rising rates is a certainty. They consider negative rates and deflation a near impossibility. In actuality, it maybe closer to a coin flip. Owning things like 10-year treasury bonds and other high-quality income securities will look like a stroke of genius if we get into this type of environment. To be clear, I'm not saying we are headed for deflation and negative rates, but I am saying that investors have eliminated this as a possible outcome. Most investment firms are running ads saying "Investing in a Rising Rate Environment" or "How Hikes will Hurt your Portfolio." It's consensus belief that rates are going up and bond investors are facing certain headwinds. But running with the herd can get you trampled. The best investments are made in areas where few see it coming. Right now, most people making this argument prefer to remain anonymous. Unfortunately for me, anonymity is reserved for Fed officials, not newsletter writers.

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No Exit. Perhaps Janet Yellen should brush up on her Sartre. After all, she seems to be starring in the monetary policy equivalent of his classic play--only in her case it might be that Hell is other central bankers, rather than merely other people.

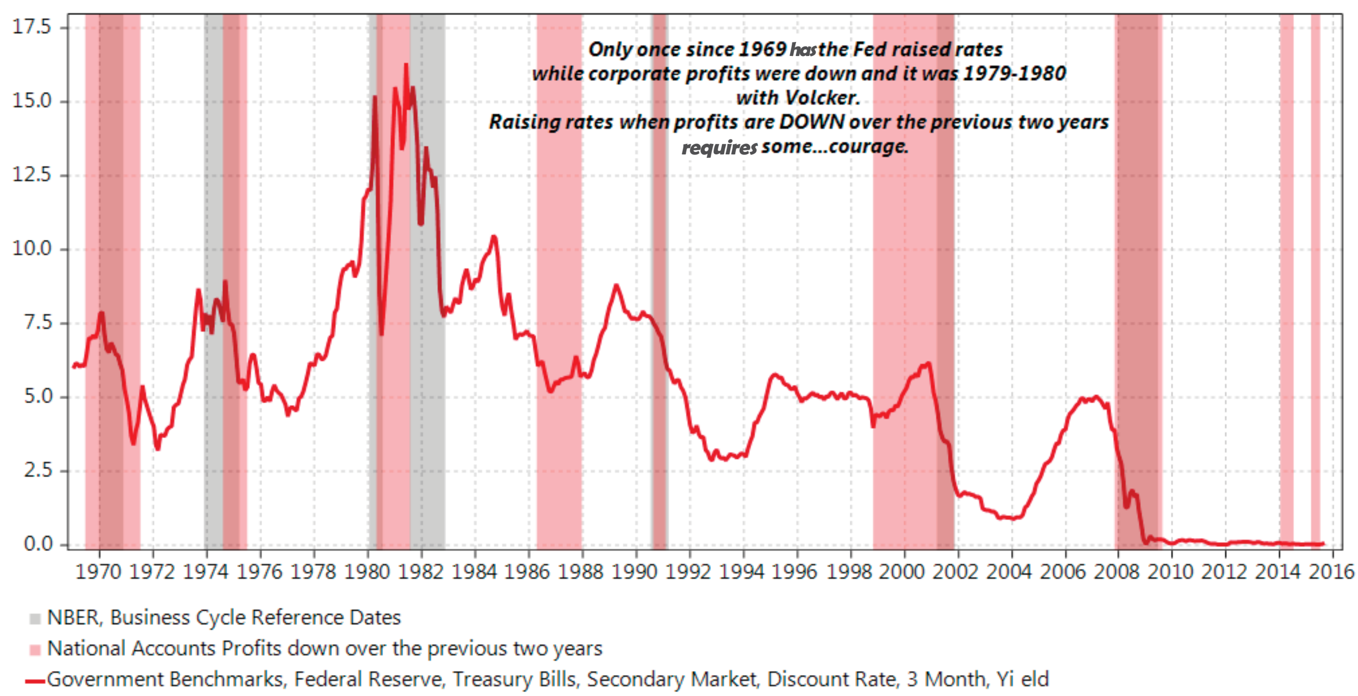
As Worth points out in his section of this edition of the Evergreen Exchange, Ms. Yellen is discovering that she needs to be mindful of the impact of her actions—or lack thereof—on her counterparts around the world. In turn, she needs to be aware of what they are doing and how that affects the Fed's torturous and long-delayed effort to raise rates even by a measly ¼%.

