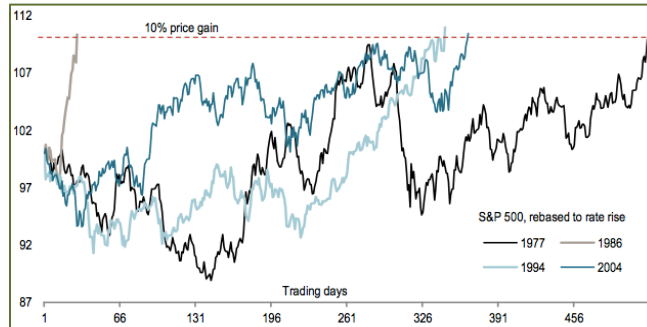


## A Maturing Bull Market

*Whether it's the best of times or the worst of times, it's the only time we've got.* - Art Buchwald

When the FOMC does eventually raise rates, it will be the first change in rates since December 2008 and the first hike since June 2006. There is historical data (such that rear-view mirror driving works, but okay) that suggests that while rate hikes have historically led to greater volatility in equity markets, they have not marked the end of equity bull markets. On average 6 months after the first rate rise equities have risen 3.7%.<sup>1</sup> In fact, three of the four monetary policy turning points, within 18 months, the S&P 500 rose by at least 10% from its level when rates rose (with the S&P gaining around 10% in just one month following 1986's rate rise). The one exception was 1977, when it took two years to achieve a 10% gain.<sup>2</sup>

### Equity Markets Tend to Continue to Make Gains Post Fed Rate Increases



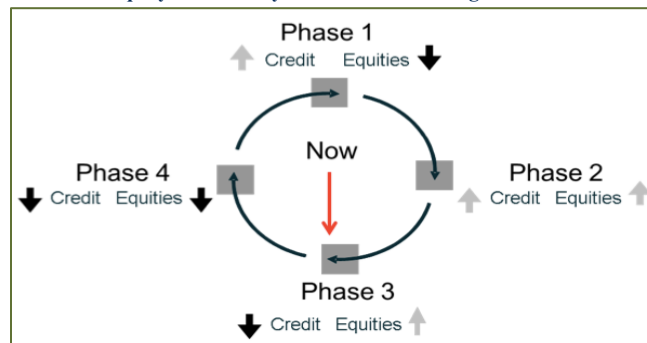
Source: Thompson Reuters, Credit Suisse Research

A coming rate hike is common market perspective. It has been our view that a gentle rate rise in the US, coupled with reasonably good US economic data and dynamics as we enter 3Q14, should suggest that credit spreads turn up but equities rally on further increases in EPS. This “phase” lasted another 1-3 years in the 1980s and 1990s. In the last cycle it only lasted 4 months. Volatility should rise. Typically such markets await bubbles and see outperformance from large-cap and cyclical stocks. This profitable but increasingly unstable period ends when global EPS turns down. We do not think this moment is imminent but where are we on the *phase* or *cycle* calendar or clock?

## Market Clock – What Time is it?

We find further support regarding our concerns around what is probably year-end 2014 in recent work by *Citibank Research* equating the market to a clock and breaking market cycles into four (4) phases. It appears and feels like we are in and around what they describe as “Phase 3”. During Phase 3, the credit bull market ends, spreads start to rise as investor appetite for rising leverage wanes. But the equity bull market continues as profits and CEO risk appetites rise further.<sup>3</sup>

### Credit/Equity Markets Cycles – Are we heading into Phase 3?



Source: Citi Research

Citi's work looks back at prior equity and credit cycles in this fashion. Spreads rose by around 300bp in 1988-90 and 1997-00. Spreads rose 126bp in 2007. During a Phase 3, the credit bear market begins, but the equity bull market continues. Their work suggests that it is usually too early to sell equities at this point. Equities rose another 30% in 1988-90, 50% in 1997-00 although they only rose another 3% in 2007.<sup>4</sup> The current economic data in the US, to our thinking, also supports this.

