Impatient and Exhausted

As we enter the seventh year of this country's awakening, I for one, am exhausted. Raised on 30-minute television programs, we all keep waiting for this show to end so the next can begin. Instead, we have a miniseries.

Every economic cycle has a turning point – that moment when the trend in place changes over to its opposite. The Sterling Theory proposes that it occurs when people just collectively think a new direction is due because "it always ended about now." I wrote about this in *Civilization: Act 2,* April 2011, and used schooling fish as an example of simultaneous directional change without apparent leadership or command. With people it seems to come from excessive exhaustion (current) or excessive jubilation (dot-com bubble). Why and how this happens is mostly theory, but something in our genetic makeup finally says "enough," and impatience takes over.

I also wrote of anxiety, a powerful force for either going mad or acting – most of us act. I have come to think, however, that there is a momentary hesitation, a somewhat vague moment before the first real step. That is the current moment.

I believe the current attitude of Americans is signaling a shift to better times in spite of the internal rot of government, in spite of the vacuousness of American life, in spite of the crushing debt we all find ourselves coping with. Surely, we are saying, there has to be a better way to live. At this instant things are vague but it seems to me most feel it's time to change direction and bits and pieces of good news support that feeling. In some ways the unspoken best news is the passage of 5 years and the quiet healing that allowed.

So if, in fact, we are about to get on with it and live in an environment of weak everything – economy, government, morals, politics, what will our world look like – what should we expect? Here is where I forecast – unlike advisors' newsletters and the usual pundits in the media who report what is or, more accurately, what was, I think it's time to make some predictions. To wit:

Income, Interest Rates and Inflation

You're in a casino. The $100 you limited yourself to play with is now $300. Do you go out for a nice dinner or stick around to see if you can make a few hundred more? That fairly well describes the bond market – a great run that cannot, definitionally, continue, so it won't. Many will stay and look for the absolute last dollar, bless 'em. I have begun to exit on the base assumption that inflation and interest rates will rise. Which first? Does it matter, as there is an 80%-85% correlation between them. The factors that influence one influence both. My most likely scenario is that interest rates follow – that inflation is first and becomes more obvious. That, in theory, should trigger the long bondholders to sell, driving prices down and rates up.

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The greater concern than all that, which will likely be quick, is the folks still chasing bonds for income – and there are a lot of them if the data about bond mutual-fund purchases are anywhere near correct. Those funds tend to “dumbbell” – keep some large percentage of fund assets due in, say, 1 to 2 years and then go out 15 to 30 years with another large percentage for yield. The theory is the short stuff will cover redemptions. Great theory until redemptions exceed available short maturities and the fund has to sell mid to long maturities to meet calls for redemption.

Adding to risk, these funds compete with each other for investor dollars as that drives their profits. What do they compete on? Yield, of course. How do you create even more yield? Well, with leverage and buying lesser quality – junk to you and me. These are all normal actions when bond prices are rising – and hard to reverse when bond prices fall quicker than they rose. In the last few days I have read (and often between the lines) that bond traders and managers of these funds are getting nervous. I note, as they do, that the Fed is “softer” on maintaining the flood of liquidity from bond buying, is beginning to talk of how it will end and is referencing more often the good points in this recovery which is their precursor to ending the money flood, in my opinion.

But, individual investors continue buying non-U.S. debt and particularly emerging market debt. Hard to fault them – some fat yields are available. Polish bonds, for example, produced 6% in 2011, reflecting a solid economy and fiscal controls. The zloty, however, fell 14% against the dollar for a net loss overall. The same case closer to home was Mexico; the return was 9.4% but also an 11.6% sell-off in the peso. My point is that <u>currency</u> risk now measures out at twice the <u>credit</u> risk – that is often missed even by experienced investors. If you simply must have those non-U.S. yields, buy the bond and hedge the currency – and don’t forget to deduct the hedge cost from your great returns. But two last points – some bond funds don’t bother to hedge (expensive) and, to my mind, the trend is now a flight to safety meaning more global issues under currency pressure from a stronger dollar.

With an expectation of noticeable and rising inflation before year-end – say to the 3½% area – and a subsequent rise in interest rates, say to the 4½% region on the long bond, it seems to me that

1) we will experience further softening in housing as mortgage rates rise;
2) global cash in circulation – hot money – will gravitate here to our relatively safer debt and dollar; and
3) exports will weaken with dollar improvement.

