KAVAR Canvas

The science of investing. The art of integration.

January 2015

Issue XIX

Avoiding Road Rage

Written By: Douglas Ciocca

Over the course of the last 9 months, I have had the interesting, and challenging, experience of teaching my oldest daughter to drive. The process has possessed moments both harrowing and heartening as we align her emotional and technical predispositions with the conventions of motor vehicle operation.

Advancement, or assimilation, in any pursuit can breed complacency or even contempt and driving is no different. Having 28 years of (mostly) solid experience behind the wheel, I take for granted much of what rattles a road rookie.

In order to be a good instructor, I've had to reacquaint with the fundamental rules of the road while incorporating some more progressive propositions: "Hands at 10 and 2," "Pass only in the left lane," and "NEVER, EVER TEXT AND DRIVE!!" Doing so, I think, has made me a better teacher, and surreptitiously spawned some credible corollaries for navigating the current capital markets.

For starters, both drivers and investors rely heavily on a dashboard - upon which flashing lights and pretty colors convey invaluable information. Both too monitor their mirrors - to anticipate, to assess and to attribute a propensity for prosperity or problems.

If the financial markets had a GPS, their ride would be smoother, more direct and decidedly boring. But in the absence of a Maps app, an investor's destination can hit speed bumps on the market's journey that may require course correction. Wall Street has been littered with many such bumps to start this year.

Defensive posturing provides comfort as congestion and volatility elevates – a modicum of which is always healthy for a driver or an investor – as both become keenly aware of the detrimental consequences of their blind spots.

So, let's explore some of the potholes that have emerged in the market's path, and some alternate routes to consider for 2015:

Pothole #1: Interest Rates are going to move higher.

The Federal Reserve Bank (Fed) has made it no secret that they intend to raise interest rates in 2015. And for that I want to whole-heartedly say: "thank goodness!" After completing the microscopically measured "tapering" process (the gradual reduction of extraordinarily accommodative monetary policy) last year, they are on the precipice of actually extracting some stimulus from the economy by increasing borrowing costs thru open market operations.

Why do I think this is good news? Simply because the Fed has maintained the same monetary policy stance since the depths of the financial crisis in 2008-2009, and the economy is considerably different (read: better) than it was back then. The policy posture has been recessive and is now ill-equipped to fight things, like a recession, if there is a turn in the business cycle.

The Fed reminds us regularly that they possess a dual-mandate: to promote both maximum employment and price stability, but there are extents to which the Fed alone can influence either. This newsletter is not long enough to explore the current dysfunctional bureaucratic environment in Washington but we will touch on the widespread deflationary influence of falling commodity prices. Both have been impediments which forestall the timing of the Fed's next move.

Avoiding Road Rage

Regardless, the diminishing returns of the elongated easy credit environment have been apparent in the form of low loan demand, high investor cash balances and massive currency strength. I think it is time for the Fed and its new head, Janet Yellen, to exhibit an element of proactivity and an ounce of prevention for the long-term health of the US economy.

Slow and symbolic modifications can give way (month-to-years from now) to those more substantive and systematic should the job market keep improving and if wage inflation presages product-pricing pressures. The key is getting started in tuning into the business cycle.

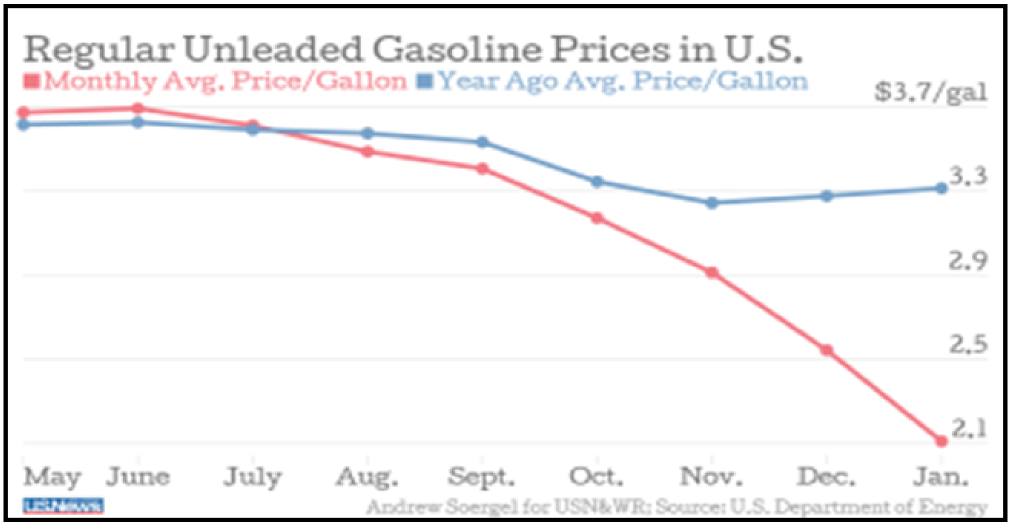
So, if this is a good thing, why has the stock market exhibited action that would indicate otherwise? There is both a mathematical and a psychological answer to that question.

