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Spotlight Stealer

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With the first six months of the year coming to a close last week, we at Kavar Capital have been engaged in our quarter-end attribution analysis. No more complicated than determining what assisted or challenged our portfolios, the process is likewise intuitive and instructive. It begins with: "who?", transitions to: "why?" and culminates with: "now what?" Thematically for this quarter, and really for the entirety of 2013, financial markets have been subject to Broadway's ***Chorus Line*** effect as they possessed one and only ***One Singular Sensation*** - and that was US Stocks.

Act 1. The "Who?": The performance disparity amongst asset classes has been pronounced and perplexing, (for reasons we'll explore), yet persistent. The table below presents several index results and their attendant asset classes from 1/1/13 – 6/30/13[1]:

Index	Asset Class	YTD Perf thru 6/30/13
S&P 500 Index	US Stocks	12.67%
Dow Jones Corporate Bond Index	Investment Grade Corporate Bonds	-5.38%
Euro Stoxx 50 Index	Blue-Chip Eurozone Stocks	-1.26%
Thompson/Reuters Commodity Index	Commodity Futures Prices	-6.57%

While this review of indices is by no means exhaustive, its critique is conclusive: portfolios populated with assets other than US stocks experienced a performance anxiety comparable to that of an understudy on Opening Night.

And so the curtain falls on the facts, as we postulate on the "Why?" and speculate on the "Now What?"

Act 2. The "Why?"

Why was the US stock market so strong and everything else less so? And why are bonds and commodities downright weak?

Historically, stock market returns are comprised of four elements: *earnings growth, dividends, inflation and multiple expansion or contraction*. (A "multiple" is short-hand for a Price/Earnings (P/E) multiple – an indication of how many dollars in price an investor is willing to pay for every dollar of earnings. Multiples tend to expand during times of strong underlying economic growth, accommodative monetary policy (read: low interest rates) and geopolitical harmony. Contraction tends to occur when few or none of these aforementioned conditions exist.)

The companies that comprise the S&P 500 grew their earnings at an annual rate of 2.6%[2] in the first quarter and expect annualized growth of 0.4%[3] in the second. The annual dividend yield of that index is 2.08%[4]. Inflation (as measured by the Consumer Price Index, aka CPI) averaged 1.9%[5] for the first 5 months of the year (June has not yet been reported) and the P/E of the S&P 500 expanded from 13.91 to 15.67[6]. Totaling these together, with some smoothing in order to average, gets us an S&P return expectation of approximately 6.2%[7]. For sure, this is a static snapshot of a dynamic system and therefore some distortion is defendable, but the actual return is more than half what would have been predicted based on the inputs identified above! Why would that happen? I believe the credit for the stock market move this

