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Tenuous Global Backdrop for the Fed's Decision Next Wednesday

We urge investors in the coming year to sort out the strong from the vulnerable in portfolios (please see our Outlook 2016). Unfortunately, in short periods of either "panic or euphoria," markets often do just the opposite.

As the Fed approaches a likely first tightening step for the cycle next week, the global backdrop for its move once again appears increasingly tenuous. However, we continue to see a very gradual exit from the Fed's extraordinary stimulus as a relative *stabilizer* compared to an alternative of reacting (yet again) to international uncertainties. Just as we saw in September, **if the Fed deems a tiny step away from emergency stimulus as too risky, it simply provides another form of restraint through policy uncertainty.**

The international uncertainties driven by decisions just this month have indeed increased legitimately:

1) OPEC's decision last week to suspend output quotas and continue producing crude oil at near record levels served as a catalyst for range-breaking new cycle lows in the oil price. This was even as the consensus expected no action at the OPEC meeting. The result highlights how different the cartel's strategy of maintaining market share at the expense of price is from its decisions of the past two decades. It focuses attention on the vulnerabilities of producers with weak balance sheets and a "Darwinian" path toward rebalanced oil supply/demand (please see idea #6 in our Outlook 2016: Top Conviction Ideas). Such large movements in petroleum are virtually always a market challenge across asset classes.

2) China today subtly hinted at a policy of further Yuan depreciation as it said it would start referencing the value of its currency against a basket of exchange rates rather than just the U.S. dollar. China's strong currency has been a relative stabilizer for otherwise deeply pressured EM exchange rates across the world. A further devaluation will be seen as a competitive threat for some emerging markets with both idiosyncratic local vulnerabilities and exposure to U.S. monetary policy risks. The Chinese Yuan fell to a 2011 low today against the U.S. dollar (please see our Outlook 2016 Article: Exploiting Volatility).

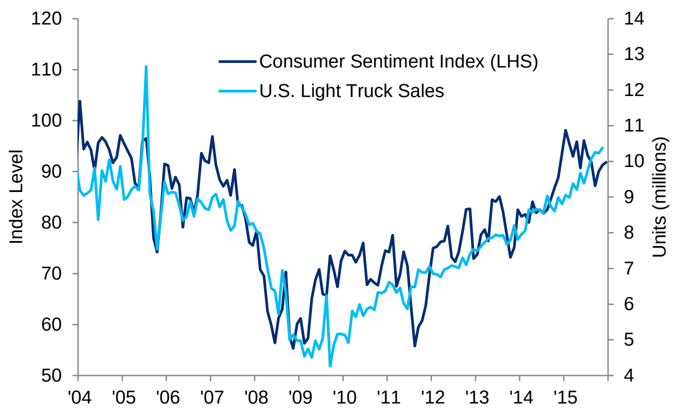
3) Investors in Eurozone assets continue to reel from policy uncertainty after the ECB seemed to guide markets into expectations for stepped up stimulus, only to be admonished by some governing council members after the fact that such expectations were "absurd." Expectations for monetary policy actions priced into markets effectively deliver a strong portion of the stimulus itself. The ECB may need to work incrementally harder in the future to maintain "policy traction" in markets in order to deliver its aims. This is why European markets are, for the moment, sharing strongly in the brunt of the negative impact from the issues of 1-2 above, despite a central bank that is actively working to shield the region from external deflation risk.

Shaking the "Loose Fruit" from the Tree Limbs

Predictably, the approach of the Fed's miniscule step to move away from emergency accommodation next week has "shaken loose" vulnerabilities - or to say another way - raised the visibility of the consequences of such an action. It should be noted that long-term Treasuries are rising solidly in the face of firm expectations of an initial Fed tightening step next week (please see idea #4 in our Outlook 2016: Top Conviction Ideas). This shows that the strongest sovereign bond markets are not among the most vulnerable financial assets. As we note in Outlook 2016 linked above, investors shouldn't fear duration, but rather, raise portfolio credit quality, and in some cases raise duration.

