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THE FARR VIEW

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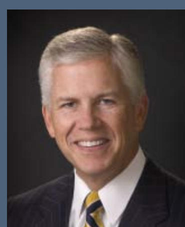

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Conflicting Signals

Following a very tepid start, it now appears as though the Federal Reserve has embarked, in earnest, on its first tightening cycle since 2004-2006. During the previous cycle, the central bank raised the Fed Funds rate a total of 17 times, in increments of 0.25%, before finally reaching a peak of 5.25% in 2006. This time around, the Fed is clearly taking a more cautious approach having increased the Fed Funds rate just 4 times in 18 months. The caution this time around reflects relatively low and uneven economic growth as well as subdued levels of inflation. But there is one similarity between then and now that is worth pointing out.

Well into the tightening cycle in 2005, the Fed could not understand why long-term interest rates had not risen in response to significant increases in the Fed Funds rate. Even after the Fed Funds rate reached 4% from a starting point of 1%, the yield on the 10-year Treasury bond still hadn't budged much. Fed Chairman Alan Greenspan repeatedly referred to the behavior of long-term interest rates as a "conundrum" before finally settling on a "global savings glut" as the source of unusually strong demand for Treasury bonds (and therefore stubbornly low long-term interest rates).

Fast forward to 2017, and we could be seeing the same pattern develop. Despite ongoing assurances from the Federal Reserve that economic growth is set to accelerate and inflation to rise toward its target of 2%, long-term bond yields fell precipitously beginning in mid-March. The yield on the 10-year Treasury bond plummeted from a high of about 2.63% in mid-March to a low of 2.13% in mid-June. Since that time bond yields have rebounded somewhat, but they remain meaningfully lower from those first-quarter highs.

Under normal circumstances, bond yields would be expected to rise against the backdrop of accelerating economic growth, rising inflation, and a Fed intent on removing policy accommodation. Higher economic growth would be expected to raise the demand for loans, and therefore the cost to borrow, while rising inflation would further increase nominal interest rates. As well, we would expect bond prices to fall (and yields to rise) with the Fed signaling further interest-rate hikes and plans to begin selling assets from its $4.5 trillion bond portfolio. So what gives? Why aren't long-term rates increasing to reflect these developments?

One of two things is happening, in our opinion. The first possibility is that the markets are concerned about a policy mistake by the Fed. Under this scenario,

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the economy is not on a path toward acceleration beyond the 2% pace of the last 8 years. As a result, investors are unconvinced that the Fed will follow through with its plans to remove policy accommodation. The second possibility is that the bond market is wrong and the Fed is correct. Under this scenario, economic growth is indeed set to accelerate, and therefore the threat of higher inflation must be addressed through the removal of policy accommodation.

In the first scenario, there is a solid case to be made that the Fed, armed with recent data, will actually slow or halt interest-rate increases going forward. There are already individual members of the Fed that have made public their view that inflation is not high enough to justify methodical interest-rate increases. And indeed, as we look at the numbers, it's hard not to sympathize with those dissenting voices. Wage growth remains stubbornly low even as the unemployment rate has dropped to 4.4%. Year-over-year growth in average hourly earnings has decelerated to 2.5% from the high of 2.9% in December, 2016. This has confounded the Fed as it calls into question one of its most basic economic tenets, which says that falling unemployment will lead to higher inflation.

Other inflation indicators are telling the same story. Growth in the Consumer Price Index (excluding Food & Energy) has dropped precipitously over the past several months from over 2.3% to just 1.7% in May. Similarly, the Fed's preferred measure of consumer inflation, the Personal Consumption Expenditures deflator, has also dropped for four straight months to just 1.4% in May. Chair Yellen contends

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that transitory factors such as the drop in oil prices and falling prices for mobile phone contracts are causing the near-term deceleration. Is she right?

If Chair Yellen is not right, the stakes are quite high. Interest-rate hikes could have dramatic implications for an economy that has only produced an average of just 2% growth during eight years of near-zero interest rates. A policy mistake that isn't caught in time could risk thrusting a still-fragile and debt-ridden economy into recession. So, the drop in longer-term Treasury yields could be signaling an increased likelihood of a Fed-induced recession.

The second (and less likely) possibility could be that the bond market just has it wrong. It could be that the Fed has managed its exit perfectly so far, neither underestimating inflationary pressures nor creating financial-market dislocations with negative ramifications. As I write, the bond market continues a sell-off that began on June 26 and has seen the yield on the 10-year Treasury rise to 2.37%. Is this increase in interest rates representative of a capitulation by bond investors? Is it likely that 1) the Fed is smarter than the collective wisdom of the bond market; and 2) the Fed has designed a near-flawless reversal from an unprecedented monetary experiment?

For our part, we think the Fed could indeed be in the early stages of making a policy mistake. Ideally, the Fed should have begun the process of removing policy accommodation (raising interest rates) several years ago. The emergency measures taken were no longer necessary once the immediate threat of the financial crisis passed. As things currently stand, though, the Fed will likely soon recognize that in the absence of aggressive fiscal stimulus from Congress (the odds of which are decreasing each day), the economy is not strong enough to withstand sizeable increases in interest rates. At that time, the Fed will likely pause and reevaluate. Unfortunately, simply deferring interest-rate hikes (again!) may not have the benign and soothing impact on the markets as in times past.

