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Weathering the Storm

Written By: Douglas Ciocca

It has become common to blame the weather for any reported weakness in recent economic data. And such meteorological attribution has in turn spurred cries for a reduction in the Fed's "taper" trail.

"Tapering" is the gradual reduction of the monthly bond buying undertaken by the Federal Reserve Bank.

The bond buying was/is intended to keep interest rates low and to catalyze economic growth by mobilizing money. Its reduction signals a shift in the extreme provision of loose monetary policy by the Fed.

However, certain data points have claimed immunity – (i.e. last's week's durable goods orders, new home sales and Chicago Purchasing Manager's Index[1]) - from the season's chill, setting up a snowball fight of sorts, amongst the economic elite.

Undeniably the polar vortex has wreaked havoc with people's purchasing patterns. And since consumer spending comprises approximately 68% of GDP[2], any suspension of activity axiomatically will have adverse consequences on growth. But I caution against confusing delays with deferrals and I anticipate data revisions will vindicate the outlook of the optimists.

I am defining the optimists, of which I am one, in this case as those that would classify the underlying economy as good, not great, but who perceive the incremental benefits of continued extraordinarily accommodative monetary policy as not evident and potentially damaging for 2 reasons:

1. Continued currency devaluation (trading debt for dollars) has strong inflationary tendencies;
2. It increases the ill-preparedness of the Fed to be even remotely anticipatory in addressing any cyclical economic weakness for which we may be due based on historical patterns.

Please understand that in my current state of optimism, I am not predicting a near-term contraction in the economy, but am merely pointing out that the Fed has maintained a very similar thrust in its policy initiatives for more than 5 years while the underlying economy has changed/improved considerably.

This lack of progressivity challenges the agility necessary to preemptively address emergent issues and importantly, I believe that the efficacy of the Fed's current emphasis has hit its point of diminishing return benefits. Some data to support this statement:

1. Savers are not saving less than they were one year ago[3];
2. Mortgage refinancing's are down[4];
3. Legislative gridlock may be thawing a bit (snubbing it's nose to the tundra's of America) as seen through some constructive dialogue on the proposed infrastructure bill last week[5].

By unfalteringly focusing on low interest rates (until the "taper" that just began in December of 2013) the Fed has stoked the stock market - long known as the preeminent measure of the wealth effect.

And in doing so, the Fed and the stock market have developed a critical co-dependency –the implicit commitment by the Fed to minimize volatility has heightened the average investor's interest in accepting the risks of owning stocks.

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This has developed to such a degree that stock investors get verklempt at the mere mention of a less accommodative Fed and will look for any reason, including the weather, to bring the Fed back in full force.

So while tapering and the attendant modification of monetary policy are transitional and telegraphed, market reactions tend to be less so. Such was the topic of conversation last Thursday when I was a guest of the incredibly talented Vonnie Quinn on Bloomberg radio.

Our conversation buttressed the Senate testimony of the new head of the Fed, Janet Yellen, and her nuanced parsing of actual inquiry from political pontificating.

Consistently, our elected officials queried Yellen's thoughts on the weather's impact on policy modifications and challenged the adherence to her successor's forward guidance on additional adjustments.

I expressed to Ms. Quinn how ill-advised that I thought the Fed would be to reverse course at this point; how poor their track record has been at presaging cyclical turns in the economy with prophylactic monetary policy; and how their insistence on persistence (I wish I used that specific rhyme!) has impeded the natural forces of the economy to shine through….even if that involves some dislocation in stock markets (OK, the whole answer reads a heck of a lot better than I was able to communicate to Vonnie!)

If the Fed continues on its path of tapering - extracting excessive monetary accommodation in recognition of the fact the economy has improved and the beneficial extent of its benevolence bestowed, what does the investment landscape look like?

I think it looks a lot like the first two months of this year. I think it is not easy. And I think that we need to become more accustomed to volatility.

I think it makes sense that interest rates have risen well off of their lows of last year, but off their highs to start the year – as their price support is a function of an investor's interest in income and protection and not of bureaucratic manipulation.

I think the prices of stocks will be tied more closely to the growth rates of their profitability and the delivery of their dividends and NOT on the expansion of their earnings multiples (p/e's).[6]

I think that political self-interest will manifest itself in compromise and capital formation, the likes of which only a mid-term election can spawn.

And lastly, I think that as with all changing seasons, the distinction of the outgoing from the incoming can create indecision, frustration and opportunity – balancing your portfolio for the buoyancy benefits of both should prove prescient.

[1] Source: Bloomberg Market Data

[2] Source: JP Morgan Asset Management Guide to the Markets Q1 2014

[3] http://www.tradingeconomics.com/united-states/personal-savings

[4] http://pbn.com/US-mortgage-applications-slip,95344

[5] http://www.washingtonpost.com/politics/obama-touts-302-billion-transportation-bill/2014/02/26/e08ce67c-9efb-11e3-9ba6-800d1192d08b_story.html

[6] http://www.bloomberg.com/news/2013-11-22/stocks-rise-for-two-reasons-earnings-growth-and-multiple-expansion.html

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11460 Tomahawk Creek Parkway, Suite 420, Leawood, KS 66211 (913) 428-3300