Without a doubt, it's a much more complicated world than when Paul Volcker valiantly set out to slay the inflation monster 35 years ago. The Fed now is faced with something Mr. Volcker might have relished but could not imagine: imported deflation.

As previously discussed in prior EVAs, this was not how what John Hussman calls the "spew of projectile money creation" in the major economies was supposed to work. Rather, it was meant to inflate assets AND consumer prices, with wages rising as well. Instead, however, binge-printing has led to currency wars whereby various countries try to weaken their exchange rate to gain a competitive advantage versus their trading partners. This, in turn, has caused widespread deflation of raw materials at a rate unseen outside of global recessions. But because lower commodity prices actually help US consumer purchasing power, this type of deflation is viewed as a generally beneficial event--unless you happen to work in the energy, mining or agriculture industries or are an emerging nation reliant on raw materials exports.

When deflation decides to spread to stock and real estate prices, though, it prompts a very different reaction. We've seen that scenario viciously play out twice over the past 15 years and some—including this author—would argue we're in the early stages of round three. Admittedly, outside of the natural resource-related sectors and emerging stock markets, so far all we've seen is a mild and much over-due correction. What could flummox the still-complacent consensus (per Barron's last week, all major Wall Street strategists remain bullish), is if the Fed finally feels compelled to raise rates even as US corporate profits are rolling over. As the below chart makes clear, this has only happened once in the last 45 years.

FIGURE 2: THE FED'S CONUNDRUM



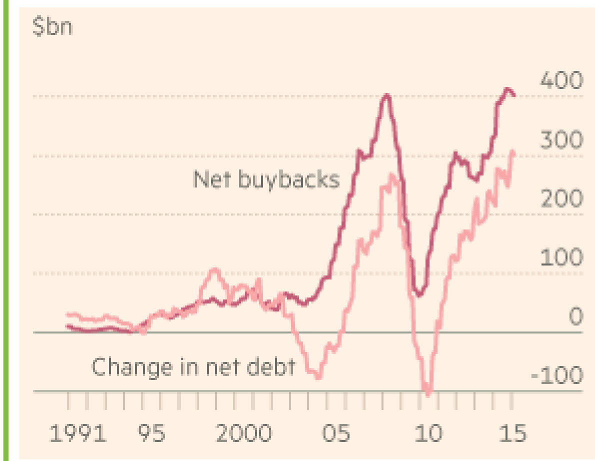
Source: Gavekal Data, Macrobond

Despite the prevailing mind-set on Wall Street that the Fed can finesse its way out of this, we remain convinced, as I've written before, that the Fed has printed itself into a very tight corner. If it sticks to its Pontius Pilate routine—washing its hands of any tightening responsibilities--the excess money it has created will likely continue to spill into momentum stocks, art, over-priced share-repurchases, and $100 million homes (we've recently set a record for the listing of those, by the way). At some point, these not-so-tiny bubbles will implode just as they did for commodities. As you can see below, the buy-back craze is looking eerily similar to conditions circa 2007 and is another sign of top-of-the-market behavior.

On the other hand, if it tightens, the Fed will be the one left holding the BB-gun that punctured this latest balloon of speculative excess. Moreover, it's clear Yellen & Co. will incur the wrath of numerous central banks, not to mention the International Monetary Fund (IMF), if rates are finally raised. The Fed might even get blamed for a further down-leg in China's currency which could unleash another paroxysm of selling such as we saw last month.

