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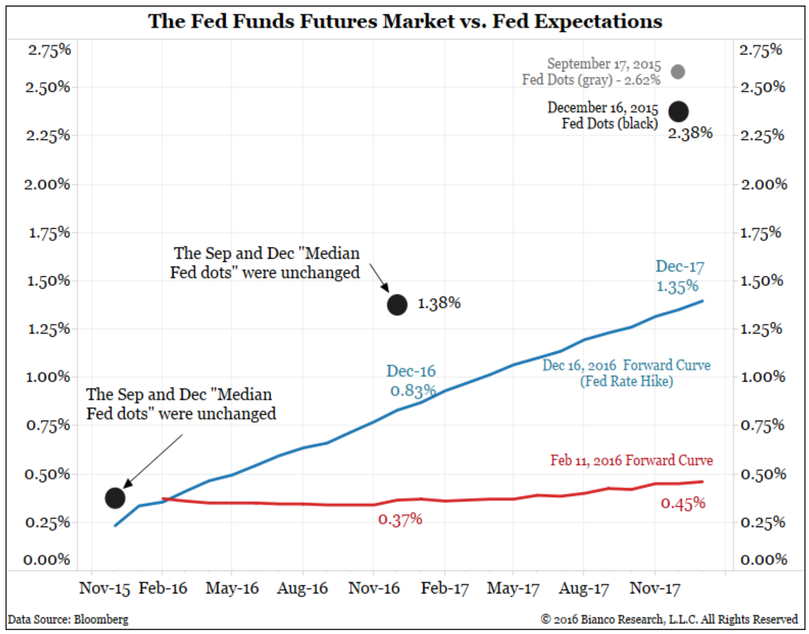
Rationally Irrational – Why We Remain Positive

We believe the most **rational** explanation for the stock market's recent decline is the recent dramatic change in the consensus view of the economic outlook. We think the current caution on the economic outlook is best illustrated by looking at how interest rate expectations have changed, since interest rate forecasts tend to express investors' expectations about growth. Expectations for Fed funds (the primary interest rate set by the Federal Reserve) have fallen sharply. In November, the markets were expecting the Fed to increase short-term rates to 1.35 by Dec 2017 (upper blue line).



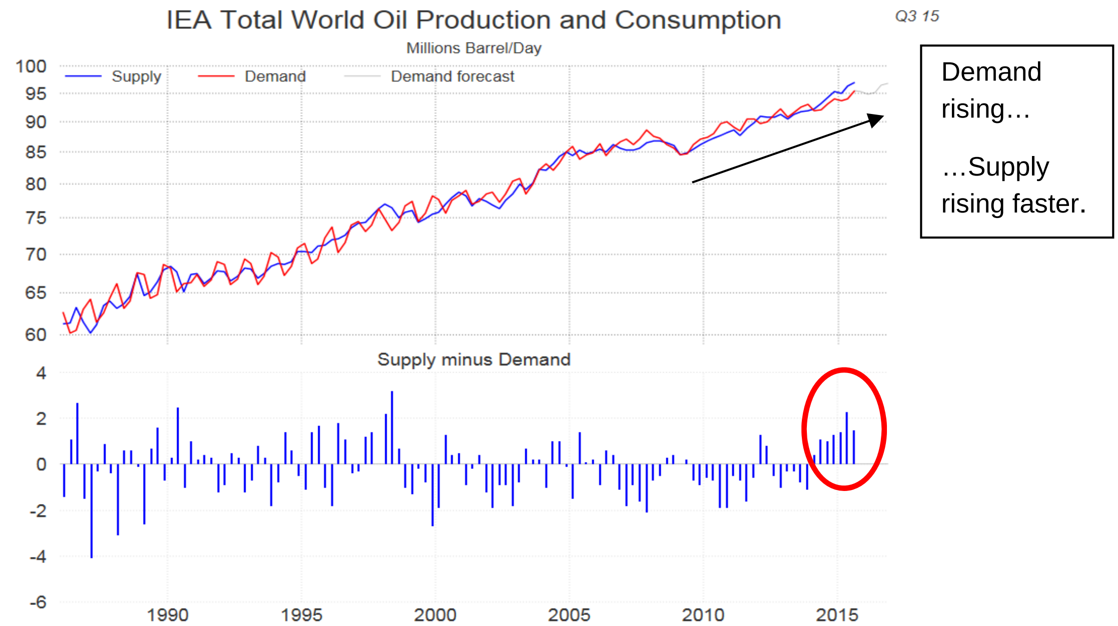
Source: Bianco Research LLC, Bloomberg. Past performance is no guarantee of future results.

Now investors are expecting the Federal funds rate to be below 0.5% at the end of 2017 (lower red line). Such a significant change in a short time is one indicator of increased pessimism about the economic outlook as expressed by investors attempting to look forward. We think they are now too pessimistic.

We do not see the evidence for this pessimism in the current economic data, and hence view the markets' moves this year as **irrationally** pessimistic. Retail sales are strong, unemployment is falling, surveys by Evercore ISI suggest major cities such as San Francisco, Seattle, LA, Atlanta, Miami, and Austin are not just growing strongly, but potentially booming.

