Shiny Objects

It never ceases to amaze me how easy it is to distract investors with the latest narrative, like a three-year-old that has his attention diverted by every object that passes in front of his gaze.

Narratives this year have ranged from the “animal spirits” in markets, to markets being “offensively overvalued,” to how the historic low volatility is the harbinger of bad things to come. These topics are certainly the lifeblood of networks like CNBC, which are sitting at decade lows in viewership. But the truth is that while these themes may be fun to read about, they simply don’t move markets beyond a few days.

Nothing has more impact on the direction of asset prices than economic conditions and how central banks respond to those conditions. Period.

In the span of 72 hours last week, with a little dirty hawkish talk from a couple of Fed members, market-based odds of a March rate hike went from 35% to 90%! The real question is, what changed? Absolutely nothing but investors’ focus. U.S. economic data and real-time financial markets have signaled all year that the Fed has a clear path to hike, if they choose to do so.

Data Dependent

I’ve said it many times over the last few months: U.S. growth has been improving and continues to improve. Last week, despite being a mixed bag, the latest PMI and ISM data for manufacturing and services further confirmed this fact.

The most important aspect of this data series is what the composite PMI, the combo platter of service and manufacturing, implies about the trajectory of U.S. growth. The composite January and February readings signal that the U.S. economy is growing at a +2.5% annual clip. This is critical because if the economy is growing at anywhere near +2.5%, that’s a nice acceleration from Q4’s annual GDP growth of +1.9%.

I monitor two proprietary market indices to get a real-time read on what the market is anticipating for U.S. growth. One index tracks markets that perform well when U.S. growth is accelerating, and the other tracks markets that perform well when U.S. growth is slowing.

So far this year, the High Growth index is outperforming the Slow Growth index by 150 basis points, and has led the way since the very first week of the year. Just last week, the High Growth index gained 38 basis points while the Slow Growth index lost 110 basis points.

Markets are confirming in real time the trajectory of U.S. growth implied by the lagged data. A strengthening economy has a huge impact on asset prices, and it also gives the Fed the green light to raise rates for the second time in three months. Remember, the Fed raised rates for the first time in ten years back in December 2015 even though U.S. growth had been slowing for six months. That rate hike had a hand in the ensuing industrial recession the U.S. experienced last year. So, if they were crazy enough to hike when the data didn’t support it, then why would they hold off hiking rates now?

Market Stability

Anyone who has watched the Fed over the last few years knows that they are as concerned with the "stability" of financial markets as they are with growth, labor and inflation data. Well, on this front they are all out of reasons to hold off on another rate hike.

To say that the S&P 500 is on a tear right now is an understatement. Since Trump's win, the S&P 500 has gained 12%, posting 17 record closes and adding over $2.8T to the U.S. equity market cap. It's been 96 trading days since the S&P experienced a daily decline of over 1%, and it's by far the best-performing equity market in the G7 so far this year.

It's not just the broader U.S. equity market that is ripping; it's every single sector within the S&P. Eight of the nine sectors are sitting right at or reaching brand new all-time highs. The Technology SPDR ETF (XLK) is playing kissy face with its dot-com bubble high from March 2000. The only sector that doesn't look perfectly bullish is the U.S. energy sector, but it's still trading at two-year highs.

If the Fed is worried about disrupting the markets, they can put that worry to rest. Hell, a 10% correction in U.S. equity markets would be very healthy, and if it materializes while U.S. data continues to accelerate, it's a "back the truck up" kind of buying opportunity.

Yields and the Greenback

I have no idea if the Fed will raise rates this month or not. I know that the runway is cleared for take-off, but only they know if they are ready to fly. Luckily for you and me, we don't have to be Nostradamus to know the right way to trade markets before and after the March 15 meeting.

While the USD has been weak most of this year, it has still managed to trade above $100 for all but just 10 trading days. It should also be pointed out that prior to investors' reawakening to the rate hike reality last week, the greenback was already four weeks into re-exerting its bullish mojo since hitting an intermediate-term bottom on February 2.

U.S. yields paint a similar picture. Both 10- and 30-year yields have been consolidating for the last few months following the huge post-election spike. The 10-year yield has tested and respected the 2.31% line on several occasions, and the 30-year yield has held its own line in the sand at 2.90%.

Whether or not the Fed raises rates on March 15, you can expect (as long as the Fed isn't easing and U.S. data keeps accelerating) the USD to trade above $97, and U.S. yields to hold above the lower end of their post-election consolidation trading ranges.

The Bottom Line

There is only one playbook for trading an environment characterized by accelerating U.S. growth alongside an elevated U.S. dollar and rising U.S. yields. On pullbacks, you want to be LONG equity markets like U.S. financials and U.S. technology. On the flipside, you want to avoid or selectively SHORT anything that is or looks like a bond: long-dated Treasuries, utilities and REITs, to name a few.

It's easy to get distracted by shiny objects, especially in this world where we are constantly inundated with "breaking news," tweets and notifications. The truth is

that the more information that is heaped onto us, the more difficult it becomes to keep our focus on what truly matters. That said, staying data dependent, process driven and risk conscious gives you the best chance of success in consistently deciphering the signal from the noise.

Stay data-dependent, process driven, and risk conscious, my friends.

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