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U.S. Economy Shows its Independence from the Fed in July

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Geopolitical risks are escalating, most recently with Israel and the Palestinians battling in the Gaza Strip. Europe has *déjà vu* on another nascent banking crisis in Portugal, and the South China Sea is mired in border disputes between Vietnam and China. Meanwhile in the United States, economic statistics are all but singing the Star-Spangled Banner, with a new meaning signifying imminent independence from the Fed. The economic data are so strong that Fed Chair Janet Yellen will be compelled to wrap up quantitative easing (QE), raise interest rates and restore freedom to the markets. We expect market volatility to increase as a result; investors should critically evaluate the effectiveness of their portfolios, because in our view, this normalization of rates is not priced into the market.

The strength of the U.S. economy has surprised the markets but especially the Fed. The Fed did not expect to be caught off guard at the success of its dual mandate for inflation and employment, but boy did they miss it. Well, the U.S. economy is not quite at its target but it is proceeding at a much faster clip than the Fed anticipated a mere six months ago. This is both good news and bad news: good for the economy with growth higher but bad for the market, as volatility moves higher too. Don't get our message wrong: we have been and continue to be optimistic on U.S. and global market prospects. But current trends warrant a renewed vigilance on risks, some of which we do not believe are fully discounted by the market. The primary risk we see is the Fed's unwinding of its zero interest-rate policy.

Unwinding the Zero Interest-Rate Policy

In the current, perpetually low volatility environment, risks are building that can be attributed to the Fed's zero interest-rate policy. It is increasingly evident that this policy's usefulness has passed, that it is becoming more destructive than remedial. The Fed's easy money has created a cluster of bets around "short volatility," that is, selling volatility with expectations of profiting by risk remaining low in perpetuity. We see this expectation most vividly in the CBOE Volatility Index (VIX), which has stayed near record lows for far too long. This is unrealistic and is similar to the problems created in the past by the so-called central bank "put," the expectation that the Fed would remain the buyer of last resort. A "put" is a floor or lower limit protecting an investor, a kind of insurance that can be purchased; but when it is perceived as paid for by the Fed and costless to investors, it creates a kind of "moral hazard" or bad behavior that begets more bad behavior in allocating to risk assets. This extreme betting or "shorting of volatility" was in fact one of the excesses that led to the Great Financial Crisis (GFC). In her most recent testimony before Congress, Fed Chair Yellen noted that "low interest rates may provide incentives for some investors to 'reach for yield' ." She went on to mention certain asset classes she deemed overpriced.

Executive Summary

- The U.S. economy is recovering strongly, which will compel the U.S. Federal Reserve (Fed) to withdraw its support.
- Winding down quantitative easing and zero interest rates will bring greater market volatility.
- In our view, investors should embrace risk assets within an effectively diversified portfolio on positive economic growth and corporate earnings.
- Markets ultimately will be free of Fed influence, a positive for sustainable economic growth.

Bonds Take Lead Over Equities During Market "Pullback."

Index	July-14	YTD
Equity		
S&P 500	-1.4	5.7
S&P MidCap 400	-4.3	2.9
S&P SmallCap 600	-5.5	-2.5
Global REITs	0.3	12.6
EAFE	-2.0	3.1
Emerging Markets	2.0	8.5
Average	-1.8	5.0
Fixed Income		
Corporate	-0.1	5.6
U.S. Treasury 20+	0.7	13.9
Global Aggregate	-0.9	4.0
High Yield	-1.3	4.1
Average	-0.4	6.9
Overall Average	**-1.2**	**5.8**