There's Gold in Them Thar Hills!

While inflation has been quite tame by traditional metrics, it is not true that all inflation has been well contained. Asset prices continue a relentless and nearly uninterrupted ascent. The S&P 500 was up 8.2% (excluding dividends) in the first half despite the fact that oil prices descended into bear market territory (-20%+) during the quarter. The sharp drop in oil, which is the same factor that led to the S&P 500's last correction (-10%+) in late 2015 and early 2016, negatively affected Energy-sector stocks once again. However, very strong performance among Health Care and Technology stocks was fortunately enough to offset the Energy weakness this time around.

There is little doubt that stock prices are being supported by the promise of fiscal stimulus. Despite setbacks on health care reform, tax cuts, and infrastructure spending, it appears as though Wall Street is discounting some favorable outcomes in the near future. All the while, interest rates remain remarkably well contained. One negative side effect of the Fed's aggressive monetary policy is that it has emboldened investors to take on more risk than they otherwise would due to the belief that the Fed will be there to bail them out. This "moral hazard", which we have been warning about for the past 8 years, will be very difficult for the Fed to reverse. Investors think they have two ways to win: Either fiscal stimulus gooses corporate earnings or failure to enact fiscal stimulus results in low interest rates as far as the eye can see.

Housing prices have also been appreciating at a very rapid pace. The S&P 500 Case Shiller 20-City Home Price Index has increased a whopping 47%, for an annualized rate of 8%, since its low in 2012. The index now stands just 4% below the all-time highs immediately preceding the Financial Crisis in 2006. Eight years of ultra-low interest rates have certainly worked their magic for homeowners!

The Downside of Asset Inflation

Rapid asset-price inflation is not all good news. The wealth created by soaring asset prices over the past several years, combined with stagnant middle-class incomes, has caused economic inequality the likes of which this country hasn't seen in many decades. By some studies, the gap between the "haves" and the "have-nots" is the widest since prior to the Great Depression. As a result, middle-class angst has been on display in very visible ways in recent years. Political and social instability will only increase as economic inequality continues to grow.

High asset prices also raise the cost of saving for retirement. This will affect lower-income folks, who have yet to save much for retirement, the hardest. Just as low interest rates have effectively pulled forward future demand for goods and services, they have also effectively pulled forward future investment returns on assets like stocks, bonds and housing. Seemingly minor reductions in investment returns can have dramatic implications on the long-term growth of an investment portfolio. And the home is generally one of the consumer's largest assets.

The rising wealth gap has generational implications as well. Younger folks who

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are just starting out are not only faced with large student loans (resulting from tuition inflation), but they also might have trouble buying a first home due to home price appreciation, lack of lucrative employment opportunities, and tougher mortgage underwriting standards. Rapid increases in health care costs will hit these younger folks disproportionately hard as well. And last but not least, high stock prices may force younger folks to set aside more for retirement as expectations for future returns fall.

And then there's the risk of asset bubbles. The Fed's actions over the past 20 years have undoubtedly led to "boom-bust" cycles that can be devastating for investment portfolios. There appears to be little appetite for learning from past mistakes as the Fed continues to use the only tool in its toolbox to fight economic downturns (which are normal!).

In summary, our view is that more robust and sustainable economic growth will only be achieved if and when larger segments of the population begin to share in the benefits of economic growth. We have not yet reached the watershed moment for this problem.

Warnings Signs?

Another "conundrum" that has developed this year is the high level of investor complacency that is perhaps best measured by the CBOE Volatility Index for the S&P 500 (commonly referred to as the "VIX"). The VIX measures the cost of buying protection against market downturns through the purchase of options. During 2017 the VIX descended to its lowest levels since 2007 – a fairly stunning statistic if you consider how far stock prices have risen as well as the level of fiscal policy uncertainty.

The rotation into Technology and Health Care stocks has offset weakness in Energy stocks this year. In general, rotations like this are a positive sign of market resilience. However, the strong first-half performance of the Technology sector, and indeed the market at large, was heavily influenced by a small number of mega-cap stocks that have done exceedingly well this year. Shares of Amazon, Apple, Alphabet, Facebook and Microsoft increased an average 23% in the first half, and their combined market capitalization of nearly $3 trillion is bigger than the Gross Domestic Product of all but four nations. The heavy contribution by these few names to overall index returns represents a lack of market "breadth." In general, professional investors prefer to see a market rally that is more broad-based, or driven by a large number of companies and industry groups. When leadership narrows, it often indicates that the broader market may be running out of steam.

The Bright Side – Corporate Earnings

According to data from FactSet, earnings for the S&P 500 are expected to grow by 10% in 2017 and by 12% in 2018. While estimates have been revised down fairly consistently in recent years, we are somewhat optimistic because revenue growth has been picking up in recent quarters. This means that rather than relying on ever-increasing profit margins, future earnings growth may be derived, to a greater extent, by top-line gains. We will maintain a cautious posture, though, as revenue and earnings expectations are, to some extent, predicated on favorable fiscal policy.