Mathematically speaking, stock prices are determined by present valuing a company's (or a market's) cash flows at what is called the "discount-rate". Such a rate is designed to weigh a company's cost of capital (above a risk-free rate) and its level of ambiguity in obtaining its projected cash flows. The higher this "discount-rate" the lower the present value, or price.

Psychologically speaking, investors are creatures of habit who have been spoiled by exceptionally low interest rates and an unambiguous thrust of the Fed to stimulate asset/stock prices. A change of course can create cantankerousness.

Pothole #2: Oil prices have plunged.

I told my daughter the other day that she is lucky to be getting her driver's license when the price of a gallon of gasoline is only 50 cents higher than the year she was born. Of course, had that same conversation taken place on the day she obtained her learner's permit, barely nine months ago, such would not have been the case.



As most everyone has seen, heard and experienced, the price of a barrel of oil has been in a free-fall of late – dropping over 50% in 6 months from $100.36 to approximately $47.50[1] as of this writing. This has prompted intense and immense rounds of the blame-game as both consumers and producers are befuddled by its persistent plummeting.

But it's lame to lay blame about a game that's always been the same: supply and demand provides the frame!

Yes, the OPEC (Organization of Petroleum Exporting Countries, which provide approximately 40% of the world's oil needs) ministers that refuse to lower production from the Middle East come across as villainous to us Americans, since their stubbornness threatens the strength of our large domestic drillers, their fracking siblings and both of their common stock prices. And yes, the fact that Iraq is back and pumping at record levels may push the market-clearing price even lower than it is today, impacting the energy credit (bond) markets.

The OPEC member countries, the frackers and Iraqi's had a decent estimate of the global oil appetite before drilling their next wells, horizontal or otherwise. And without an obvious demand catalyst, additional supply must lower prices. What caught the market, and us, by surprise is the extent to which the largest producers of oil are content to let the price drop before even considering an alteration of their supply. The OPEC members are willing to massively suppress their profit margins to preserve their status as the marginal producer of energy inputs – globally.

As the balance of production between new and old worlds is indeterminate, so too is the long-term impact on their related stock and bond prices.

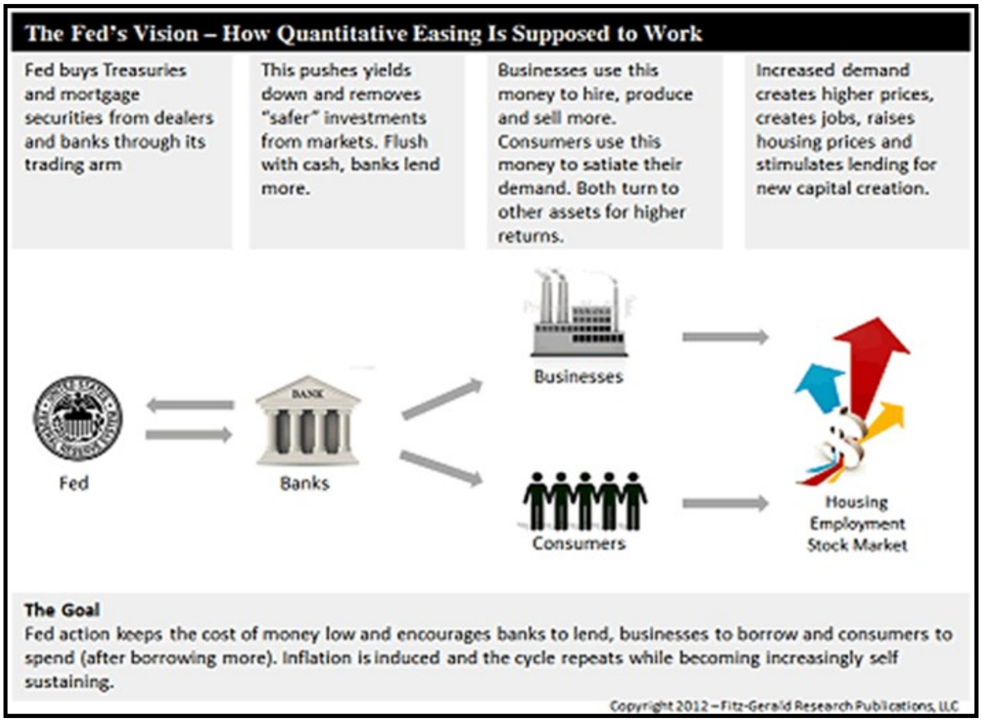
Pothole #3: European economic crisis concerns.