We fully acknowledge that there is a major recession in the oil and basic material sectors affecting certain states, but the collapse in oil prices is driving vehicles sales to records and boosting consumer demand – as it tends to do when the reason for the collapse is excess supply rather than falling demand. The chart below (Page 2) depicts both supply and demand for oil, and the bottom panel shows the surplus or deficit. One can see clearly that the surplus that has built up since 2014 is far larger and more persistent than any surplus seen over the past 30 years, but also that demand continues to rise. In our view, we see no sign of a collapse in demand that would indicate a recession. Some analysts have suggested that continued declines in the price of oil could trigger recession through oil company bankruptcies and collapsing growth in commodity-dependent emerging economies. As discussed in greater detail in our Strategic View dated January 26, 2016, we are skeptical that the oil industry's debt or employment levels are large enough to offset the tremendous benefits consumers receive from lower oil prices. We further believe that what emerging economies need most is a healthy China and that low oil prices are greatly aiding China's transition to consumption led growth.

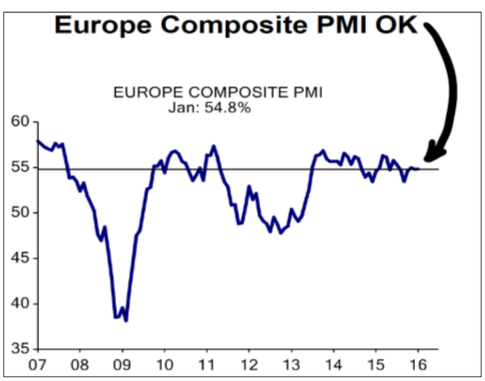
THE WEEKLY CHART: OIL PRICES ARE DOWN DUE TO EXCESS SUPPLY NOT FALLING DEMAND



Source: Thomson Reuters Datastream, RiverFront Investment Group. Past performance is no guarantee of future results.

Regardless of the offsetting benefits of declining oil prices, we think continued dramatic declines in oil prices are unlikely. **At current prices it is only a question of *when* supply is reduced, not *whether* it will happen,** in our view. We believe the short productive life of fracked wells will drop US production by the end of the year, and oil markets are likely to stabilize in the near future as a result. US production cuts may come even sooner if storage facilities continue to fill up and producers cannot store the oil they produce. We believe that if these anticipated US production declines do not provide oil price stability soon, then OPEC member states and Russia may have no choice but to bury their political differences and agree to production cuts. We think cuts to US and even OPEC production will only curb the current surplus, and oil prices would likely remain attractive for oil consumers for the year to come. In our view, investors appear to be irrationally assuming that producers will never respond to declining oil prices and that oil prices will continue their precipitous decline toward zero.

We also disagree with the sudden consensus that Europe is lapsing back into recession. In the period immediately following the fiscal crisis of 2008, Europe pursued an unsuccessful combination of tight monetary and fiscal policies; a level of pessimism during that period was justified, in our view.



Source: Evercore ISI, as of 01/2016.

Since taking office in late 2012, Mario Draghi has slowly but steadily moved the European Central Bank (ECB) away from the tight monetary policies of his predecessor. In the past 18 months Draghi has embraced quantitative easing and negative interest rates. Although there is no consensus about fiscal policy in Europe due to heavy debt loads, we believe the European economy is clearly responding to Draghi's monetary stimulus - Europe's purchasing managers survey, one of our favorite real time indicators of corporate activity, has registered strong readings in the mid 50's for nearly two years through January 2016 (chart left). Any reading above 50 suggests economic expansion. Declining exports to China are a risk to future growth, but we believe that low oil prices have so increased the buying power of European consumers that domestic demand will more than compensate.

A final source of what we believe is **irrationality** is the notion that policy makers and central banks are "out of bullets". We disagree. A primary rule in our tactical strategies is "don't fight the Fed" or any other determined central bank. Central banks can print money, and this power allows them to stimulate borrowing, monetize excessive debts and even force lenders to accept negative interest rates (an elegant way of allowing borrowers to repay less than the face amount of their loans). ***The question***

investors should ask is not whether central bankers have the power to move markets, but rather do central bankers have the will to use the powers at their disposal?

We believe that the primary problems faced by the global economy are heavy debt loads and excess capacity in commodities and low value-added manufactured goods (steel, chemicals, etc.). Central bankers have powerful tools to fight these problems, but frequently hesitate to use them because of the risks entailed. Quantitative easing (QE) can unleash inflation and encourage asset bubbles if pursued too aggressively or too long. Negative interest rates (NIR) are such a new policy tool that no one can with certainty predict all the risks entailed in this new policy option (most economic textbooks continue to assert that zero is the "lower bound" for rates despite four major central banks embracing negative rates over the past 18 months).

Central bankers are rightfully fearful of the potential consequences of QE and NIR, and therefore usually resort to these policies when the risks of doing nothing appear greater than the risks of these powerful policy tools. Recent market volatility has put every central banker on notice that the global economy could be at risk, and that falling equity markets could precipitate the economic slowdown that investors and central bankers fear. The more volatile the equity market, the more likely that central bankers conclude that the risks of doing nothing are greater than risks of additional QE or pushing rates even more negative. If these additional policies are unleashed, investors who fight them by selling stocks or holding overly large cash positions may discover just how powerful central bankers continue to be.

A Rational Conclusion? We fully understand why markets are fearful at present, but if our fundamental optimism about modest growth and not global recession is right, we could look back on this period as an opportunity to buy assets from the 'irrationally fearful'. Furthermore, as we argued last week, while investor fear during times of volatility is rational, we believe it is irrational to abandon a well-thought-out investment plan as a result of volatility. If this volatility teaches you to recognize that your tolerance for risk isn't what you thought, then we suggest altering the plan, not abandoning it.

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