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In Pursuit of Value

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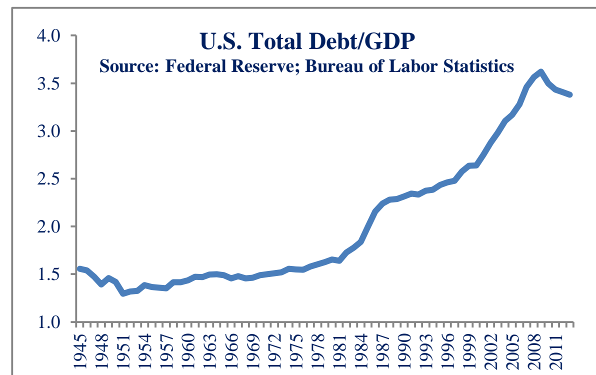
Interest Rates

At some point this year it's likely the Federal Reserve will raise interest rates, at least based on the signals they are providing. If they increase the Fed Funds rate in June, the earliest plausible timing, it will mark nine years since the last time they tightened. The Financial Crisis of 2008 was responsible for many superlatives; among those is that it was followed by the longest ever period without a Fed rate hike (the historical series begins in 1954 on the Fed's H.15 release).

The first rate hike following an extended absence is always fraught, and the Fed's regular communication reflects their appreciation of this. Even though it ought not to surprise when it happens, that's probably expecting too much. Although the initial rise will be one of the stories of 2015, more important is how high rates eventually move. Where is the equilibrium short term interest rate? What is the real yield (i.e. net of inflation) on ten year treasuries? These are the changed inputs that will affect the pricing of all other assets.

In *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors*, I drew an analogy between the Government-controlled low interest rates that followed World War II and the attendant war-related jump in U.S. debt with the situation today. In the first instance there existed an explicit agreement between the Treasury and the Federal Reserve to maintain low rates so as to ease the debt burden while it was paid down. Of course, no such agreement exists today, and yet monetary policy quickly acknowledged that excessive debt requires low rates. Negative real rates (that is, nominal rates below inflation) reduce the real cost of debt and is the least painful form of wealth transfer from savers to borrowers.

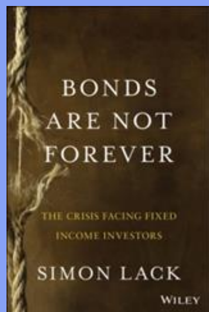
Although the 2008 financial crisis was fundamentally about too much debt, total U.S. debt as measured by the Fed's Flow of Funds report continued to rise, reaching over $56 trillion in 2013 (as a percentage of GDP it has moderated somewhat). This is private and public sector debt. As the household sector reduced leverage after 2008, the public sector increased its bond holdings, most notably through the Federal Reserve's program of Quantitative Easing which grew its balance to $4.4 trillion before it stopped buying last October (however, it's still growing through reinvestment of interest income). Total Debt/GDP has moderated somewhat as the chart shows, but overall debt levels remain at historically very high levels. In short, this does still not look like an economy that is set up to withstand high interest rates. Therefore, we believe that rate rises will remain moderate either through the Fed's cautious approach or through an overly aggressive series of hikes being halted by an adverse GDP response to an onerous cost of financing. Low rates, and low real rates continue to be in our national interest.



One result of this is that the Federal Government consistently overestimates its cost of financing. A recent article highlighted that for almost twenty years the U.S. Treasury and Office of Management and Budget have expected higher yields on ten year treasuries (along with most economists) than actually occurred. Consequently, while there's rarely much to celebrate with respect to government finances, successive deficits have turned out to be less than budgeted based on forecast interest rates. In fact, you probably have to go back to 1994 when the Fed raised rates sharply to find a time when there was an upside surprise. It certainly surprised Orange County at the time, whose aggressive investments in structured notes linked to short term rates collapsed and pushed them into bankruptcy.

