Martone Capital Management: Weekly Investment Commentary (2/23/2016)

Equities and credit both rallied last week. Developed equity markets were up around the world, with Japanese stocks the top performer.

Unfortunately, investors still face many challenges. Risks of a recession appear to have moderated, but weakness in corporate earnings has not. Another challenge for investors will be the Federal Reserve's (Fed's) course of action. The Fed is likely to be true to its word and proceed cautiously, but inflation has strengthened, suggesting that the central bank may not be quite as dovish as the market expects.

Despite last week's better tone to the markets, the problem for investors is that the basic fundamentals have not changed very much.

Take oil, for example, an investor fixation this year. Oil rallied last week after a statement from Saudi Arabia and Russia suggested they will maintain production at January levels, if other nations agree to participate.

But there are a number of reasons to be skeptical that this agreement can correct the excess supply problem that has led to the plunge in prices. First, it is not clear that the agreement will hold, as Iran has refused to commit to capping production. Second, Iraq and Saudi Arabia had already increased production in January and Russia is also close to its maximum production capacity. Finally, even at existing levels, there is too much supply. U.S. oil inventories recently reached their highest level in 86 years.

For equities, even if the global economy manages to skirt an economic recession, it is clear we're in the midst of a deepening profits recession. Earnings per share (EPS) of S&P 500 companies are on pace to decline 3.9% versus a year ago, and this quarter alone is shaping up to see a 4.8% contraction from the previous year.

In the past, soft growth, tightening financial conditions and falling inflation expectations would have at least provoked a response from the Fed. Although we still believe that central banks in Europe, Japan and probably China will continue to ease, the Fed is in a bit of a bind. Economic data, particularly manufacturing, are soft while inflation expectations remain near multi-year lows. That said, most measures of realized inflation are improving. U.S. core inflation is now running at 2.2%, the fastest pace since the fall of 2008. Prices on imported goods, both oil and non-energy-related products, continue to fall, but housing and medical inflation are accelerating.

The Fed is unlikely to raise interest rates four times this year, as it suggested last December, but will the central bankers wait out all of 2016? Probably not, yet this is exactly what the futures market is suggesting. As such, any hikes would represent a more hawkish stance than the market is currently discounting. If this occurs in the context of a stronger dollar, it will represent a further tightening of already challenging financial market conditions.

For investors, there are several implications. First, the Fed is unlikely to provide the same backstop for asset prices as it has in recent years. Second, in a world in which central bank policy is both less available and less potent, volatility is more likely to remain above its historical average.

Finally, today's inflation expectations are most likely too low. Even in a world of slow growth, weak productivity and diminishing labor market slack, inflation may be higher than today's diminished expectations suggest. Under this scenario, Treasury Inflation Protected Securities (TIPS) may represent a good long-term opportunity.