All investor eyes will be on Mario Draghi this week. Mr. Draghi is the head of the European Central Bank (ECB) which is similar in construct to the US Fed, who oversees the economic well-being of not one, but seventeen, European countries by interfacing with their central banks.

He has the spotlight as he announces the details of his plans to jump-start the European economy w/ a stimulus plan eerily similar to that first deployed in the US in 2011 under the title of "Quantitative Easing", or QE.

QE is, "an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity"[2].

The graphic below depicts the intent of a well-designed plan of QE as conducted by the Fed w/ aspirations of emulation across the pond:



The Fed's Vision – How Quantitative Easing Is Supposed to Work

Fed buys Treasuries and mortgage securities from dealers and banks through its trading arm

This pushes yields down and removes "safer" investments from markets. Flush with cash, banks lend more.

Businesses use this money to hire, produce and sell more. Consumers use this money to satiate their demand. Both turn to other assets for higher returns.

Increased demand creates higher prices, creates jobs, raises housing prices and stimulates lending for new capital creation.

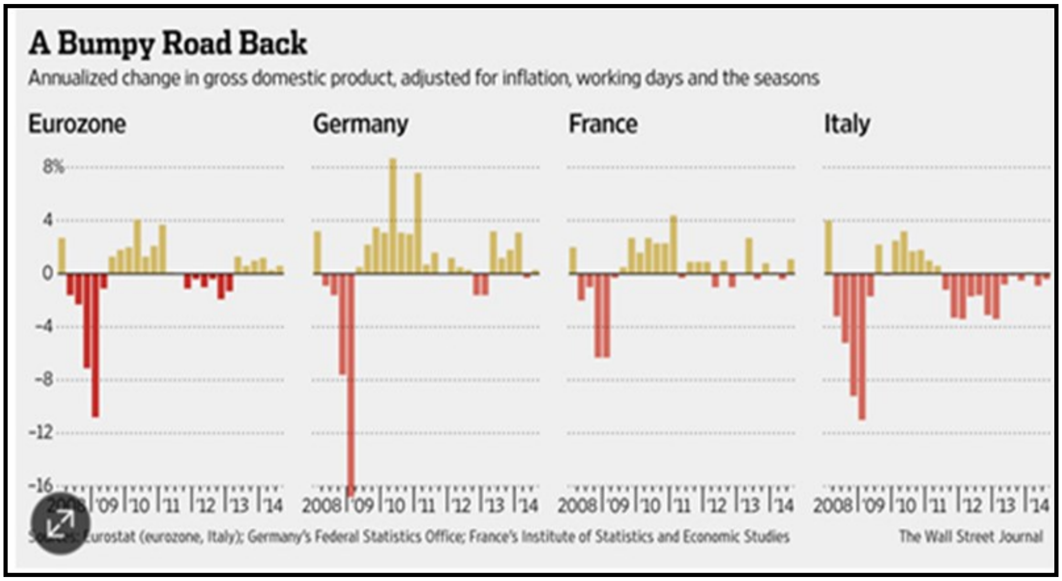
The Goal

Fed action keeps the cost of money low and encourages banks to lend, businesses to borrow and consumers to spend (after borrowing more). Inflation is induced and the cycle repeats while becoming increasingly self sustaining.

Copyright 2012 – Fitz-Gerald Research Publications, LLC

Avoiding Road Rage

The ECB is contemplating QE because many Eurozone countries are exhibiting weak, and in some cases worsening, organic economic growth rates (see chart below):



And if there is a suspension or reduction in demand from one of the US's top trading partners (the EU), it could hurt profits in a stock market already preparing to discount its cash flows at higher rates – effectively a double-whammy of valuations.