<u>Them and Us</u>

We are by no means out of our woods. The issue is that once a government like Cyprus decides to try to take near 10% of big and small depositors’ money from their accounts to cover debt, we see desperation and we certainly begin to look less ugly to the world. Europe has been off the screen for the last few months and some even felt they had finally bottomed and begun, if not a recovery, at least a hiatus from mini disasters. Nothing could be further

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from the truth as recent data shows even greater weakening, particularly in France. I have felt all along the only outcome that made sense was a deconstruction of the Euro zone. Perhaps a North and South, perhaps a few weak players forced out – but major change. What seems to be the interim step, however, are now proposed radical solutions like the Cyprus strategy to keep it together. By the way, the issue with the Cyprus banks was not so much the Russian thing, but that the weak ones held 40% or so Greek bonds in their capital base.

Germany is done with writing endless checks to bail out her neighbors. We shall see if Draghi will do “whatever it takes” to keep the Zone together, but if bullying the small players is seen as one approach the unintended consequences of bank runs and investor departures may be expected.

What’s it all about then? Well, the Euro itself, glued together with more debt, sinks further until it purges the problems. The big European banks are hit hard with withdrawals and that hot money has to go somewhere. Most likely, I think, is the U. S. dollar, further supporting it. U. S. Treasuries will likely benefit, keeping our rise in interest rates under some control. In that world gold, priced in dollars and with most of the weak holders gone, does better. Cyprus is too small, say some, to change the European game. So was Bear Stearns. The word for the moment is contagion – working for us here in the states and against the citizens of Europe.

Stocks

To date, the weaker the dollar, the stronger stocks behaved. In mid-March that relationship began to shift and they briefly fell together. Now, as the dollar shows renewed strength and valuations of stocks seem, to me, to be fairly rich, change is in the air. I am surprised to see the surveys of folks who are bullish because stocks are hitting new highs – who are these people? I suspect the same ones who think *USA Today* is a financial newspaper. This is occurring while the top 1/3 by income level saw their collective confidence <u>drop</u> 10 points (U of M Survey), first-time homebuyers’ confidence <u>dropped</u> 16 points and the booming West Coast confidence <u>dropped</u> 17 points while the East Coast <u>rose</u> 11 points.

Need I point out that the East is the financial center and the West – well, whatever it is, homes or Silicon Valley, it’s not the stock market as I think of it. In any case, investors now track things like new highs and number of up days, while insiders unload at now 10 to 1. While we become stock-bullish, emerging market stocks are off 8% since January, homebuilder stocks no longer rise when any crumb of good news is heard, and bonds – with all the prior caveats about staying at the table – rise in the search for income.

We have, then, a classic situation: A steadily improving but exceedingly modest economic recovery being overpriced in stocks because of an underlying flood of stimulus money. How much this money flood is influencing stock prices is a fair question with no reliable answer. It seems to me, however, that the money flood is falling in influence as corporate durability is

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demonstrated and legitimate reasons begin to replace stimulus money in stock prices – a whole separate paper.

We have kept about 1/3 in stocks through it all for two reasons: We had no belief the world was over and, as we've written, markets persist. Further, our choice of stocks has been substantially towards yield – on firms with rising dividends and/or needed products. Will they suffer if this market corrects? Yes, as they have two or three times in the last 6 or so years – and came through very well. Do we have confidence in our investments in Africa? Or Biotechnology? Or Technology? Yes, we do. The problem is the short term. Our focus is long, the media is super-short and the impulse to "do something" is that old anxiety thing demanding action.

Stepping back and looking at all of a client's assets discloses much: Some have businesses (equity equivalent), some have sizeable bond or bond-equivalent positions (now risk assets or, if you wish, de facto equity) and some have outside commitments to the risks of others. In each case the base rule applies: Bonds are risky in the long run, stocks are risky in the short run and in bonds it is now the long run – this bond rally is well over a decade old. Neither asset runs free of risk. In brief, bonds have, to me, more risk than stocks right now, in spite of the insanity of new investors. Would I buy stocks here? No. Would I keep what I have and ride out 2013? Yes. Will there be a correction greater than, say, 10%? No. Will I buy stocks in a correction? Yes.

<u>Alternative Assets</u>

A definition in common use is anything that's not stocks or bonds and that will do for our purpose. Lumped in are real estate, timber farms, raw commodities, hedge funds, funds of funds, precious metals, art, collector cars and horse semen, among other fascinating things to do with your money when plain old stocks and bonds bore you. We are fans, have been for over 30 years and, like all good ideas, have watched this product area be abused, as always, to make a buck. The advent of the ETF – the Exchange Traded Fund – greatly broadened the appeal and access to the retail, small dollar investor. No longer was one or two million an entry level, now you could buy a pool of real estate or collector cars or precious metals for whatever was the last traded two-digit price. Never mind the folks building these pools had little or no experience in the asset class – the name of their firm served to credential them.

My affection for stock ETFs is well known – I like the ability to buy a basket of just biotech companies or just Africa. I can weave that into a portfolio of individual stocks and gain, if you would, sector participation with diversity. The creators of stock-focused ETFs usually come from the stock research or stock management community, so it's not a new thing for them. When it becomes country-specific, say Brazil, then extra effort to sort out accounting issues can arise, but it's still manageable, it's still familiar.