The Federal Reserve has also been reducing its rate forecasts. The now ubiquitous "blue dots" which graphically represent each FOMC member's forecast, have been reflective of a steadily delayed start of tightening. I began following these back in 2012 when the Fed first began publishing them as part of a move towards greater openness. The Fed isn't much good at forecasting rates either, even though they have as much information as anybody and the opportunity to have policy follow their own forecasts. Three years ago they expected to have begun raising rates by 2013, so they're likely to be at least two years late in that respect. What I find more interesting though is the evolution of their equilibrium rate, or the level at which they believe the Fed Funds rate is neutral. In 2012 the median forecast of FOMC members was 4% with several at 4.25%. As of last September (the most recent set of FOMC projections available) the median was 3.63%. Their inflation target of around 2% hasn't changed, so the Fed has quietly embraced modestly lower real rates. The fact that equilibrium isn't quite as far away should result in less urgency to get there.

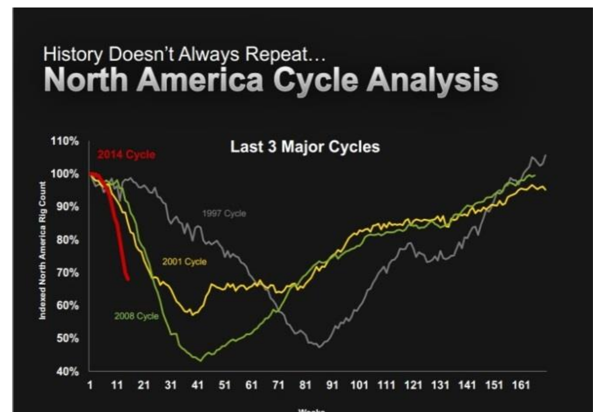
SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



That all sounds a lot like a forecast, and forecasts can be wrong. A firm that invests solely in equities and shuns bonds needs to contemplate a bond market surprise that impacts stocks. Part of the solution is to limit one's equity investments to companies with strong balance sheets and low leverage, which reduces their potential vulnerability to rising rates. This is the case with our Hedged Dividend Capture (DivCap) and High Dividend Low Beta (HighDiv) Strategies as well to most of the names in Deep Value. Another solution is to invest in companies with high growth rates, which is the case for our MLP Strategy and its related variations including the mutual fund we advise, because of the bias towards MLP General Partners that typically grow their distributions much faster than the underlying MLPs which they control. Both our core MLP Strategy and our Energy Infrastructure Strategy (also available in mutual fund format) should experience >10% distribution growth rates across the companies they own, compared with the Alerian MLP Index's <5% growth rate in 2014.

The last series of Fed rate hikes ran from 2004-06 as Alan Greenspan followed a methodical 0.25% increase at every FOMC meeting (roughly twice a quarter). The Fed Funds rate rose from 1% to 5.25% during this time, a process that on a chart fairly resembles a staircase such was its regularity. Although rate hikes are a distant memory, I do recall commentators frequently challenging that the Fed was "behind the curve" and would need to move faster. In her most recent Congressional testimony Fed Chair Janet Yellen maintained the tradition of her predecessors in retaining her flexibility. The warnings are plain, and yet the Fed's own inflation forecast has it below their 2% target until 2016. Continued labor market improvement is also a pre-requisite for them to move. There are bound to be some critics that the Fed is moving too slowly, but they should have ample data supporting their cautious approach.

Domestic Oil Production



The U.S. rig count has reacted sharply in recent weeks to the collapse in oil prices. In our view this reflects the flexibility of much unconventional drilling in that decline rates are faster than for conventional wells and known oil reserves can easily be left in the ground until more favorable prices are available. Recent earnings reports for MLPs have generally reaffirmed previously communicated guidance, although in some cases planned growth capex has been curtailed.

The chart is from a recent presentation by oil servicer Haliburton (HAL). Rather than continue producing from unprofitable wells, many U.S. E&P companies are sufficiently nimble that they can slow operations quickly.