July 2013

COMMENTARY

When the Fed Speaks…

As we entered the final month of the quarter, we were struggling mightlily to come up with a topic for July's Commentary. We like to plan these things out in advance, but were having very little luck. The IRS and NSA had made significant news of late. The subjects would have been interesting, but we could only come up with a marginal tie in to investing. There were riots in Turkey and our withdrawal from Afghanistan has been accelerating. But once again, we couldn't envisulaize envision the use of time – ours and yours – given the lack of substantial investment implications. We were dispairing of our task and marvelling at the likes of Jim Cramer who on CNBC's Mad Money has something to say EVERY night. Then on Wednesday, June 19 the Federal Reserve released a few words of Chairman Ben Bernanke, and the world went into panic. Suddenly we had found our topic.

ECONOMIC STATISTICS					
	2nd Qtr (6/30/13)	1st Qtr (3/31/13)	*% Change*	1 Yr Ago (6/30/12)	*% Change*
S&P 500 Index	1,606.28	1,569.19	*2.4%*	1,362.16	*17.9%*
10 Year Treasury Yield	2.49%	1.85%		1.64%	
Gold Spot ($ / oz)	$1,234.57	$1,596.82	*-22.7%*	$1,597.40	*-22.7%*
WTI Crude Oil (next future)	$96.56	$97.23	*-0.7%*	$84.96	*13.7%*
GDP Qtr / Qtr	N/A	1.8%		1.3%	
CPI Y / Y	1.4% (May)	1.5%		1.7%	
Unemployment Rate	7.6%	7.6%		8.2%	

At about 2PM that Wednesday, the S&P stood at roughly 1650. By day's end the index had fallen to 1629 and the next day it fell to 1588. Approximately 3.8% had been eroded from the total value of equities in that short time span. What did our friend Ben say that was of such significance?

First, the Fed Chairman stated that the downside risk to the economy had decreased. He then announced that the Fed had raised its estimates of GDP growth from 3% to 3.5% while at the same time lowering its expectations of unemployment to 6.5%. He then stated, "If the incoming data are broadly consistent with this forecast, the committee currently anticipates that it would be appropriate to moderate the pace of [bond] purchases later this year." Assuming the Fed's analysis held true, the Fed would "continue to reduce the pace of purchases in measured steps through the first half of next year, ending purchases around mid-year."

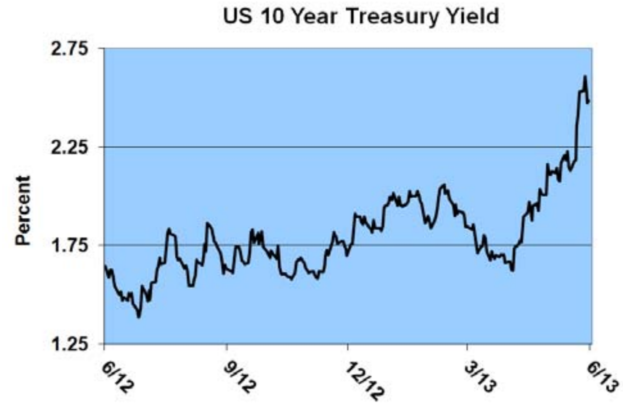
So let's get this straight – the economy currently appears to be growing faster than the Fed expected. If this pattern holds, then emergency measures which began five years ago will likely be wound down. A medical analogy would be if you had a heart attack, survived, and then after a slow but steady recovery you returned to work. The doctor then says, "Your health appears to be normal. If it stays like this we will cease performing CPR." No wonder panic set in!

If you're confused, don't feel bad. We've been left scratching our heads too. Actually, there is some basis for the initial panic and it stems from what we believe is a myth. While others might disagree with us, many have taken the view that the only reason why the stock market has rallied to the level it has is that the Fed has been pumping the markets with cheap money. If the cheap money disappears, so goes the argument, then the bubble will pop and all asset prices will fall.

We disagree with the premise. While the Fed has been providing cheap money, it has (in our opinion) broadly distorted investment incentives. While some have said that low yields have forced investors into so-called riskier assets, we believe this impact was offset to a large extent by other unintended consequences. First, the low rates of return meant that investors weren't being adequately compensated for the risk they were taking. Therefore many stood on the sidelines. Further, the distorted rates of return meant that the future was even more uncertain. While stocks might offer potentially higher returns than bonds, policy uncertainty increased the perceived risk proportionally to the higher potential returns. We believe this perceived risk has tamped down equity valuations and has driven Treasury yields lower.

Finally, the low rates of potential return may have also manifested themselves in lower rates of saving and lower rates of direct investment into the economy. This last effect may have resulted in lower GDP growth than otherwise might have occurred. Since equity prices are a function of both expected earnings and the cost of capital, who knows where equity prices would have been if savings and investment had been higher? It is our contention that until questions regarding both monetary and fiscal policy clarify themselves, investors will require a higher return if they are to be induced into the equity markets. A higher required return translates into a lower current price.

What then accounts for steadily higher equity prices? We think the answer is as simple as the steady progress of corporate profits and a grudging conviction that just maybe the world isn't actually coming to an end in the immediate future. Though this is our contention, perception often becomes reality. To the extent that investors believe that the market is being supported largely on the back of the Fed, should the Fed cease providing cheap money many investors will head for the hills. To many, it's that old conundrum, "It's not what I think that's important. It's what I think others will think that's important." With this mindset, it's no wonder that short term panics so easily occur! Still, we believe that in order for markets to return to some sense of normalcy, we need the Fed to cease behaving as if the economy will collapse without its perpetual interventions.



It appears that the Federal Reserve realizes this. With Ben Bernanke's announcement, the Fed is stating that the economy is at an inflection point. The Fed Chairman is trying to prepare the investment community and the nation for the reality that the time is coming when we shouldn't depend so heavily on the Federal Reserve to keep the economy moving along. There's no doubt that many are frightened. And those betting heavily on the Fed providing cheap money may suffer real losses. While it's way too early to declare that there has been a permanent shift, interest rates have risen consistently in anticipation of a change in Fed policy. Between the end of the first quarter and just prior to the release of Bernanke's comments, the 10 year U.S. Treasury interest rate rose from 1.85% to 2.13%. By quarter end, the rate had jumped to 2.49%. Consequently, over the course of the second quarter bond performance has largely turned negative. The Barclays Aggregate Bond Index fell 2.33% for the quarter. Bonds with longer than average maturities and durations have, in general, fallen further.

We don't want readers to get the sense that all of this is bad news. We firmly believe that the Fed's interventions are a hindrance and a source – though not the sole source – of many distortions in the economy and in the securities markets. We may even find that with a change in Fed policy, the markets place more rational valuations on both equities (higher) and bonds (lower). As an analogy, imagine telling your grown up children that they are perfectly capable of supporting themselves and living on their own. They may kick, scream, and perhaps throw the occasional tantrum. But once they leave your house and stop receiving your dollars, in most cases they will find that they can survive on their own. Perhaps they will even flourish! So while the road may be bumpy, we could not be happier with the Fed Chairman's recent announcement.