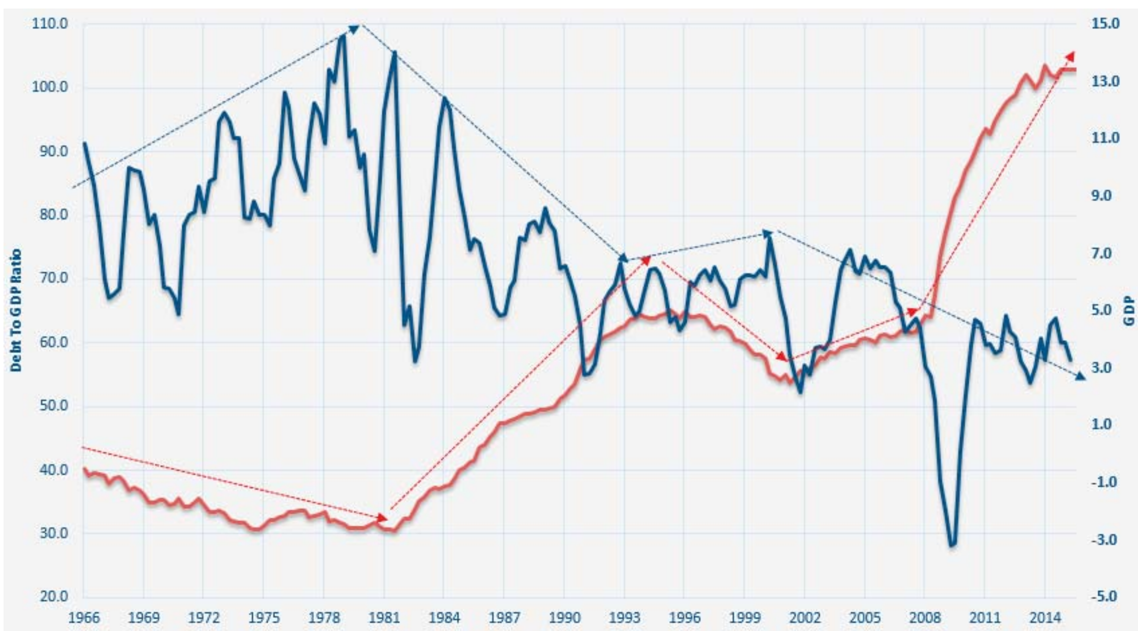
If you're like me, it's hard to avoid the conclusion that so much angst over a tiny rate hike, that should have happened long ago, is almost comical. But I don't think there's laughter ringing in the halls of the Mariner Eccles Building—which the Fed calls home—these days. It can't tickle their funny bone when they see stocks falling after they don't raise rates, as has just happened, making it seem as though they are truly damned if they do and damned if they don't. And it's no laughing matter that after years of essentially zero interest rates and a massive build-up of debt, economic growth, even in the US, remains as inspiring as…well…a Fed press conference.

FIGURE 3: US STOCKS LEVER UP, BUY-BACK



Source: Société Générale

FIGURE 4: DEBT UP, GROWTH RATE DOWN—AN UNHAPPY DIVERGENCE!