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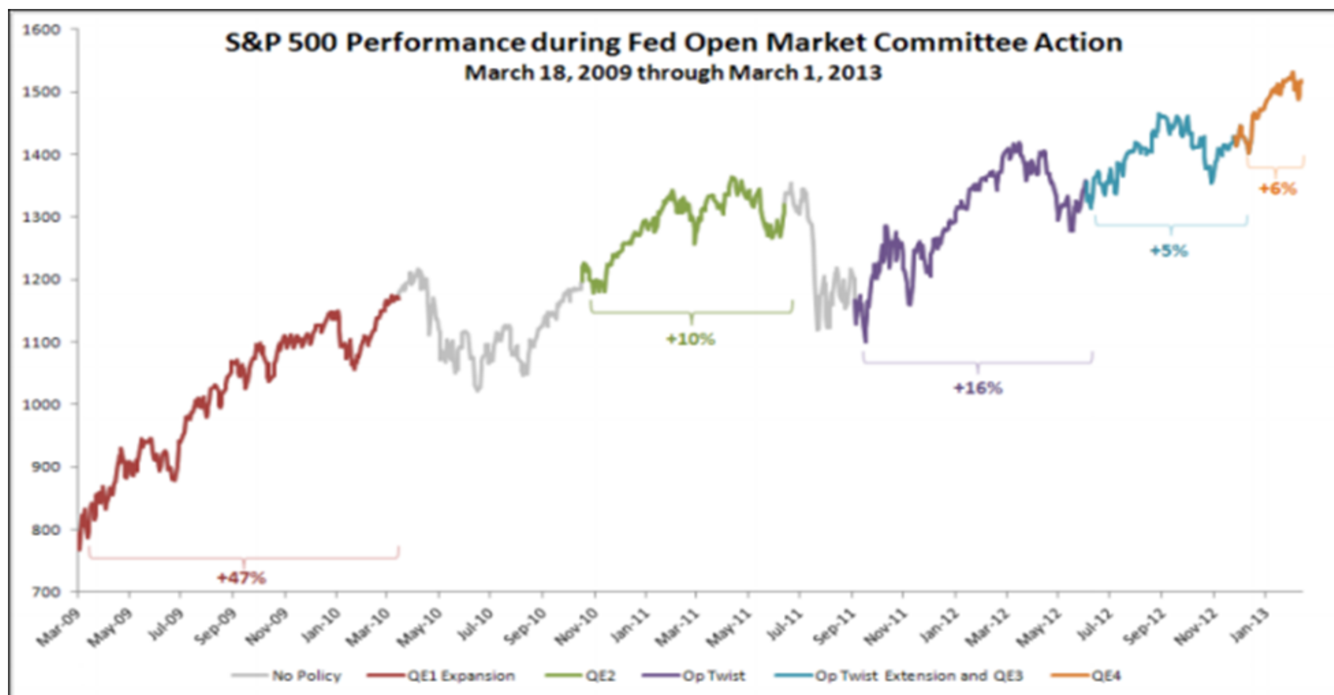
year lays less with the actors (the stocks themselves) and more with the director. And that director, of course, is Dr. Ben Bernanke, head of the Fed.

If there has ever been a Fed director that could be characterized as aggressively accommodative, it is Bernanke. The force of his will and the girth of his balance sheet have laid dollars on the doorsteps of many accepting Americans – lowering both the premium on risk and the discount rate on future cash flows. Low discount rates equate to low costs of capital, low servicing costs and low levels of ambiguity in analyzing investment prospects. Such a trifecta essentially elevates demand which props up prices. And ever since the Fed has embarked on such an easy-money track, code-named Quantitative Easing(QE) 1-4, stock markets have performed well. Such performance is well-accounted for by the chart below.



Source: DoubleLine Capital

It is interesting to think of this in terms of more mainstream assets, like a house purchased with a mortgage: The lower the cost of capital, (mortgage rates price off of Fed Funds rates, which is the rate that is set by the Fed), the more manageable the payment and the higher the present value of the home were you to appraise or sell it. Since a home is typically one of the largest assets on a family's balance sheet, its appreciation positively impacts net worth, predisposing households to spend in proportion to their abundance. This is known in economics as the "wealth effect", and its impact can theoretically catalyze virtuous circles of capital formation.

Until recently, stocks claimed no exclusive on the benefits of Bernanke's benevolence. No, the bond market too was cast in a favorable light as the Fed manufactured anemically low lending rates through its open market operations, while voraciously buying mostly mortgage bonds and Treasury bonds. In many respects, the Fed has actually "made the market" in the primary auctions and the secondary markets for these credits. Think about this, the Federal Reserve Bank is buying $85 billion in mortgage and Treasury bonds every month and currently owns over 20% of the total US Treasury debt[8]. The Fed is disproportionately bearing the burden of financing the operations of our country and the efficient clearing of our mortgage market, simply by ballooning its balance sheet. With such steady and reliable demand, the price of such instruments will be biased to be stable or to rise, as in the inverse world of bond math, high prices equal low yields.

