Martone Capital Management: Weekly Investment Commentary (12/15/2015)

Last week, stocks fell sharply and bond yields dropped as investors reassessed their tolerance for risk.

The selloff means year-to-date returns for U.S. equities are once again negative. Many international markets also surrendered the majority of their 2015 gains. Investor sentiment has turned more cautious, with market volatility rising to a two-month high, despite the continuation of the mergers and acquisitions boom - chemical giants DuPont and Dow announced Friday they have agreed to merge - which has frequently helped stocks this year.

Investors seem prepared for the Federal Reserve (Fed) to raise interest rates for the first time in nine years tomorrow. As such, the negative market sentiment is not being driven by the Fed, but by the collapse in oil prices. Paying less at the pump might seem like a good thing, but the drop in crude has reinforced fears over slow economic growth and deflation, placing pressure on a range of asset classes related to energy.

Investors currently place the odds of Fed liftoff this week at approximately 75%, as indicated by the futures markets. With a rate hike largely expected, investors will instead be focused on the language the Fed issues around its path going forward. Our base case is that the Fed will go out of its way to stress that the tightening cycle will be gentle and gradual.

An initial hike, particularly one as well-telegraphed as this one and which will still keep rates at very low levels, is not a tremendous threat. However, other factors are raising investor anxiety. In particular, the recent collapse in oil prices raises more questions over asset classes ranging from high yield bonds to emerging markets.

To the extent lower oil prices are supportive of consumption, why are investors reacting so negatively to what should be good for global growth? Part of the problem is what the collapse in oil suggests about the growth outlook and the potential for more disinflation. Concerns over deflation are once again manifesting.