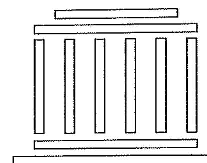
Investment Tally & Perspective



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"Jack be nimble, Jack be quick, Jack jump over the candlestick"

As we write this, Treasury Secretary Jack Lew is sounding the crisis alarm over the debt ceiling deadline. In thinking how the Treasury must remain flexible, our current version of this famous rhyme, with poetic liberty, follows: "Jack must gamble, and use all tricks, to pay the bills, in cash not chips."

Contentious debates and political battles are as old, or older, than modern times, and virtually all countries and levels of government wrestle with budget and debt issues, including the federal government of the United States of America. Yet when you are a superpower with the largest economy in the world, whose currency is used more than any other as the primary reserve for security and trade, then it's not good to air your dirty laundry around the world in live time. Our policymakers all too often seem to forget that their words and actions have global ramifications.

While the D.C. drama is indeed serious, for investors the more important determinant of asset prices (stocks, bonds, real estate) is the path of monetary policy set by our central bank. This issue of Tally & Perspective reviews related issues, including the current investment outlook.

The D.C Circus – We've Seen This Show Before

As of this writing, the budget impasse in Washington is unresolved, and growing fears that the debt ceiling will not be raised in time for our federal government to satisfy all its obligations is already having negative impacts at home and abroad. Yet markets are rising this morning (Thursday, October 10th), as the warring parties and the President are now talking, and the compromise we have been expecting appears more probable, though still uncertain. Both parties understand the massive economic costs of playing a game of chicken with the debt limit, so we look for a deal to raise the debt ceiling combined with a continuing budget resolution before Treasury cash becomes depleted.

The Investor's Dilemma: After Being Forced to Take Risk, When to Protect Capital?

Since the Great Recession and financial crisis, a key component of Fed plans to stimulate the economy has been, and remains, supporting higher asset values for stocks and real estate. By keeping interest rates at record low levels, the Fed has assisted a great number of consumers and businesses refinance their loans and lower their payments, as well as those who have taken on new debt to purchase homes, autos and for business investments (with the greatest benefactor being the U.S. government, with trillions of dollars of debt).

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MAJOR INDUSTRIALIZED COUNTRIES

	2013 Est. GDP	Unemployment	Estim. 2013 CPI	Budget Balance	Government Bond Rates
Britain	1.3%	7.7%	2.7%	-7.6%	2.86%
Canada	1.7%	7.1%	1.4%	-2.9%	2.58%
France	-0.1%	11.0%	1.1%	**-4.2%**	2.36%
Germany	0.5%	6.8%	1.7%	**0.3%**	1.82%
Italy	-1.8%	12.0%	1.5%	**-3.5%**	4.38%
Japan	1.8%	3.8%	0.1%	-8.3%	0.68%
Spain	-1.6%	26.3%	1.6%	**-7.3%**	4.26%
Switzerland	1.4%	3.2%	-0.1%	0.2%	1.14%
United States	1.6%	7.3%	1.5%	-4.0%	2.62%

Note: Interest rates in bold are Euro currency rates.

Data from The Economist, September 28, 2013

EQUITY INDEX RETURNS

Period Ending September 30, 2013	2013				Average Annual Returns			
	1st Q 13	2nd Q 13	3rd Q 13	YTD	1 Year	3 Year	5 Year	10 Year
S&P 500	10.61%	2.91%	5.24%	19.79%	19.34%	16.27%	10.02%	7.57%
NASDAQ Composite	8.52%	4.52%	11.19%	26.12%	22.77%	18.17%	13.76%	7.75%
Dow Jones Ind. Avg.	11.93%	2.92%	2.12%	17.64%	15.59%	14.94%	9.93%	7.74%
Russell 2000	12.39%	3.08%	10.21%	27.69%	30.06%	18.29%	11.15%	9.64%
MSCI EAFE (Foreign Index)	5.13%	-0.98%	11.56%	16.14%	23.77%	8.47%	6.35%	8.01%

Data from Morningstar.