190 basis points difference

Source: FactSet, FTSE NAREIT, Voya Investment Management

We feel that the Fed's jawboning on excesses is a form of "forward guidance," an effort to rein in the zero rate policy effect well before it takes action. This has seemed to come out of nowhere but the data on inflation and unemployment have surprised the Fed. GDP has been another surprise: take the second quarter GDP report at 4%, add 2.1% inflation (CPI) and then U.S. nominal GDP is over 6%! The Fed's plan to "crawl, walk, run" in order to roll off its $4 trillion balance sheet suddenly looks problematic. Back to the markets, July's end of month volatility should not be construed as an outlier. Instead, it is more likely a "shot across the bow" before the real move to independence from the Fed takes place. This is not 2011, when markets were ultimately pummeled by a U.S. credit downgrade and euro crisis policy mistakes; it is a natural progression back to normal markets that are free and independent of the Federal Reserve, as they should be. But this means a pullback is likely, and though uncomfortable, it will be very hard to time. Thus, investors should prepare to ride through this impending volatility. Again, this is good news for the economy if not for the markets in the short term, as we next show in an update of the fundamentals.

Fundamentals of the U.S. Economy

Corporate earnings are surprising on the upside with growth not seen in two years. Current growth, with 81% of the S&P 500 reporting, is 8.1% over last year at this time. Revenue growth is also positive leaping 4.3%, a resurgence not seen since second quarter 2012. Top line and bottom line strength in U.S. corporate profits is a sure sign the global economy is stronger than is widely believed, since half their revenue is derived from overseas. For example, China, the second largest economy in the world, surprised with a 7.5% growth rate and emerging markets continue to dominate global growth and continue to be supportive of markets.

The economic backdrop in which these companies operate is also strengthening:

- Inflation as measured by the consumer price index (CPI) increased 2.1% exceeding the Fed's target of 2% banishing the fears of deflation that are still haunting Europe.
- Consumer confidence is building; the latest Consumer Confidence Index reading of 90.9 in July is the highest level since October 2007, which should help consumer spending.
- Retail sales for June rose an unimpressive 0.2% but that was after retail sales for May were revised up from 0.3% to 0.5%, and by the way hit an all-time record high of $439 billion. Automobile sales have led the way in spending and surged to an eight year high in July.
- The labor market steadily exhibits signs of improvement. Initial unemployment claims are trending at pre-recession lows and the latest nonfarm payroll report showed the sixth straight month of plus 200,000 jobs, a streak not seen since 1997.
- The housing sector's trajectory remains positive although housing starts slipped to 893,000 (annual rate) from 1.02 million. It is estimated that the U.S. needs about 1.7 million homes a year to keep up with population growth. On the flip side, home builder confidence is actually getting more bullish. Housing permits for new single family homes rose 2.6%, the fastest rate in seven months and prices are still on the upswing, rising 9.3% year-over-year.
- The latest ISM manufacturing index reading was robust, rising to 57.1 in July

A broad historical view of debt markets shows that senior loans potentially offer some protection against the threat of rising U.S. interest rates.

Periods of Rising Interest Rates			Annualized Returns			
Begins	Lasts (Months)	Rise in U.S. 2-Year Treasury Yields	U.S. Gov't Bonds	Global Bonds	High Yield Bonds	Senior Loans
Feb-94	11	+312 bps	-5.09%	1.13%	-3.41%	9.33%
Mar-96	5	+61 bps	-0.28%	4.33%	5.01%	8.56%
Nov-98	19	+227 bps	0.68%	-3.91%	2.11%	5.17%
Jul-03	37	+365 bps	1.66%	4.50%	8.73%	6.35%
Apr-08	3	+72 bps	-7.44%	-8.73%	7.23%	18.02%
Nov-10	5	+25 bps	-5.57%	-3.21%	11.22%	11.16%
Average:	**13**	**+177 bps**	**-2.67%**	**-0.98%**	**5.15%**	**9.76%**

Note: Covers the period January 31, 2000, to July 31, 2013. U.S. Government Bonds, Global Bonds, High Yield Bonds and Senior Loans are represented by the Barclays Capital U.S. Government Bond, Global Aggregate and U.S. Corporate High Yield indexes, and Credit Suisse Leveraged Loan Index, respectively.