## Agnosticism and Dynamism in Portfolio Allocation Decisions

<sup>1</sup> *Global Equity Strategy* – Credit Suisse August 13, 2014

<sup>2</sup> IBID

<sup>3</sup> *Global Equity Strategist – A Maturing Bull*, Citi Research August 14, 2014

<sup>4</sup> IBID



What decisions does this thesis suggest? We are still more optimistic about risk-adjusted returns from Developed Markets (“DM”) over Emerging Markets (“EM”). Further, given our *BRACE* methodology and agnosticism regarding direction (long/short), securities (equities, options thereon, fixed income), we are mining for those nuggets (trades) that meet very specific bottom-up value criteria and have a plausible *Revaluation Catalyst* that can take the position in a step-function change to fair value. The discussion above is one about the weather, so to speak. And the sun shines today (*the here and now*), but this is a long trip we are on (*the there and then*). As captain of the ship, we maintain a complete stock of everything from sunblock and bathing suits to foul weather gear. Whether a sunny passage or stormy, Tiburon is charting the voyage with a plan to put into port on time, rewarded and unscathed.

### Increased Equity Market Volatility

While equity returns can be healthy in Phase 3, they become increasingly unstable. We have previously noted a close relationship between equity market volatility and credit spreads. As spreads rise, we would expect the VIX to follow. That is exactly what has happened in recent weeks. Investors probably will continue to buy the equity market dips, but these dips are likely to get bigger. The time to raise leveraged exposure to equities is the more stable Phase 2, not the increasingly unstable Phase 3. To this end (and as discussed earlier in “Emerging Themes/Strategy Commentary”), we have moderated Fund leverage and reduced the number of positions.

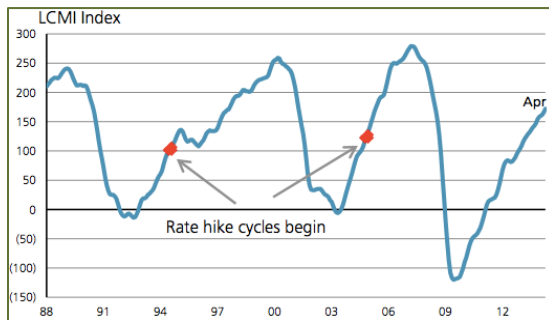
It is our view that markets could become volatile around the end of this year for two reasons: 1) The analysis of previous monetary policy turning points above suggests that markets have tended to peak around 4 months+ before the first rate rise (which we still believe will most likely be 2Q15). This would equate to a market peak around year-end; and 2) we would note that equity markets corrected 4 to 5 weeks after the end of QE1 and QE2. It appears that the Federal Reserve will complete their current program of net asset purchases in October this year, again suggesting possible market deterioration toward the end of this year.

### Yellen and the Jackson Hole Speech

In her Jackson Hole speech, Chairperson Yellen cited a new indicator created at the Fed to provide a “better” measure of labor market conditions, the *Labor Market Conditions Index*, or “LCMI”. She notes that “this broadly based metric supports the conclusion that the labor market has improved significantly over the past year, but it also suggests that the decline in the unemployment rate over this period somewhat overstates the improvement in overall labor market conditions.”<sup>5</sup>

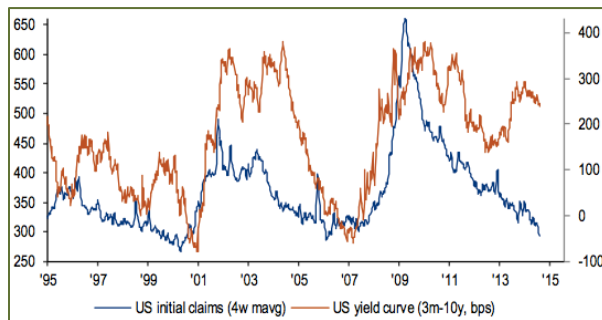
As of April (latest data), the Fed's Labor Market Conditions Index (“LMCI”) was well above the levels seen at the start of the previous two Federal funds rate hiking cycles. Indeed, history shows that Fed tightening started well before what LMCI lost in recession was recovered. In the last recession, the LMCI fall was unusually steep.

### Rate Hike Has Taken Longer This Cycle – Why and When?



Source: Federal Reserve

### US Jobless Claims vs US Yield Curve – What Should Happen?



Source: BofA Merrill Lynch Global Investing Strategy, Bloomberg

A rate hike in the US is likely in 2Q15. Low rates wrought much. But real job and wage growth, corporate capital expenditure less so than wealth creation for the more affluent and the stoking of shareholder-friendly activities by companies.

Peter M. Lupoff

September, 2014

Tiburon Capital Management, LLC

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<sup>5</sup> Chair Janet Yellen Speech at Jackson Hole, August 22, 2014 <http://www.federalreserve.gov/newsevents/speech/yellen20140822a.htm>