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So for the first part of this year, stocks and bonds somewhat peacefully co-existed, with the interest rate on the 10-year bond hitting a low of 1.6%[9] on May 1st. But that all ended just 3 weeks later, on the 22nd of May. For that was the day that Bernanke, in a Congressional testimony, first uttered the word that now spawns 12,500,000 Google results in 0.24 seconds……Bernanke indicated that the Fed may "taper" its bond buying and stiffen in its policy posture. This term, "taper", by definition, means: "to reduce gradually."[10] However, there was nothing gradual in the re-pricing of bonds and stocks that took place subsequent to that utterance. From May 22nd until June 28th, the S&P 500 fell 5% and the yield on the 10-year bond went from 1.92% to 2.48%[11]. Volatility made an abrupt return to the financial markets, coyly characterized in the financial press as, "the taper tantrum". And its reverberations extended beyond the jurisdictions of the Congressional leaders on whom Bernanke imparted his intentions. Yes, the emerging countries around the world, on whom the US relies upon for manufacturing, labor and consumption experienced a rather dramatic drop in their equity and fixed income markets as well. As an example, the MSCI Emerging Markets Index has dropped 13.19% in the first 6 months of this year[12].

In addition, I think that the tapering talk was at least partially responsible for the weakness that ensued in commodities markets. A prospective by-product of less accommodative monetary policy, as gradual as it may be, is that fewer dollars will be injected into the money supply. Axiomatically, fewer incoming dollars make the outstanding ones more valuable, thereby appreciating the currency and devaluing anything that is denominated in it - think gold or silver for example. An accomplice to the commodity decline was a growth rate contraction on the part of some of the world's largest resource raiders, namely China and India[13].

Act 3. The "Now What?" (sorry, no intermission)

Let's start with stocks. In consideration of the 4 historical drivers of stocks, absent a large pop in earnings in the back half of the year, I think that the bulk of the US Market's annual return has been made in the first half. One key insight and one key caveat – Insight: I believe that the indication, or action, of tapering by the Fed will limit any multiple expansion for the balance of the year. If, as was stated earlier, the preconditions for higher P/E's are strong underlying economic growth, accommodative monetary policy (low interest rates) and geopolitical harmony, then a US economy that hopes to grow a mere 1.0%[14] in the second quarter with a Fed that is disengaging amidst a firestorm of upheaval in the Middle East does not deserve more slack in the valuation of its stock market. Caveat: this is not to say that some specific stocks will not do very well in the last 6 months of the year.

Due to this outlook, we are very much aligning with active management in our domestic (and foreign) stock positions – be they through mutual funds or direct investments. There are parts of the world growing much faster than that of the US (not hard to believe at our whopping 1% GDP growth rate!) and allocating capital in those directions is prudent, I believe. In addition to active management, we are advocating a "value" orientation to stock selection. With few strong identifiable macro growth trends, fundamentally sound companies that have efficient profit models make sense to us, particularly those stocks that pay dividends to their shareholders, within the borders of the US and beyond.

Regarding the bond market - the lair of the Fed and the whipping post of the year's first half - I think that there is risk in abandoning this asset class for the following 2 reasons. First, I mentioned earlier the benefit of low rates to the mortgaged home buyer – affordability and marketability. Since the Fed discussed its tapering plan, the average rate on a 30-year mortgage has gone from 3.45% to 4.61%[15]. Not only will this dampen demand for homes, but all of the cottage industries attendant to a healthy housing market could feel negative downstream effects. With housing being such a critical component to a broad economic recovery, I think the Fed may take measures to stem the tide of adverse consequences were they to become systemic. Bear in mind that in Bernanke's press conference at the conclusion of the June 20th Fed meeting, having seen the jump in mortgages rates since his mere muttering on May 22nd, he specifically singled out the mortgage securities market as immune from the temptations of tapering. Such assurances did nothing to mitigate the migration out of bonds, making it likely to necessitate some unconventional maneuvering – the Fed still has a few tricks up it proverbial sleeve.

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Second, in an economy of below-trend GDP growth (the whopping 1%), and CPI averaging 1.9%, many risk-averse investors may keep a bid in bonds courtesy of their dual qualities of income generation and principal protection, to conceivably attain positive real yields (nominal yield minus inflation). To reiterate: we still find value in certain fixed income securities that offer returns above inflation with stable creditworthiness and we base our yield goals on a tax-equivalent basis (net yield after tax).