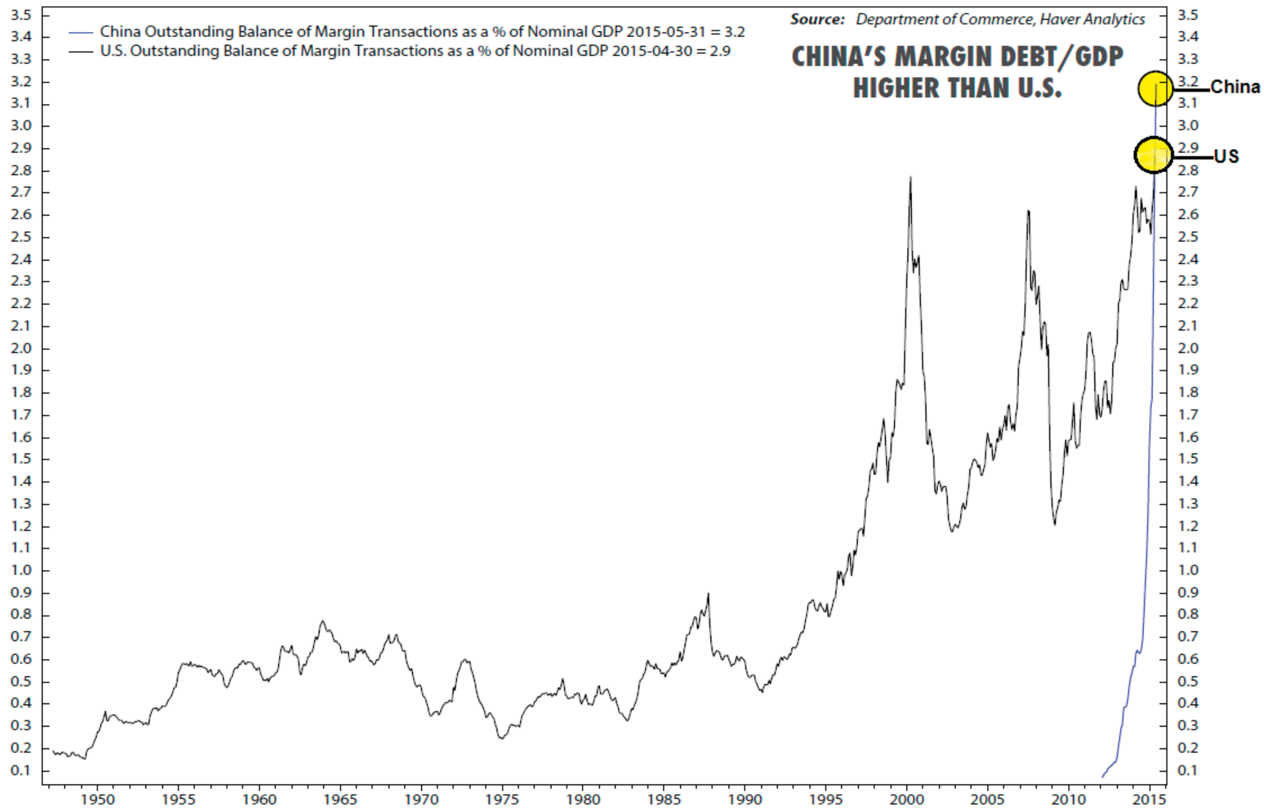


Source: Skënderbeg

The brutal reality is that the Fed doesn't have a solution to the deflationary pressures caused by currency wars, widespread industrial overcapacity, and excessive debt. In fact, some of its "remedies" are aggravating the condition such as by encouraging the accumulation of more debt for financial speculation. If you missed this in past EVAs, US margin debt isn't much better than in China right before its recent market meltdown.

So what's the Fed to do? I wish I knew but I am convinced there is no easy exit. Like the characters in Sartre's play, even when economic data was stronger—and the door to interest rate normalization was open—the Fed failed to go through it, preferring to remain in the familiar trap of zero interest rates it created for itself. Bull markets are built on confidence and this one has been exceptionally reliant on faith in the Fed to limit downside risk. It's increasingly apparent the market's faith in the Fed is flagging as it continually comes up with excuses not to begin normalizing rates. It would be the ultimate irony if all of the Fed's volatility suppression winds up creating rampant instability, as I believe it will.

FIGURE 5: US VERSUS CHINA MARGIN DEBT AS A SHARE OF GDP



Source: Ned Davis Research

To paraphrase Churchill, when faced with a choice between market stability and its own credibility, the Fed has repeatedly chosen stability. Now they will have neither.

