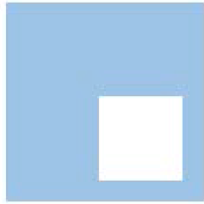

ABSOLUTE TOTAL RETURN

FOURTH QUARTER 2015 COMMENTARY

By: Shawn Blau, PhD

"Don't Fight the Fed!"

The 4th quarter of 2015 saw the US central bank tighten interest rates for the first time in almost a decade. The Fed had given several "false alarms" earlier in the year but finally plunged in and raised the Fed Funds target rate from its previous range of 0 – 0.25% to the current range of 0.25% - 0.50% now. This was the first time that the Fed had raised the Fed Funds rates since the middle of 2006.

The Fed had previously raised its little-used "Discount Rate" from 0.50% previously to the current 0.75% level. In addition, back at the end of 2014, the Fed halted its stockpiling of bonds in its final quantitative easing (QE) program. So, now the US Fed is in full tightening mode.

This has enormous implications for stock-market investors.

"FANG" Stocks, and the "Nifty-Nine"

The year 2015 was virtually flat for the US stock market, but that somewhat hides the full story. Most individual stocks were significantly down for the year. The market was held up by a very few large-cap growth stocks. These were known as the "FANG Stocks" and the "Nifty Nine." The FANG Stocks included Facebook (up 34%), Amazon (up 118%), Netflix (up 134%), and Google (now called Alphabet) (up 45%).

In addition to the FANG stocks the following 4 stocks made up the "Nifty Nine," which kept the S&P 500 Index from falling: Microsoft, Salesforce, eBay, and Priceline.

With the return to Fed tightening, these 9 large-cap growth stocks have fallen out of fashion. Here are some elements of the new Fed regime:

Volatility

The 3rd quarter of 2015 saw a sudden return of market volatility. We expect that this will only increase in 2016 in reaction to the Fed's tightening regime. Since 2009, the Fed's "loose money" regime had squelched out most market volatility. Now that the Fed has reversed course, volatility is bound to increase. As a result, we expect that the "VIX" Index will climb above 20 for much of 2016.

Flattening Yield Curve

When the Fed halted previous stimulative easing programs – including QE1, QE2, QE3, and "Operation Twist" – the bond market responded with a flattening of the yield curve. This involves long term interest rates coming closer to short term rates. We expect this to occur in 2016 as well.

Growth Style vs. Value Style

Growth Style involves investing in stocks with high growth rates of metrics like earnings or sales. Value Style involves investing in stocks that are inexpensive with regard to metrics like earnings, cash-flow, or book-value. Historically, over the long-term, Value investors such as Warren Buffett have out-performed Growth Style investors; however, this is not true every year. As described above, in 2015, nine very large-cap Growth stocks dominated the market. We expect this to reverse in 2016, and Value Style to re-emerge.

Rotation of Sectors

Historically, periods of Fed loosening (such as 2009-2015) have favored cyclical sectors, such as autos, construction, consumer cyclicals, industrials, technology, emerging markets, and transportation stocks.

Periods of Fed tightening (such as December 2015 onward) have favored defensive sectors, such as Equity REIT's, utilities, consumer staples, healthcare, and telecom. We expect these sectors to re-emerge in 2016.

Volatility Creates Opportunities

As always, higher volatility creates investment opportunities. Often, "the baby gets thrown out with the bathwater." We expect this to occur as well in 2016, and we await the opportunities.

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