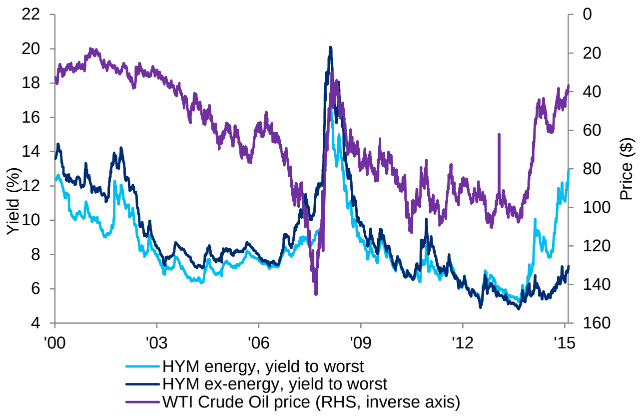
We highlighted some external weaknesses in the backdrop for the Fed's decision above. However, the U.S.'s own, internal backdrop has long argued for less stimulus, if merely to extend the ultimate life of the expansion. U.S. labor demand grew at a pace 3.3X the growth rate of the labor force over the past year, After reporting 211,000 monthly job gains for November, today the U.S. reported the largest gain in core retail sales in seven months. Signs of petroleum weakness fueling strength elsewhere are far from the rarity that press reports suggest (see figure 1).

Figure 1. Consumer Sentiment vs. U.S. Light Truck Sales



Sources: Haver Analytics as of December 11, 2015.

Figure 2. U.S. HY energy & ex-energy yields vs. Crude Oil Price



Source: The Yield Book as of December 11, 2015.

Despite a disappointing year, investors in 2015 have been fortunate in many respects. Away from correction periods like August/September, markets have rationally diverged where fundamentals have. Darlings in the equity market are generally firms that are reporting strong revenue and profit growth. In the high yield debt market, one can see that the extent of the rout in oil producers is in an entirely different class from other issuers (see figure 2).

As an example of divergence, sub investment grade airline debt can be bought for a mere 5% yield. Even amid legitimate market liquidity fears, this performance divergence makes sense from a fundamental perspective, as the world has never been driven into recession by excess oil supplies.

The broad-based high yield downturn of 2008 stemmed from a catastrophic broad-based economic downturn. While risks have increased as the expansion shows signs of wear, we don't expect such a downturn in the coming year. Meanwhile, policymakers such as those at the ECB will likely have to revisit their monetary decisions just as the Fed will in the coming week.

Finally, we would once again point to the market reactions from past periods where markets assumed Fed action was forthcoming, but the Fed decided against it. As our figure 3 shows, **there have been six cases when markets expected a tightening step by the Fed** during the current policy announcement regime **and the Fed *did not act.*** Presumably driven by whatever stayed the Fed's hand, **emerging market equity returns were negative in the month that followed in five of six cases, generally reversing any immediate relief that was felt that day.**

In the end, the fundamental vulnerabilities and strengths of particular emerging markets were most important. We would expect the same if the Fed were to choose to stand down in the coming week.

Figure 3: Rate Hike Expected, Fed Doesn't Move

Cycle Position	Date	Probability of Hike Priced In? (%)**	Probability Limited to 100%	MXN (Daily % Chg)	One Month Return	MSCI EM Shares (Daily % Chg)	One Month Return
Mid Cycle	06-Jul-94	64	64	*	*	0.67	11.18
Mid Cycle	27-Sep-94	104	100	*	*	(0.38)	(3.54)
Mid Cycle (1)	20-Dec-94	148	100	(10.82)	(30.93)	0.20	(10.84)
First Hike	03-Jul-96	56	56	(0.30)	1.29	0.29	(5.03)
First Hike	24-Sep-96	68	68	0.72	(5.36)	0.16	(0.99)
First Hike	09-Feb-09	54	54	0.09	(0.20)	0.79	(1.01)
	Average	82	74				

Sources: Haver Analytics and Bloomberg as of September 11, 2015. Past performance is no guarantee of future results, and actual results may vary. Future movements could deviate from historical patterns.
Note: 1 This is first day of the new floating Peso regime. *The Mexican peso was pegged to the USD from November 1991-December 21, 1994. **Probabilities over 100 indicate market priced larger than 25 bps move. Dividends were excluded from 1-month returns. Mexican peso is used as an example of an emerging market currency response to the FOMC. MSCI EM is an index of emerging market stock markets.

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