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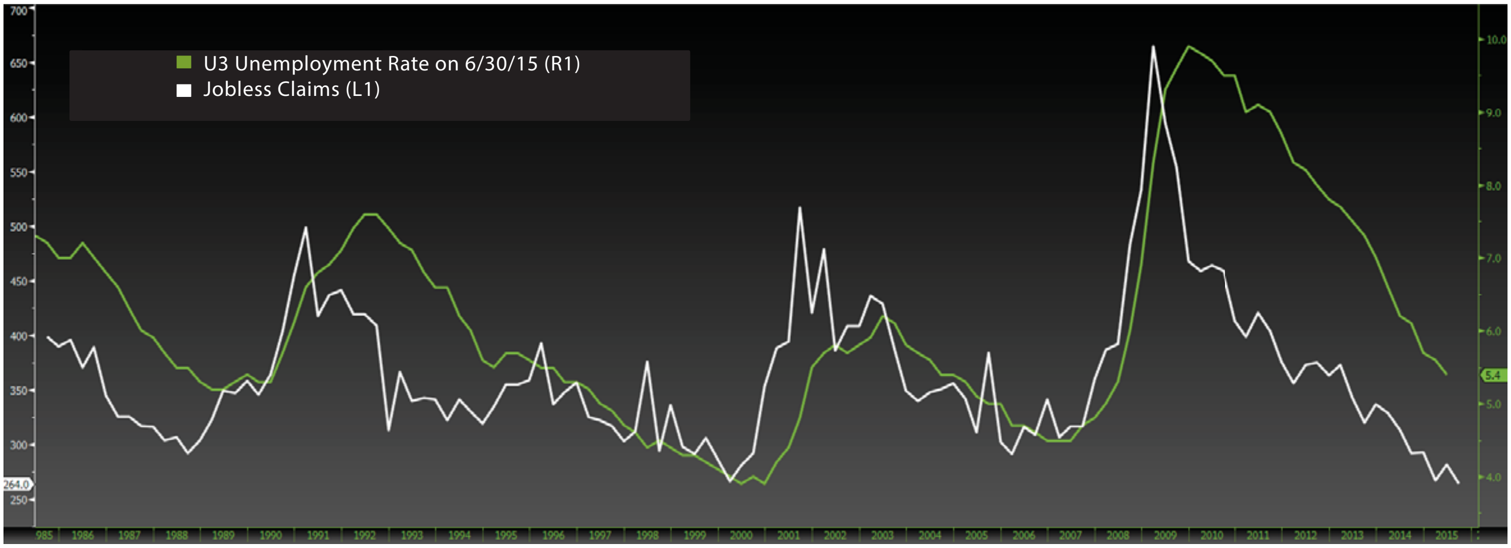
The "Global Mandate" Myth. Ok. I'll admit it. I am still scratching my head after last week's Fed decision. While I am not terribly surprised the still-divided Federal Open Market Committee (FOMC) voted to delay hiking interest rates in September; I'm shocked by the way the committee mis-framed its decision as a function of "global economic & financial developments". And I am absolutely stunned by the way a number of my peers are interpreting that message.

In its June 2015 policy statement, the FOMC clearly indicated that it would be "appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2% objective over the medium term."

Since then, the labor market has continued to tighten…

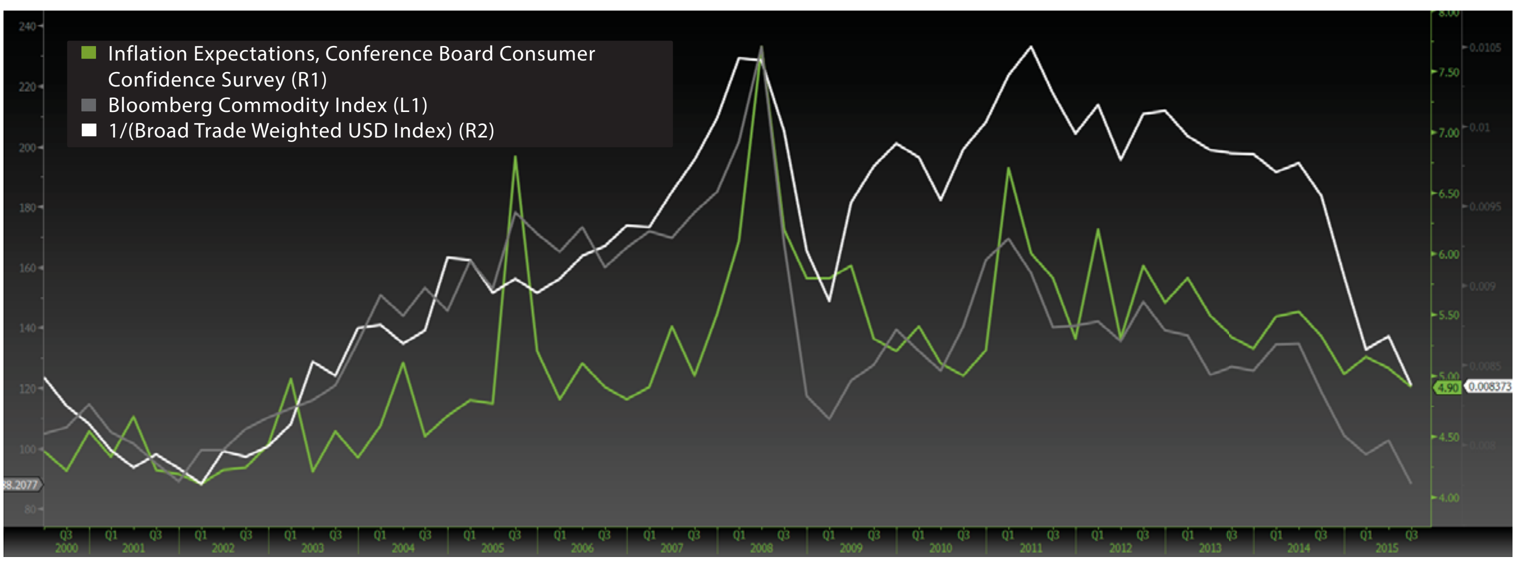
FIGURE 6: THE LABOR MARKET IS APPROACHING "FULL EMPLOYMENT"



