

# MARKET COMMENTARY

FOURTH QUARTER 2015

## 2016: When Doves Cry?

The title *When Doves Cry* might mean something different to you depending on if you are a music fan or a financial market fan. We believe its writer, Prince, symbolizes (♯) the current market environment.

Music fans will recognize this article's title as a reference to the number one hit song from the 1984 movie *Purple Rain* that launched the musician Prince (later to be known by the above symbol rather than his name) into superstar status. Financial market "fans" will recognize the title as a reference to a subset of individuals who profess a bias to low interest rates and "easy money" to cure what ails the economy. In this increasingly polarized environment, allow us to broker a United States election year compromise.

Prince Rogers Nelson was born in Minneapolis, Minnesota, in June 1958, which coincidentally marked the low point and last time in the 20th century that the federal funds rate was below 1%. Conversely, the release of *When Doves Cry* in 1984 marked the last time that rate was above 10%. While Prince's musical doves cried tears of pain from a broken love affair, the financial market's doves cried tears of joy given the subsequent 30-year march to lower interest rates.

While we have no particular insights into the current status of Prince's musical doves, we believe it is probable that monetary policy doves will shed tears in 2016 and 2017 as the Federal Reserve continues to hike interest rates, a process begun in December 2015 after the rate remained at near zero and unchanged since 2008. Given Prince's Minnesota roots, perhaps it is poetic justice that Narayana Kocherlakota, the president of the Federal Reserve Bank of Minneapolis and the Fed's leading monetary dove, retired at the end of 2015.

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### Relax — The Doves will be Crying, not Dying

We believe the U.S. economy stands on a firm footing and will be able to withstand the 2016 rate hikes. Given the healthy state of the U.S. consumer and banks, we view a recession as a low-probability outcome. After all, there doesn't appear to be much excess currently, except perhaps a surfeit of economic skepticism. Terms like "secular stagnation," "new normal" and "lower rates for longer" are the current economic buzzwords. Unsurprisingly, this lexicon has garnered near absolute certainty status by prognosticators and investors alike — nearly everyone, it seems, except for the majority of the members on the Federal Open Market Committee, which determines the benchmark interest rate.

The market is currently priced for nearly 1.5% less of an interest rate hike than the median Fed member expects by year end 2017. Not even the most dovish Fed member comes in below the market forecast. But while the economic and inflationary outlook will ultimately drive this path (think data-dependent Fed), the reality is that the bar is very low for upside surprises.

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## A Forecasting Matchup

**The Bond Market vs. the Federal Reserve** | Over the past few years, much has been made of the Fed's penchant for overly optimistic U.S. economic growth forecasts. The common refrain is that the bond market has been more prescient in its economic outlook than the Fed, given that interest rates have remained low in front of the Fed's misplaced optimism. However, a broader look at history shows that the U.S. Treasury market has also had its fair share of missteps.

For instance, consider the fact that during much of the 1970s, five-year U.S. Treasury buyers were "rewarded" with real negative returns as the bond market perpetually underestimated rising future inflation. Even after Paul Volcker took the reins at the Fed in 1979 and vowed to defeat inflation, "distrusting" bond investors doubted that the Fed would succeed and demanded a higher interest rate to compensate for their inflationary risks. By the time *When Doves Cry* was released in June 1984, skeptical investors had pushed the five-year U.S. Treasury yield to 13.71%. Those brave buyers who bucked the conventional wisdom were heavily rewarded as inflation averaged 3.6% annually over the next five years, a real return just north of 10%. Over much of the next 20-plus years, investors continually questioned the Fed's low inflation resolve and real returns remained elevated.

Now we must consider that we are sitting at the opposite side of the equation. Janet Yellen's Fed has vowed to create inflation, yet distrusting bond investors once again doubt that the Fed will succeed. The five-year U.S. Treasury currently yields 1.76%, below the Fed's inflation target of 2%. If this Fed ultimately experiences success like Volcker's did, current buyers of treasuries may experience negative real returns. Certainly there are many reasons for bond yields to remain low, but the market has priced in very little cushion for an upside forecasting error.

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## A Volatile but Positive 2016 Macro Backdrop

Central bank tightening cycles create increased volatility as liquidity is drained from the market. As Warren Buffett stated, "It's only when the tide goes out that you learn who has been swimming naked."

In other words, when the liquidity tide ebbs, the risk of being caught investing based upon past trends rather than underlying fundamentals often becomes troublesome.

Successful investing requires not only reading the economic tea leaves, but then determining if that outcome is already priced into the markets and how the future may yield a different answer. The past is littered with trends that morphed into investment certainties such as "peak oil," the technology bubble and the "Nifty Fifty" stock era. In fact, wasn't it just a short time ago that China was expected to be the world's dominant economy by now? While we certainly aren't suggesting that inflation and interest rates are returning to the levels of the 1980s or even the 1990s, we're not counting out an upside surprise.

Given the extremely low expectations coupled with the extraordinary policy accommodation the Fed now has to remove, we believe that volatility will continue into 2016. The good news is that the cause will be continued positive economic growth, and while it will create shorter-term volatility, it will also lay the foundation for intermediate and longer-term positive returns. As such, we maintain our outlook for mid-single digit equity returns in 2016.

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## A Closing Word on Diversification

Whether we have convinced you of our thesis or not, we hope to have provided reminders of the uncertainty that continually envelops markets. Ours is a probability-based business where success is typically determined by who keeps the most of what they have earned. This is why diversification is vital to longer-term investment success, even if it often means sacrificing some shorter-term returns. While "certain" time periods never exist, the next few years promise to be filled with volatility and uncertainty. Against this backdrop, investors must maintain their discipline. Having witnessed numerous market cycles, we are now entering the arena in which many individual investors make costly mistakes. For evidence, we have to look no further than the tech bubble of the late 1990s. After years of technology-driven U.S. large capitalization stock outperformance, the common wisdom back then became that diversification was dead. But over the next few years, those who followed that line of thinking ended up making a very costly mistake.

So 58 years after Prince was born in 1958, one must consider that we have reached a low point in interest rates that may extend well into the 21st century. This provides a fertile ground for increasing market volatility. Consequently, we continue to advocate for a broadly diversified portfolio to provide our clients the means to meet their long-term goals and objectives.

Happy New Year!

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historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market. The securities of small capitalization companies are subject to higher volatility than larger, more established companies and may be less liquid. With fixed income securities, such as bonds, interest rates and bond prices tend to move in opposite directions. When interest rates fall, bond prices typically rise; and conversely, when interest rates rise, bond prices typically fall. This also holds true for bond mutual funds. When interest rates are at low levels, there is risk that a sustained rise in interest rates may cause losses to the price of bonds or market value of bond funds that you own. At maturity, however, the issuer of the bond is obligated to return the principal to the investor. The longer the maturity of a bond or of bonds held in a bond fund, the greater the degree of a price or market value change resulting from a change in interest rates (also known as duration risk). Bond funds continuously replace the bonds they hold as they mature and thus do not usually have maturity dates and are not obligated to return the investor's principal. Additionally, high-yield bonds and bond funds that invest in high-yield bonds present greater credit risk than investment-grade bonds. Bond and bond fund investors should carefully consider risks such as interest rate risk, credit risk, liquidity risk and inflation risk before investing in a particular bond or bond fund.