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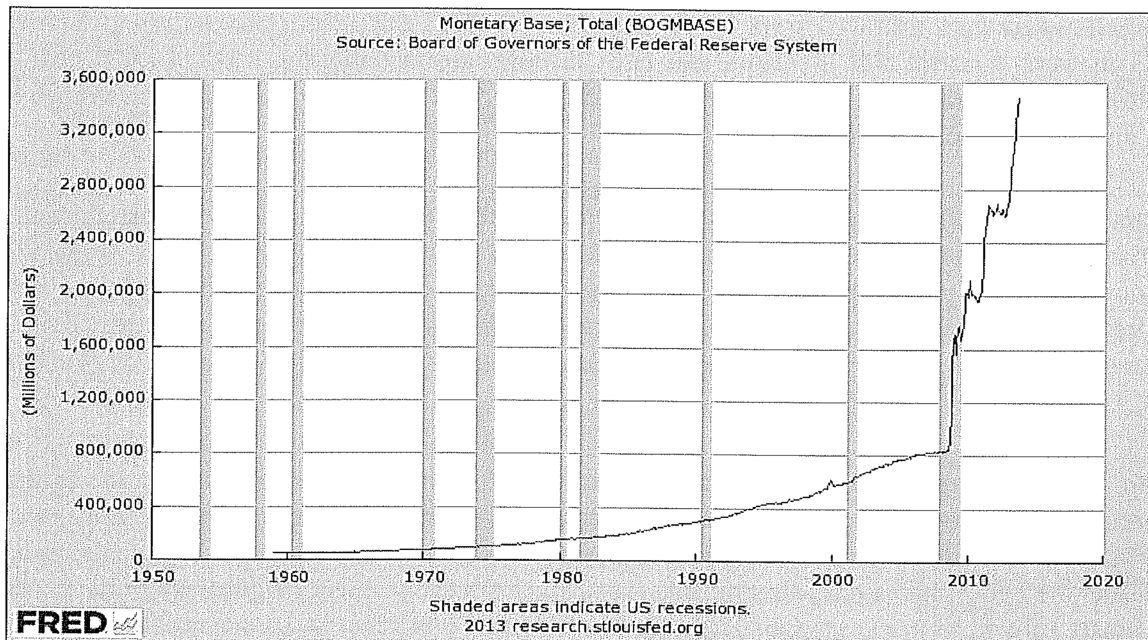
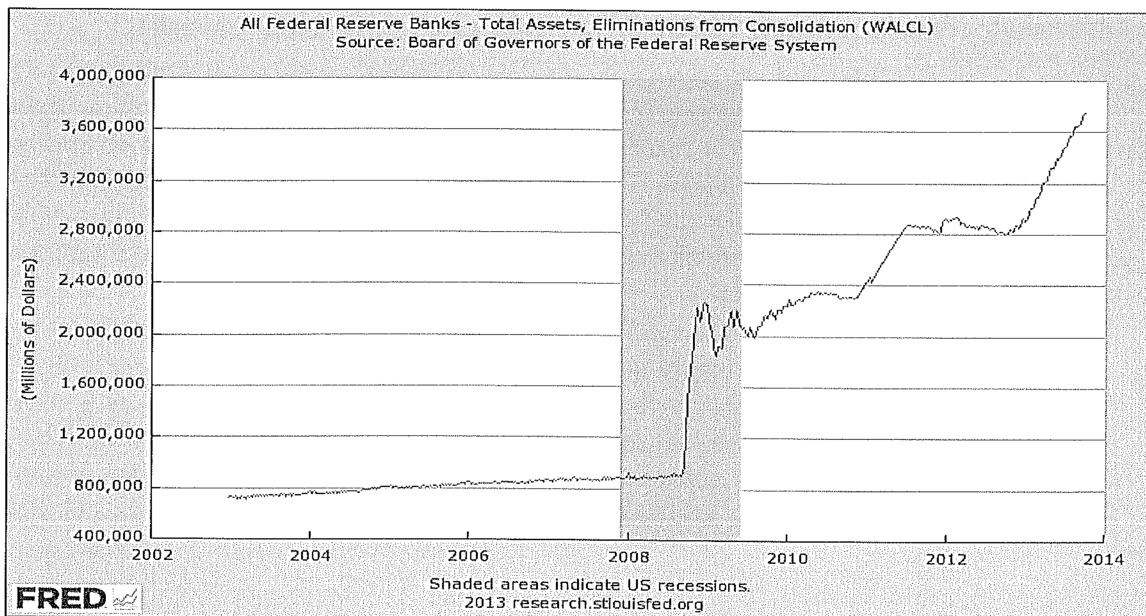
On the flipside, near zero and record low interest rates have eliminated the ability of savers and investors to earn a respectable return without taking risks, so the Fed has clearly pushed investors farther out on the risk spectrum.

This is fine while the Fed has your back. What happens when the Fed reverses their easy money policies, or if markets don't conform to the best made plans? While we don't know when the Fed will change course, we do believe trends evident in the following two graphs are unsustainable (the Monetary Base may simply be viewed as the amount of currency or money supply in circulation, and Total Assets are the amount of bonds held by the Federal Reserve Banks).





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Knowing What We Don't Know

We continually seek to learn from our experiences, good or bad, and we certainly learned a great deal from the past two bear markets. One painful lesson was the importance of knowing what we don't know. Let us explain and connect it to our current investment outlook.

In the late 1990s when the build-out of the Internet occurred, tech stocks rose to bubble valuations. While we enjoyed and participated in those rising markets, we also knew that the valuations were unsustainable, and we reduced exposure while prices were high. However, while we may have been smart enough to recognize bubble valuations for tech stocks and largely avoid the first two years of decline (2000-2001), what then followed took us by surprise. In 2002 the accounting frauds at Enron and WorldCom were exposed and investors lost faith in corporate accounting, causing the whole stock market to decline nearly 40%. We never envisioned non-tech stocks being crushed from events which had no direct bearing on their operations.

In a similar manner, we recognized that real estate in the mid-2000s had reached bubble valuations in many markets, and we identified certain mortgage securities (CDOs, derivatives) as time bombs waiting to explode. While we were smart enough to recognize the real estate bubble and the triggering fuse, we never dreamed that these securities could actually cause global financial chaos and a true breakdown of the financial system, resulting in the demise of so many major companies such as AIG, Washington Mutual, Lehman, Bear Stearns, etc.

We share our history of knowledge and ignorance as it is relevant to the present and future. In the two prior periods, even though we were smart enough to recognize bubbles and understood the causes, we did not anticipate the damage spreading to companies and individuals who were innocent bystanders (as an aside, the Fed played a contributing role is causing both the tech and real estate bubbles). Today, we are smart enough to know that the Fed cannot continue on its present course indefinitely, and that there will be unintended consequences from Fed actions. While we don't know when or where the reverberations will surface, some market turbulence must be expected as things normalize.

Strategy Summary – In brief, we view the recent decline in interest rates as a respite following the sharp rise earlier this year, so we are once again managing bond portfolios with the expectation that higher rates are likely in the months and years ahead. For stocks, the open spigot of Fed liquidity will probably bring indices to new high levels, once the budget and debt issues are resolved. While we plan on participating in this rally, our investment strategies will remain flexible and subject to course corrections, as the landscape around us changes.