Source: Evergreen GaveKal, Bloomberg

… and inflation expectations have remained relatively stable, despite what the committee believes is a short-lived drag from a strong US dollar and weak commodity prices.

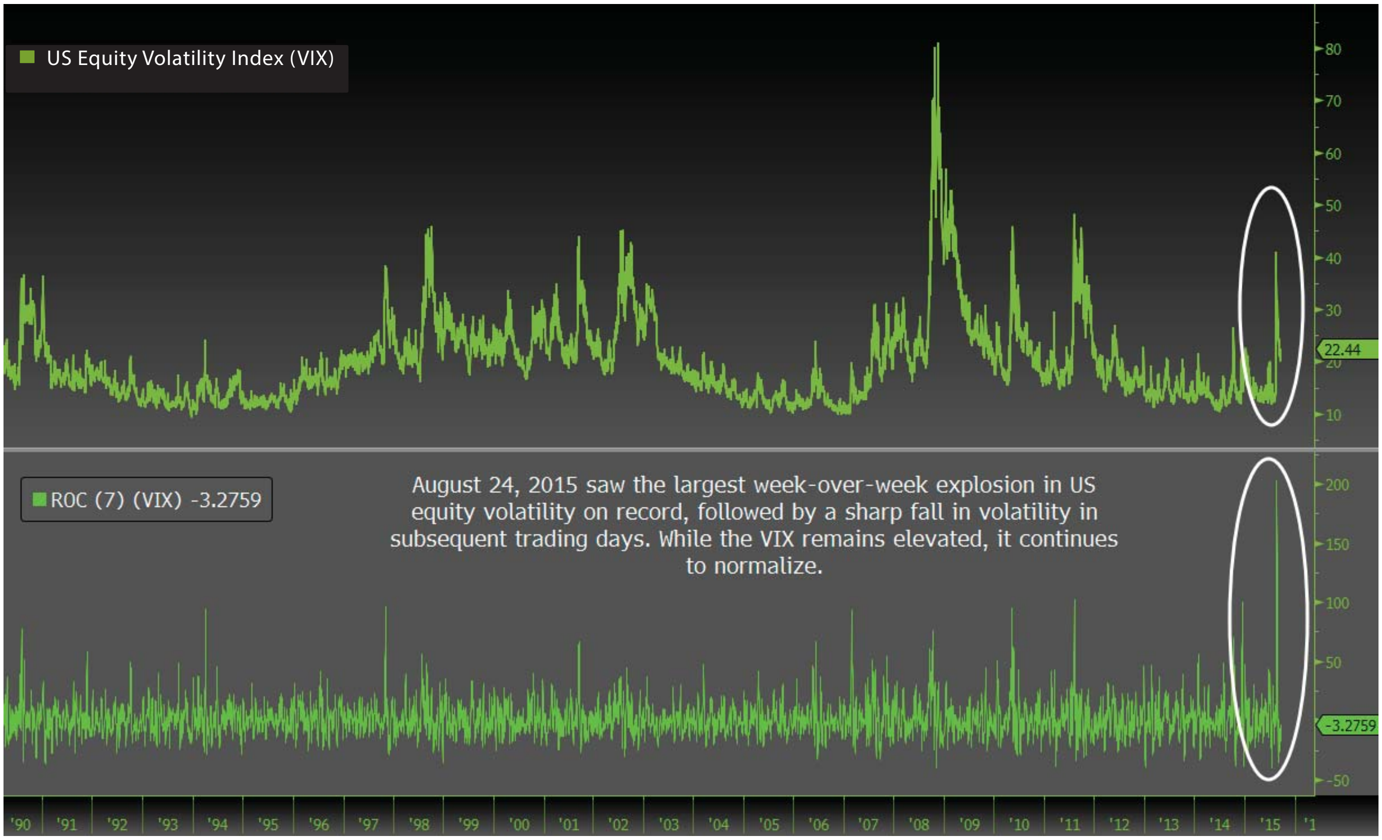
FIGURE 7: INFLATION EXPECTATIONS REMAIN RELATIVELY STABLE



Source: Evergreen GaveKal, Bloomberg

Despite the late August volatility explosion shown below—which calmed significantly before the FOMC met on September 16 & 17—you would think the data-dependent Fed would be closer to following through with a hike than it was in June 2015 even in light of rising risks abroad.

FIGURE 8: US EQUITY VOLATILITY IS RECEDING FROM ITS AUGUST HIGHS



Source: Evergreen GaveKal, Bloomberg

After all, the Fed Board of Governors Vice Chair Stanley Fischer—one of the FOMC's "main spokespeople" according to the recently retired Dallas Fed president Richard Fisher—delivered the exact same speech on "The Federal Reserve and the Global Economy" twice in the last twelve months (in October 2014 & May 2015). On both occasions, Fischer acknowledged the risks a Fed hike would pose to emerging markets and explained that, aside from clear communication, the FOMC has no other *global* responsibilities that should stand in the way of its *domestic* dual mandate (i.e. full employment within the context of price stability).

That's why last week's announcement was so remarkable. While the FOMC acknowledged it had virtually everything it needed to move forward with a hike, the press statement announced instead that the committee would be "monitoring developments abroad… particularly in China and the emerging markets" which the FOMC worried "may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." It was a near unanimous decision, with every member of the FOMC voting for the delay except Richmond Fed President Jeffrey Lacker.

From that perspective, last week's policy announcement smacked to many observers of not just an ordinary delay, but a radical change in policy. Some pundits—including CNBC's Rick Santelli—have even suggested the Fed's newfound concern for global stability amounts to a third policy mandate that will force the FOMC to keep interest rates a lot lower for a lot longer. If you subscribe to that view, like Morgan Stanley's head of global currency strategy, you have to conclude that "we're in a different world now."