The ECB has their work cut out for them as there is far from unanimity among its constituent countries as to the details of course to chart, though all seem like-minded in the need for policy intervention to goose growth and catalyze capital formation. The key will be the size, scope and timing of their copy-cat QE and until such answers are provided, volatile trading should endure.

Maneuvering around these potholes is by no means easy and the financial markets are no test track. Our approach, which recently has been about as cool as driving with your Dad, is: balancing an actively managed global portfolio with a contrarian nature and a value-bias. Let's peek under the hood at those parts:

A Global Portfolio. We think that there is considerable value in investments outside of the US. This is due partially to the weakness that is prompting the ECB to act. It is also due to the prospective cash flow discounting of the beneficiaries of that act. Think about Europe in these terms:

- They are generally only importers of oil – the low price could help profits[3];
- Their weaker currency repatriates exports inexpensively;
- Valuations of their stock markets are at a discount to those of the US[4];
- Sentiment is very poor[5];
- Dividend yields at around 1.5x that of their US counterparts[6];

We think that adding exposure to companies in parts of the world with monetary policy tailwinds via specific stock selection or active mutual fund management can be a sound part of an equity strategy – particularly in what are known as interest rate sensitive or early-cycle sectors.

Avoiding Road Rage

A Contrarian Nature. While we don’t get much snow here in Kansas, where I grew up, a common piece of winter driving advice was: steer in the direction of your slide! We’d say the same about investing – sometimes the best values exist in the most challenging and troubled areas. As such, we not only feel strongly about the European opportunity, but also that there is some benefit to considering energy stocks and bonds in light of the recent sell-off.

We anticipate some mean reversion to be driven by the price drop, but consolidation is bound to ride alongside. While a myriad of estimates exist regarding the number of start-up drilling, service and pipeline companies spawned by the shale boom, the recent commodity price drop may upend some of their profit models. This dislocation can prove positive for deep-pocketed players interested in bolstering their reserves or service offerings and ultimately raising their profitability.

Also, when cash flow projections contract, creditors get cranky. Cranky creditors (bond holders) have been known to pull prices down indiscriminately, providing the discerning bond investor with a compelling opportunity to own high-quality issues at jalopy prices.

A Value-Bias. This is a comparative characterization with respect to a “growth” bias. Value investors seek evidentiary capability of companies to generate cash flow, pay dividends and expand market share. Theirs (ours) is not an aspirational emphasis but something more tangible and thereby more comforting. As the international economy grinds its gears, we think that accentuating the ascertainable adds a defensive chassis that can better protect a portfolio.

We’ll keep in close touch as we traverse these capital market highways and byways, always mindful of focusing on the fundamentals, keeping your portfolio alignment well-balanced and remaining attentive to signs that provide information about the road ahead.

[1] Source: Bloomberg Market Data

[2] http://www.investopedia.com/terms/q/quantitative-easing.asp

[3] http://uk.reuters.com/article/2014/10/15/uk-europe-energy-imports-idUKKCN0I411G20141015

[4] Source: JP Morgan Asset Management

[5] https://www.tradingfloor.com/posts/market-close-poor-eurozone-pmi-weighs-on-european-market-sentiment-2547941

[6] http://www.nytimes.com/2014/10/12/business/mutfund/the-hunt-for-dividends-may-shift-to-europe.html?_r=0

IMPORTANT DISCLOSURES:

The views expressed herein are those of Douglas Ciocca on January 21, 2015 and are subject to change at any time based on market or other conditions, as are statements of financial market trends, which are based on current market conditions. This information is provided as a service to clients and friends of Kavar Capital Partners, LLC solely for their own use and information. The information provided is for general informational purposes only and should not be considered an individualized recommendation of any particular security, strategy or investment product, and should not be construed as, investment, legal or tax advice. Past performance does not ensure future results. Kavar Capital Partners, LLC makes no warranties with regard to the information or results obtained by its use and disclaims any liability arising out of your use of, or reliance on, the information. The information is subject to change and, although based on information that Kavar Capital Partners, LLC considers reliable, it is not guaranteed as to accuracy or completeness. This information may become outdated and we are not obligated to update any information or opinions contained herein. Articles may not necessarily reflect the investment position or the strategies of our firm.