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'Tis the Season to Taper

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With Thanksgiving falling so late this year, the transition into the Christmas season descended upon our home with blinding speed. Tree trimming, yard decorating, shopping, baking, (I'll try and list something that I actually assisted my wife with in just a minute), card preparation, present-hiding, oh and re-immersing in the classic Christmas programs (ha! there it was), has occupied all of our free time.

While our children are getting bigger (only 1 believer left in the bunch!) their enthusiasms for the Christmas television specials has not diminished a smidge. I'm not sure what it is about the classics that endear themselves to us more with repetition, but the associations and nostalgia attendant to the season's' most sympathetic characters binds us as tightly as any wrapped gift under the tree.

This past weekend, we indulged in 2 children's book adaptations to the little and big screen, respectively: Dr. Seuss's, "How the Grinch Stole Christmas," and Chris Van Allsburg's, "The Polar Express." They are equally remarkable in their cinematic contrast, (the former being released in 1966 and the latter in 2004), and their conscientious consistency, both reinforcing the message that true gifts lie in the giving.

Magically, though some might say strangely, I experienced something new this year in viewing each production. It was a veritable epiphany of yule tide treasures perceptible perhaps only to the money managing maligned. Despite no corroboration from my kids and in spite of their credible comparisons of me to Christmas-sentiment charlatans, certain corollaries are compulsory!

How obvious the message now seems from the dancing conductor and the waiters aboard the Polar Express! They are plainly surrogates for Janet Yellen, the new head of the Federal Reserve Bank, and her interest-rate setting staff of Fed officials, intent upon stoking the incipient growth of the US economy. For upon serving hot chocolate to their passengers, they belt out repetitively: "Here we've only got one rule…….never, ever, let it cool!" http://www.youtube.com/watch?v=5Uuw3JKLO1g).

Just as clear is that Seuss's disenfranchised Who's in Who-ville are really proxies for the international investment community as the Federal Reserve prepares to modify its mantra of cheap money! While the Grinch is extracting gifts upon which persistency has become dependent, the Whos melodically demonstrate their defiance to disruption thru cultural cohesion.

So, in essence, each aforementioned scene from its respective Christmas production simply represents a point along the progression of an imminent policy modification of the Federal Reserve Bank. Now that oughta get you more into the holiday spirit!

We've been writing about the prospect of the Federal Reserve Bank shifting its monetary policy posture for several months. The Fed is currently operating under an extraordinarily accommodative approach known as Quantitative Easing (QE) 3. QE 3 commits the Fed to purchasing $85 billion every month in Treasury and

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mortgage obligations (bonds) in order to provide liquidity to those markets. They have, however, insinuated that change is coming. This change, characterized by outgoing Fed-head, Ben Bernanke as "tapering," will reduce the monthly magnitude of those purchases, a precursor, albeit a distant one, to the Fed actually selling bonds, or raising interest rates.

In May of this year, the Fed first mentioned its tendency toward tapering and the market threw a tantrum. Bond yields and mortgage rates spiked and the stock market experienced some serious gyrations[1]. In response to this spate of volatility, the Fed refined their language, attempting to assuage investor's fears of any immediate deviation from a well-worn path (Q3 rightfully presupposes number's 1 & 2) and to keep borrowing costs low. But unlike the gullible, little Cindy Lou, who after sleepily encountering the Grinch retreated to slumber, comforted by his claims to be Santa, market participants have been less trusting - rates have not fully retraced despite the initiation of tapering being been forestalled[2].

So the questions for Conductor Yellen are two-fold: is it possible to keep the economy from cooling while applying the brakes to the current course of monetary policy? And what are the investment implications?

Well, I recently read an article about a new wireless power transfer technology for use in high capacity transit, namely railcars (perhaps a Christmas miracle that it dovetails so well with the Polar Express imagery) code-named: OLEV (On-Line Electric Vehicle). "OLEV does not need to be parked at a charging station to have a fully powered battery. It gets charged while running, idling, and parking, enabling a reduction in size of the reserve battery down to one-fifth of the battery on board a regular electric car"[3]. Such is the ambition of the US economy – to self-sustain its forward motion by attaining a rate of growth (as measured by gross domestic product (GDP)) in excess of its cost of capital, net of inflation. By balancing such growth (as measured by GDP and the rate of unemployment) with inflation (as measured by the Consumer Price Index (CPI)), the Fed has set its anticipatory targets by which it intends to apply more or less ongoing accommodation.

The path of this course may not be smooth, as inputs that could cause derailment are multiple and the capital markets have already begun to jump the Fed's track. I believe the key to succeeding is through diligent digestion of the feedback from switches, designed to determine the trajectory, its strength and sustainability.

The investment implications are certainly challenging but ultimately underscore the prevalence of cyclicality in security selection. Common stocks tend to be parked in one of two stations: early cycle/interest rate sensitive stocks and mid-late cycle/economically sensitive stocks. Given the recent read of 3rd quarter GDP at +3.6%[4] along with the upward pressure on interest rates[2], emphasizing the economically sensitive sectors like industrials, materials, energy and information technology, seems sensible. In addition, the reported economic strength in the US has exhibited a bit of a spill-over effect to some international markets, and we would advocate for considering companies outside the borders of our country that possess similar cyclical tendencies.

Within fixed income/bond markets, very short-dated and floating-rate alternatives appeal most to us at this point. If the Conductor feels that more stoking needs to be done to keep the economy from cooling, then the disruption of such a short duration strategy will probably be prevalent in smaller gains, as opposed to a more adverse consequence of having long-duration exposure in the face of implied or actual tapering.

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As for the Whos down in Who-ville, the lesson they've taught us goes beyond seasonal and surreptitious - it speaks more to stick-to-itiveness! For often in investing, fear of transition is dire when docile will do. Perceptions of events as binary (think Y2K) are typically billowing if approached with balance.

Therefore, in allocating client capital we are mindful that: yes, the Fed is going to taper; yes, there will be some dislocation courtesy of expectation realignment and true liquidity contraction; yes, an otherwise dependable asset class (bonds) will be recalibrated in light of policy transformation; and yes, when the velocity of money increases, we'll have to protect against inflation. But in the spirit of the Whos, harmony will be our hub, and optimism our outlook as we modify our exposures consistent with our determination of their expected returns. So, while financial markets don't necessarily provide the indelible memories of so many classic holiday programs, perhaps their navigation can be assisted because of them! Happy Holidays!

[1] Source: Bloomberg Market Data. 10-year bond yield went from 1.63% on 05/01/13 to 2.99% on 09/05/13. The price of a 30-year GNMA mortgage bond went from 108.25 on 05/01/13 to 98.24 on 09/05/13. The S&P 500 had a delayed, more mild and slower move, trading from 1,669 on 05/21/13 to 1,573 on 6/24/13, before fully recovering to 1,669 by 07/11/13.

[2] Source: Bloomberg Market Data. 10-year bond yield is 2.84% as of this writing and the price of a 30-year GNMA mortgage bond is 101.13.

[3] http://www.sciencedaily.com/releases/2013/02/130212210120.htm

[4] Source: Bloomberg Market Data

IMPORTANT DISCLOSURES:

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