"It's very rare for the Fed to invoke foreign developments in its press statement as much as it did [last week]," explains noted economist and investment strategist David Rosenberg. In fact, such concerns have not factored so heavily into a Fed rate decision since the Asian Financial Crisis, and subsequent Russian Crisis, which nearly brought the US financial system to its knees in September 1998.

But is it really that bad? Has global economic and financial market turmoil reached the point—in the less than two-month period since a September hike looked like a sure thing—that we should expect a material change in US economic data and a material change in Fed policy? I don't think so. Not yet, anyway.

The slow-moving growth crisis we are seeing across the emerging world is a very different animal compared to the fast-moving financial crises that ripped through Asia in the late 1990s. Neither China, nor the fragile emerging markets find themselves in a true financial crisis today. While I agree, and have written extensively, that both China and emerging markets are increasingly vulnerable to a Fed shock, the moves we've seen so far still seem insufficient to trigger an abrupt change in Fed policy. The whole idea that the Fed would voluntarily take on a global stability mandate in an every "central banker for itself" world is just laughable.

What I do think has changed is the explosion and subsequent calm-down in volatility that largely stemmed from China's decision to un-anchor its currency in early August. When CNBC's Steve Liesman recently asked Stan Fischer in late August whether mid-September was still the appropriate time to hike interest rates, the Vice Chair replied that Beijing's surprise move had changed the macro environment in ways the FOMC still did not understand (which is exactly what I argued in our full length-August EVA published a few days before), adding "I think we've still got to wait and watch and see how this turns out."

