Asset Management

News or Noise: U.S. Economy Gains Strength; Greek Crisis Nears Boiling Point

By David Fisher, Chief Investment Officer

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Equity markets were down only slightly last week, while volatility remains in check. But the same cannot be said for fixed-income and currency markets. Both are seeing larger day-to-day swings as the economic environment shifts and central bank decision time approaches.

In today's News or Noise, we focus on the recent economic data that gives positive clues on the direction of the U.S. economy. A positive outcome in Greece could be closer to reality, which would also be a general positive for global markets. But these are all feeding into a fixed-income market that is pushing rates higher. Will rate rises continue to the point that they cut off the positive story?

No. 1: Data Confirms U.S. Economy Gaining Strength

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Multiple data points came out last week confirming that the weak first quarter and the sluggish start to the second quarter are likely dissipating and that the U.S. economy is gaining momentum as the second half of the year approaches. As recently as two weeks ago, we wrote that strong housing data along with other trends caused us to believe that the concerns about weak growth were overblown. At the time we didn't have enough information to state unequivocally that the economy is strengthening, but after last week we do think there is a newsworthy shift underway. Most economists continue to downgrade their forecasts for U.S. gross domestic product (GDP) growth in 2015 due to the slow start to the year, but the key is looking forward and seeing where things are headed. We note in headline No. 3 below that interest rates around the globe, including the U.S., have begun to rise meaningfully in recent weeks. We suspect that a big part of this move is based on the fundamental improvement to forward-looking data.

So what data do we believe confirms this shift? The key reports last week were auto sales and payroll. Auto sales came in at an annualized rate of 17.9 million units in the United States. This is a level achieved only a few times in the past, and shows a very positive environment for the auto industry. Moreover, the average price of a car is up more than 4% from the previous year, and the financing term has lengthened to 68 months. One can debate whether consumers are making wise financial decisions or not, but this fact pattern tells us they are generally confident in their financial situation.

On the payroll front, last week's reports provided a lot of good information. Though the headline unemployment rate ticked up to 5.5%, it came about from more people entering the labor force. New job creation was 280,000 for the month. Average hourly earnings are also starting to show positive momentum, which should help consumer income and spending going forward.

Economic data has not been universally strong, as retail spending has been a disappointment so far this year. But with 3.1 million new jobs in the past 12 months, housing gaining strength and auto sales near record levels, we believe that the U.S. economy is doing better than most will admit.

No. 2: Greece Issues Nearing Boil

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We don't write often about the Greek crisis as it is the quintessential "noise story," dragging on for five years at this point. But we do believe that the time for an intermediate-term solution to the crisis may finally be upon us, so we will provide some thoughts this week.

In a high-profile meeting last week, German Chancellor Angela Merkel, French President Francois Hollande and European Union head Jean-Claude Juncker met and finalized a report that the leaders stopped short of saying was a "take it or leave it" offer, but it appeared close to that. By the end of the week, hopes for any agreement occurring over the weekend were scuttled, as Greek Prime Minister Alexis Tsipras was scheduled to meet with the creditors on Friday but had to cancel that visit because of major political challenges at home. By Friday, the PM officially notified the country's creditors that the offer was unacceptable.

The International Monetary Fund had previously authorized Greece to bundle all payments due until the end of the month, and Greece did utilize this offer, deferring the first of four payments this month that was due Friday. Over the weekend the creditors announced that a follow-up meeting with Merkel, Juncker, Hollande, IMF Managing Director Christine Lagarde and European Central Bank President Mario Draghi would occur on Monday. Merkel and Hollande also confirmed they would be meeting with Tsipras at the G7 meeting in Germany on Wednesday. The creditors announced last week the desire to have the final agreement in place by June 14, which is this Sunday. The creditors continue to push for additional reforms, especially in pensions and tax collection.

The Greek Prime Minister is waging a multi-front war. At home, the populist Syriza party, which elected Tsipras, is pushing hard on any plan with additional "austerity" measures, pointing to the extreme economic depression that has hit the country over the last five years. It does appear we are down to the final act of this drama, but it remains to be seen how it will end up. But it is not just Tsipras who is dealing with pressure at home in this crisis. German citizens are becoming more agitated at the way that the Greeks are handling the discussion. Without an agreement soon, even a well-negotiated deal could run into trouble gaining approval for Merkel.

The paradox that is confronting both sides is that the Greek people are massively opposed to additional austerity measures yet they overwhelmingly want to remain in the EU (a poll over the weekend put that figure at 80%). But whether the creditors make that option available is the big unknown. To preserve negotiating leverage, the creditors have tried to communicate that leaving the EU is a possibility for Greece, but we don't think they really want to test the market with this outcome. It seems that for all parties, dragging the negotiations out comes with increasing risk. Thus we remain hopeful that this story moves from noise to news over the next week.

No. 3: Bond Yields Continue Recent Rise

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The story of the past few weeks has been focused on the interest rate markets. Rates have moved globally as the markets reduce the risks of a deflationary crisis and focus more on budding reflationary pressures. For example, in Germany, 10-year bunds nearly touched zero (they dipped below 5 bps at one point) and have since risen to nearly 1%. Though any change by the ECB in the next year or two is not likely, the market is trying to price in an environment without fears of outright deflation.

In the U.S., the focus has been on trying to determine the date of the first Fed rate hike. The two-year Treasury rate—the most sensitive to Fed policy—has moved back to 71 bps from 40 bps as recently as January. The 10-year Treasury closed Friday at 2.41%; this is fully 47% higher than it was as recently as January, when the rate bottomed at 1.64%. What are the implications of this sudden rise? First, investors who have holdings in long-term government bond funds or securities have seen dramatic declines in value already. The iShares 20+ Year Treasury ETF (ticker: TLT) closed Friday 15% below where it traded in January and is off nearly 7% in 2015. Investors in broader strategies have fared somewhat better, but many do have small losses year-to-date.

For the past few years we have held modest weights in core bond positions and have used a portion of fixed-income capital to invest in opportunistic strategies. This focus is paying off in 2015. The rate rise is not yet enough to put a damper on economic activity, but if the speed and significance of the rate increases continue, it could start weighing on growth. The corporate bond market has been very active this year, and issuance has picked up with the belief that the rate cycle may have finally hit a bottom and rates will rise going forward. For some period of time, those fearful of being left behind will come to market, but once that burst is completed, a slower pace of debt issuance could impact the stock buyback and M&A trends we spotlighted in last week's News or Noise.

Finally, a similar impact could occur on the residential housing space. We have heard anecdotal stories of homeowners and buyers trying to finalize deals or lock in mortgage rates before those rates move higher. Of course rates are at historically low levels, but with financing already difficult, challenges in qualifying for financing or purchasing a new house would be likely. One must remember that there have been many rate spikes in the past few years that fizzled out. This one may be different, but until proven for sure, we will not consider the move so far as newsworthy.

What Is News or Noise?

Like most of you, we are inundated with information on our phones, in our email inboxes and on the Internet. Clearly, the world doesn't need another investing blog to reprocess stale information or reformat the day's useless headlines. Thus, in our investment blog, "News or Noise," we've taken up the challenge of sorting through the infinite bits of background noise and seeking the few truly newsworthy nuggets of information. What are the stories today that are likely to be meaningful for investors in the future? A very small number of headlines are important, and of those, many are immediately processed by investors. Only a tiny fraction of all the new data is truly relevant and underappreciated.