The alternative asset class of non-equity assets, though, has become a fad – the idea of the moment. Retail is pushing any number of ideas under this broad heading, I think to at least

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appear capable and current with the times. Alternatives are regrettably being designed into near all portfolios generally under the cloak of diversity or, worse, safety. Close inspection, however, yields a cluttered, undefined polyglot of commodity, precious metals, real estate, country-specific and what not, ETFs. My concerns are three:

1) Does the person(s) using the alternative asset class have any knowledge, much less concern, with currency risk? Their answer that the actual ETF "does all that stuff" is not a full answer as they seldom do currency-risk analysis because it requires a well-founded macro economic view of both the U.S. and the currency of the assets.
2) Is there any macro-economic work done to determine that, say commodities, even have a case to be bought?
3) Is anyone in charge aware of the cross correlation in an investor's portfolio between which, and how much, alternative product is bought and whether that results in support for (or cancellation of the effects of) the rest of the portfolio?

How do they even decide what to put in a portfolio? Why, from a model, of course – designed somewhere other than the firm selling it. The answer, after 40-odd years of doing money management, is that there is little attention paid to the model's assumptions much less to the aggregate impact of all the alternative products. Spare me the emails about the Efficient Market hypothesis, the historic correlation of different asset groups and the derived Efficient Frontier. Enough current academic work has been done to debunk this theory from folks who think stocks are predictable under the rules of math. In any case, it's now a fad with better retail pricing than plain old stock or bond ETFs.

The alternative class is best done direct (gold, corn, etc.), focused on a specific end rather than in some agglomeration that tries to be all to every investor. I am reminded of a man I met years ago who collected ancient gold coins. That is a gorgeous alternative investment – a two-pronged investment in two non-correlated areas. Buy what fits your particular strategy, assume the folks building "blended" funds of metals, commodities and the like are, well, winging it based on historic data from a time most unlike these new times we live in. That, by the way, is the point they miss.

Spending: Military and Industrial – a small thought

I see much heavier military spending – just not the way you might think. Emphasis on cyber warfare seems to be the cast of future military effort – at the cost of large devices be they ships, planes or missiles. The point is that while the military spent rather handsomely for the last 7 or so years, the private sector has spent at slower rates. Recent capacity utilization numbers tell me we are nearly out of expansion room (the output-gap theory cut down to size). It's no secret that industry has not so much added capacity as replaced men and old machines. Any resurgence in the economy will trigger, I believe, a decent capital spending boom. Those who already have enough capacity, especially in manufacturing, can generate a great deal of cash flow even from tiny amounts of unit growth. Thus the search is for companies not facing a need to add capacity, but able to increase dividends.

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Municipal Bonds vs. Pension Debt

I have some municipal bonds in some client accounts. Of late, there have been rumblings of ending their tax-free status. Recall that a municipal bond issued by state or local governments is tax-free income, both local and Federal, to a resident of that same state. If the resident buys the municipal bond of another state, that resident pays only his local income tax on that bonds interest, but it is still exempt from Federal income tax. It's that Federal loophole the tax-and-spend crowd is salivating over. When deficits as we are now experiencing need solutions, any and all loopholes draw attention.

Concurrent with that attention is the growing awareness of state and local pension funding deficits – a problem I see as far more severe than any state or local government will admit. Two ignored points, to my mind:

1) the assumed 7% or 8% future growth of what funds they do have on hand is wildly optimistic when long-term rates of return are so low currently and future economic growth is simply assumed to return to historic levels, and, more importantly,
2) the demographic fact that very large numbers of boomers are now ready to start drawing on these under-funded plans faster than either new contributions or growth can offset, further hurting future values.

The reality is that the participants are not evenly spread out by age over the next 20 or 30 years – quite the opposite. We see, then, under-funded plans with a bulge of participants calling for their pension at the same time future returns are overstated and new plan participants are on lower salary schedules leading to lower future contributions to pay existing level benefits.

In that climate it seems to me many state and local governments may well be evaluating bond issues to make up short falls (kick the can down, etc.). In that climate, I see both downward pressure on existing municipal bond prices as Washington threatens and then a buying opportunity when states make the case that they keep this tax-free feature or ask for Federal bailouts.

There are many more topic areas worthy of prediction, but stocks, bonds and alternatives cover the bulk of investor commitments. I have addressed hedge strategies elsewhere and stressed their value. Short, very short fast, day trading is with us for the foreseeable future and requires talents we lack but feel we have identified a few capable sources. As always, if I am presented with new information that leads me to change my view, I will so advise my clients, but for now this is how I see the world.

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