Source: Credit Suisse, Barclays Capital, Voya Investment Management from 55.3 in June, its highest level since April 2011. This level of manufacturing activity is historically consistent with a GDP growth rate of 4.0%.

Effective Diversification and Current Markets

The knee-jerk reaction to volatile markets has been to go to cash, gold and defensive assets; in our view, this is an enormous mistake. We believe the correct action to take is a counterintuitive move to buy both equity and fixed income risk assets. By far the biggest mistake investors continue to make is in bonds, where an unwarranted aversion to inflation risk has prevented them from protecting their portfolios and achieving better returns. Through July it has been a horse race, but bonds have taken the lead over equities once again. That is, investors are feeling relief from the downside protection on average (see table on page 2) of their bonds one hundred ninety basis points higher than equities year to date in a broadly globally diversified portfolio. Much to the surprise of the markets the largest benefit has been from good old fashioned long U.S. Treasuries living up to their reputation for exceptional risk control.

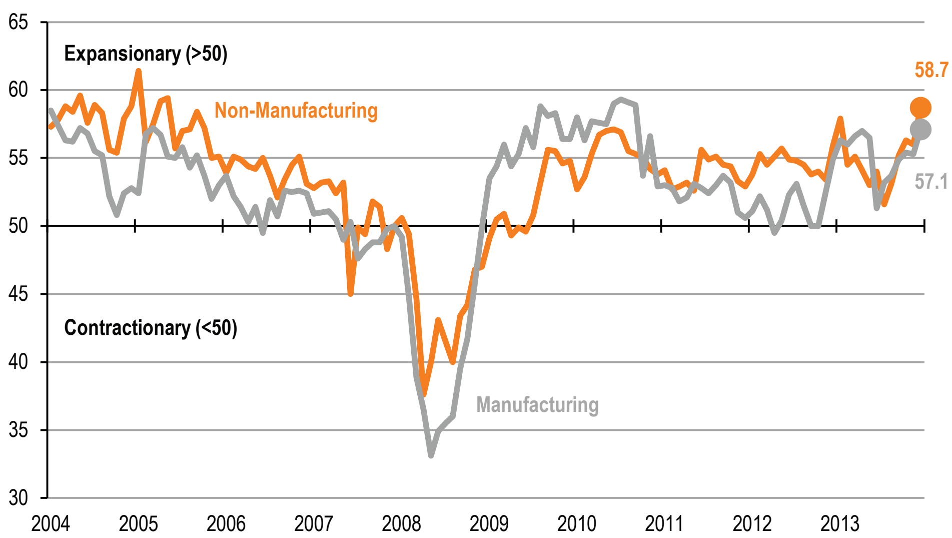
In equities another mistake is the lack of broad diversification, potentially missing this year's and July's run in emerging markets and global real estate investment trusts (REITs). A useful lesson in diversification in July: The S&P 500 is down 1.4%, whereas emerging markets are up 2.0%. Thus, being in this "risky" asset has resulted in a positive difference of 3.4%, potentially both decreasing risk and increasing return for portfolios holding such investments.

Equity markets ultimately follow the positive direction of the fundamentals, and during the volatility we foresee, bonds will make that ride smoother. The path to effective diversification is broad and global.

Economic Independence

Volatility (risk) is the other side of the coin to investment return and investors should not shy away from risks during this normalization of rates and markets. The Great Financial Crisis (GFC) has been over going on its sixth year yet investors and the Fed are operating at near emergency levels. In fact, Fed Chair Yellen, a presumed dove, is leading us back to normal in a moderate way that feels dovish although is anything but. This is her job, to bring independence to the economy and markets; it's ultimately a positive and I'll put my John Hancock on that.

The latest U.S., euro and global manufacturing reports are all indicating expansion.



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Source: Credit Suisse, Barclays, Voya Investment Management

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