Market Update: 10/13/2014
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Good evening,

Recent activity in the financial markets has gained a great deal of attention. That is typical when the general direction of the price action is negative. It is even more typical when the negativity is framed by volatility (see chart below from Bloomberg that charts the price of the S&P 500 Index (orange) vs. the VIX Volatility Index (white) since the 18th of September – the near-term high of the S&P 500[1]) and such is the case currently.

Prospective catalysts for the 4-week, 6.79% decline[2] have received abundant speculation across traditional news outlets as well as those of the social media. Shy to be short of snippets, fear mongering and fallacious factoids are fanning fires though often lack substance in their form.

Our take is more fundamental. It deals with rates: rates of interest and rates of growth. Both the mutual exclusivity of those rates and their co-dependency upon one another.

Understanding that psychology and access to capital are the axes upon which the capital markets pivot, their angularity is set by the aforementioned rates.
What the heck does that mean? Read on…..

We think that the market is getting nervous about the future direction of interest rates. Interest rates have been really low for a really long time. Former Federal Reserve Bank Chairmen, Alan Greenspan and Ben Bernanke did their darnedest to suppress borrowing costs in an effort to stimulate economy activity

at times when the economy's natural forces were preoccupied with things like 9/11, the Lehman Bros. collapse and that dreadful mortgage crisis.

Flash forward to today and the current Fed head, Janet Yellen is charged with extracting said stimulus as the economy has shown signs of normalizing. It is not an easy task however, as it turns out that the whole low interest rate initiative became really popular with consumers and companies and may have actually distorted their potential to survive and/or thrive in its absence.

To put it in context, think how irregular it would be to see an adult riding a bicycle with training wheels. The rider would likely never fall. The rider would be considered as adept on his/her bike as any other training-wheel wielding rider. As long as the training wheels stayed on, all riding tides would rise. But that is unrealistic in the real world and it is un-capitalistic in the case of the financial markets. Therefore, invariably, it must come to an end.

So who are the good riders? Which are the good companies? Who will fall? Which will fail to raise profits, grow cash flow and pay higher dividends? For those answers we'll have to wait and see, and frankly, that is unnerving.

So, yes, the market is nervous. And given that the market is the collective, psychological embodiment of all its participants (us!) it does what we do when we get nervous: We take less risk; We inventory assets; We count our money. We impose arbitrary time frames on long term objectives. All of which, in aggregate, extracts confidence from the capital markets.

However, this process is not only not unnatural, it is therapeutic. It is cathartic. And it is instructive as it relates to the adequacy and appropriateness of an investor's personal asset allocation plan.

Now, certainly one area that could mitigate the pernicious prospects of higher interest rates would be the propitious probability of high growth rates, right?

Enter recent market destabilizing exhibit #2 – Euroland. There are economic growth concerns in Europe[3] that have the potential to adversely impact the profitability of US companies and consequently compress their stock prices. A couple cases in point:

1. A weakened Euro currency (currently standing @ 1.27 euros for every dollar[4] and is down from 1.39 euros/dollar in March of this year[5]) makes US-exported products more expensive to the demand base in Europe. Theoretically, higher priced products result in lower unit volumes which could hurt profitability;
2. Axiomatically, since Europe (the 28 countries that comprise the European Union), is one of the largest trading partners for the US[6], a weaker European Union may generally be less able to sustain high demand, currency issues aside.

This is not news to the Europeans, their central bankers or their capital markets. In fact, through today, the Euro Stoxx 50 Index (roughly equivalent in stature to the US Dow Jones Industrial Average) has dropped a little over 11% in US dollar terms for 2014[7].

While there are resolutions underway to realign and reflate the European economy, their success is suspect and the strategies are not simple. We are talking about 28 independent economies with varied contributions to the economic compilation of the corpus.

I actually think that their governments' careful deliberation, specific identification of collateral assignment and contemplation on partnering with private enterprise will be very beneficial, but it will not be quick.

And this lack of synchronicity with the imminent rise in interest rates in the US has further exacerbated the erratic trading patterns/behavior.

Any skepticism on rates of growth, from wherever it may be derived, weighs heavily in the context of higher rates of interest. The two embody a critical co-dependency.

Lastly, and at the margin, when confidence is being tested, outside influences have outsized impacts on delicate market psychology. I think that the Ebola outbreak is awful and I pray for all those exposed or in fear of being so. I think that the Russia/Ukraine conflict and the Western World/ISIS conflict are tragic with no easy path to resolution. But I do not think that they are principally responsible for the recent spate of volatile and challenging stock market conditions, like some have suggested.

I think that like many events in market history, the onset of higher interest rates and the challenges of low growth rates are not binary events. We will work through these progressions. Then we will make our way onto the next ones. And each time, we'll modify our approach to be most consistent with your personal goals and your acceptance of risk as we strive to achieve them.

We'll keep in close touch as we move through this market cycle and look forward to sitting down or speaking on the phone to determine the best way for us to address this together.

Have a great night and Go Royals! dc

[1] Source: Bloomberg Market Data
[2] Source: Bloomberg Market Data
[3] http://www.reuters.com/article/2014/10/13/markets-factors-europe-idUSL6N0S80DM20141013
[4] Source: Bloomberg Market Data
[5] Source: Bloomberg Market Data
[6] http://www.trade.gov/mas/ian/build/groups/public/@tg_ian/documents/webcontent/tg_ian_003364.pdf
[7] Source: Bloomberg Market Data

IMPORTANT DISCLOSURES

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