I have excerpted a recent e-mail from PIMCO's trading floor below that buttresses our thinking along these lines:

"Admittedly we have seen the market pull forward its rate expectations due to the forthcoming reduction in the Fed's bond buying and the increase in the Fed Funds rate (market currently pricing in increase in Fed Fund by January 2015). There are a number of other influences that combined will continue to pull down yields:

a. ***Demographics:*** *Typically as investor age they prefer assets to be higher up in the capital structure and to be less volatile. In the United States, there are 35 million people aged 55-64 and 44 million people aged 65+.*
b. ***Financial shocks****: Two financial shocks in a decade (2000 and 2008) leave scars people won't forget. In 1999, households were 50% of the stock market. Then the bubble burst and the figure fell to 37% and it stayed there even into 2007 when the Dow hit its all-time high. Why? People were fearful. They remembered the NASDAQ fell 50% in 2000.*
c. ***Safe assets****: The world of safe assets is shrinking at a time when demand is increasing. France, the U.K., and the U.S. have lost their AAA ratings. Italy and Spain are rated BBB and bordering junk. Meanwhile, demand has increased due to regulatory pressures. As more derivatives (i.e. interest rate swaps) migrate to trading on exchanges, those exchanges require high-quality collateral as margin.*
d. ***Inflation****: Core prices for personal consumption expenditures, or PCE (the Fed's favored inflation gauge), is at a 50-year low of 1.1% year-over-year. Inflation won't rise meaningfully for some time because it lags the business cycle, which hasn't sped up yet.*
e. ***Cash flow****. It matters to investors and most bonds return your principal which in turn reduces the term premium in bonds.*
f. ***Global uncertainty.*** *This alone has tremendous value in terms of what one should pay as a premium to safeguard against equity and other risks. Japan, Europe, and even China pose risks that put value in bonds."*[16]

Lastly, in commodities, a sub-component of what we consider to be "alternative assets" – those that have drivers of value unique from those of stocks and bonds. These are designated as stores of value in consideration of the imminent threat of inflation, the full-valuation of traditional classes of assets and heightened volatility. They are, for us, the ultimate purveyors of negative correlation. Unwaveringly, we feel that this asset class deserves a seat at the diversification table. The unsustainable debt levels and low growth rates of the developed world are a canary in the stagflationary coal mine in spite of the low current inflation readings. The high correlations exhibited in 2007-2009, as well in just the last few weeks between stocks and bonds make a convincing case for some shock absorbency in the form of alternative assets. We run away from those touted as the "flavor of month" by the genius financial alchemists at the big banks and despise leverage, lack of transparency and high fees in this portion of our allocation. We embrace consistent and logical thinking in this area, even though such virtues may require another one – patience. We continue to look for sources of negative correlation as the prospects for a single class of assets carrying the market on its back for the balance of the year, we think, is remote.

To end as this note began, in the indelible words of Marvin Hamlisch, we continue to seek, "*one thrilling combination in every move that we make*," knowing full well the timing of such agility make percolate before performing.

Please contact me or my team with any questions and we look forward to seeing you soon.

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[1]Source: Bloomberg Market Data

[2]http://www.bloomberg.com/news/2013-07-07/analysts-boosting-s-p-500-target-11-cut-profit-growth-near-zero.html
[3]http://www.zacks.com/commentary/28030/will-earnings-growth-bottom-in-q2
[4]Source: Bloomberg Market Data

[5]Source: Bloomberg Market Data

[6]Source: Bloomberg Market Data

[7] Calculation

[8]http://finance.fortune.cnn.com/2013/06/19/bonds-ben-bernanke-fed/
[9]Source: Bloomberg Market Data

[10]http://dictionary.reference.com/browse/taper?s=t
[11]Source: Bloomberg Market Data

[12]Source: Bloomberg Market Data

[13]http://blogs.ft.com/beyond-brics/tag/china-economy/#axzz2Yf4UB8lg
[14]http://www.morningstar.com/advisor/t/77525048/pulse-barclays-cuts-u-s-q2-gdp-forecast-after-trade.htm
[15]http://www.bankrate.com/finance/mortgages/mortgage-analysis.aspx
[16]For a full transcript of this e-mail, please contact anyone at Kavar Capital Partners, LLC

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