Moreover, Fischer argued the FOMC still did not understand how the subsequent volatility in global financial markets would affect the policy landscape. "If you don't understand the market volatility—and I'm sure we don't fully understand it now—there are many, many analyses of what's going on. Yes, it does affect the timing of a decision you might want to make… But I think [the volatility in global markets] could settle fairly quickly. There is that possibility." Referring back to Beijing's currency move, he argued "[the volatility] was a reaction to something which had the potential to be very big, and which we are still looking at." [It's worth noting that Fischer was among those FOMC voters who favored a pause in September even after arguing at the Kansas City Fed's annual meeting at Jackson Hole two weeks earlier that the time was nearly right for a Fed hike.]

If you think these comments are trivial, I'd encourage you to look at the transcript from Janet Yellen's September press conference. This exact same "wait & see" attitude comes out between the lines in her prepared comments, arguing "Developments since our June meeting, including the drop in equity prices, the further appreciation of the dollar, and a widening in risk spreads, have tightened overall financial conditions to some extent. *These developments may restrain US economic activity somewhat and are likely to put further downward pressure on inflation in the near term."* [Note that her last line is a direct quote from the committee-prepared FOMC statement that warns how turmoil in China and emerging markets could weigh on both US economic activity and inflation, illustrating that it is the recent volatility that matters to FOMC policy makers and not the current or future gyrations of a weak emerging world.]

While additional bouts of extreme volatility could certainly delay or eventually, cancel, an upcoming hike, don't expect the Fed to laser focus on every economic data point coming out of China or other emerging markets in the absence of global financial contagion. While market participants will likely respond to poor Chinese economic data – like this week's remarkably weak Purchasing Managers Index (PMI) reading—as a sign the Fed will stay lower for longer, it's worth noting that the Fed (and a host of other central banks around the world) largely relies on the exclusive China Beige Book instead of the inherently flawed data that most investors are watching. In other words, amateur China watchers around the world may think they now have some special insight into Fed rate policy, but they are not even looking at the same data. While PMI measures (along with other popular data) suggest that China's economy is abruptly collapsing, Leland Miller and his team at the China Beige Book continue to report a continuation of the same structural slowdown we've been watching for years. As Leland reminded me in an email this week, "the Fed had no legitimate China-related reason not to hike [in September]."

With all of this in mind, I do not believe the Fed has adopted a third mandate aimed at preserving global stability; I do not think a Fed hike is off the table (as of today); and I think that, by poorly communicating its concerns over the recent market turmoil, the Fed is setting up a number of economies and investors for an even larger shock in the relatively near future… possibly as soon as October.

When and if that happens, watch out for a massive surge in the US dollar, a meaningful market-driven drop in the China's yuan as capital flees the Middle Kingdom at a faster pace, a broad-based emerging markets exodus, a deeper sell-off in commodity markets, an outright global recession, and a serious correction in major equity markets around the world. In the event that US equities rally in the aftermath of a Fed hike (as I argued in last month's *Evergreen Exchange*), it may be a good opportunity to get defensive.

My outlook may sound a bit extreme today, but how many investors expected a 60%+ collapse in the price of oil a year ago? Not many, and that was just the tip of the iceberg.

I believe we may soon see one of the best buying opportunities for defensively positioned, cash-heavy investors in years; but taking advantage of those opportunities will require great discipline and emotional fortitude. If we do see an explosion of fear this fall, it will be wise to remember famed investor Jeremy Grantham's advice, "The market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

OUR CURRENT LIKES & DISLIKES

No changes this week.

WE LIKE

- Large-cap growth (on a deeper pull back)
- International developed markets (on a deeper pull back)
- Canadian REITs
- Intermediate Treasure notes
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Cash
- Publicly-traded pipeline partnerships yielding 7%-12% (MLPs)
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Long-term municipal bonds
- The Indian stock market
- Long-term Treasury bonds

WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Long-term investment grade corporate bonds
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Blue chip oil stocks
- Emerging bond markets (dollar-based)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds

WE DON'T LIKE

- Real Estate Investment Trusts (REITs)*
- Small-cap value
- Mid-cap value
- Small-cap growth
- Mid-cap growth
- Floating-rate bank debt (junk)
- Lower-rated junk bonds
- Emerging stock markets

*However, some small and mid-cap issues look attractive (and are becoming even more so)