

Market Update – Part 2: 06/11/2015

Written By: Doug Ciocca

I wish I could tell you how often I've greeted my wife after work in a fashion similar to this: "Seriously, trying to understand the intentions of the Fed is like playing "Apples-to-Apples" with Mia and her friends! It's maddening!"

Certainly many of you can relate, right?

Ok, Ok, I should probably clear up a few things for those of you more civil in your spousal salutations:

"Who is Mia?" She is my 10-year old daughter.

"And who are these friends of hers?" An assortment of grade school and neighborhood pals who would likely exchange national security secrets for gum. If anyone reading this has any national security secrets, please do not share them with my daughter.

"Will you tell me again who the Fed is that is causing such consternation?" The Fed is a shortened title for the Federal Reserve Board of Governors, led by its Chairperson, Janet Yellen, which collectively sets/monitors/modifies the course of interest rates for our country. This is known as monetary policy.

"What is Apples-to-Apples¹?" This is a card game created by the mental masochists from the Mattel Corporation, which involves at least 3 participants - one of whom is known as the "judge." The others are known simply as the "Players."

There are 2 colors of cards in this game: green and red. The judge will pick and read a green card which typically possesses a single adjective, something like the word: "goofy". The other players then select from their handful of red cards (which are populated with nouns) that relates best to the adjective.....the term "best" is subjective based upon the judge's interpretation. An example:

Green Card: "Goofy"

Red Card thrown by Player 1: "Monkeys"

Red Card thrown by Player 2: "School Lunch"

Once the red cards are shuffled to conceal the identity of each thrower, the "judge" chooses the red card that, in her opinion, best matches up with the green card. Certainly in this example, both red cards could be described as "Goofy", right?! Certainly the case if you ever sampled the wax beans where I went to school!

Clearly, the outcome is arbitrary. It is based on the mood, experience and interpretation of the "Judge".

"So, what does Apples-to-Apples have to do with the Fed?" I thought you would never ask....read on.....

The Fed is on the precipice of an alteration of its monetary policy.

For over 6 years now, the Fed has done its best to stimulate our domestic economy by lowering interest rates and keeping them low. Ideally, low interest rates prompt people to borrow money for the purposes of investing, (in things like the stock market), or consuming, (in things like houses and cars).

Cheap money is designed to heighten the prospects of achieving returns in excess of their cost (investing) and to lighten the payment component of purchases (consuming).

The Fed realizes that there is a cyclical to the cost of money. They are leery that, at some point, low interest rates may elevate the demand for things, like stocks and houses, to unsustainable and unaffordable levels. It is at such a point, and hopefully somewhat proactively in order to dull the peaks and troughs of prices, that they contemplate a policy change. And that is where we are now.

The problem, as the market sees it, is that the Fed is acting akin to a temperamental “Judge” in an “Apples-to-Apples” game, but with far higher stakes.

The maddening part of the problem is that the Fed is charged with monitoring 2 key economic data points to assist in driving their policy: employment and inflation. These are both measureable numbers and they are published monthly by the data dogs at a couple bustling bureaucratic offices in our nation’s capital.

You are probably thinking that this shouldn’t be a problem and certainly shouldn’t be maddening if the data is distributed deliberately and dissected diligently right? There’s no reading between the lines, no mood rings being twisted.....oh, if only!

As the attachment to this email indicates, the Fed-Heads have read the data drastically differently and their tendencies on timing are bi-polar at best. For those who don’t own reading glasses, and you’ll need them to pour over the attachment, allow me to excerpt a few:

On the timing of an interest rate increase:

On May 22nd, Fed Chair, Janet Yellen, muses that it will take place: “...at some point this year.”

On June 1st, Boston Fed President, Eric Rosengren, suggests having: “...continued patience.”

On May 20th, Chicago Fed President, Charles Evans, offered: “...it likely will not be appropriate to begin raising the Fed Funds rate until sometime in early 2016.”

Understandably, the mixed signals from this esteemed body have left the capital markets feeling somewhat directionless.

And the result of this directionlessness (do not try and look-up that word) has manifested itself in erratic price swings in both the stock and bond markets.

The Fed would rightfully suggest that establishing a trend in the data is more important than any single point and the preponderance of the economic evidence instigates their indecisiveness.

However, on a daily basis, investment decisions are based on the expected returns of capital allocation and therefore:

Stock investors may shy away (read: sell) from the stock market if their expectation of a company’s future cash flows are being discounted to a lower present value, and;

Bond investors may shy away (still read: sell) from the bond market if they fear that the interest rates they’ll receive for loaning money tomorrow will be more than they’ll receive today.

At Kavar Capital, we feel reasonably confident that the Fed will raise rates in the not-too-distant future, and that may well be before the end of this year. Given that outlook, we are focusing:

Our stock and stock fund strategies focus on industry sectors and specific companies that possess higher growth rates in their underlying businesses than the prospectively increased cost of their capital and/or the underlying

growth in the economy. There are certain sectors, like financial services, technology and basic materials that can be direct beneficiaries given their economically-sensitive natures.

Our bond investment strategies focus on the obligations of high quality issuers that contractually offer an adequate cash flow stream to meet our objectives within this asset class at the time in which we engage them. Bonds principal values will be very susceptible to interest-rate driven price fluctuation and we need to filter out the noise that will attempt to obscure the soundness of the investment that prevailed at the time we entered.

Much as I ended last week's piece on Greece, we would expect continued volatility until the Fed decision on rates is actually implemented and not just the source of speculation.

We are conscious of the fact that from volatility emerges opportunity and we are assessing the situation with an optimistic posture and with patience – looking for investments that cheapen as a result.

The "Green Card" has yet to be laid in the Fed's game of "Apples-to-Apples" but investors are still placing their "Red's" – hoping to strike pre-emptively and hoping to ascertain the mood of the market. We'll keep in touch as the most relatable answers unfold.

¹<http://www.com-www.com/applestoapples/applestoapples-rules-official-basicset.html>

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Person	Role	Quotes	Timing	Date of Quote	Do they Reference...			Are they Concerned About...				Sources
					Jobs?	Inflation?	GDP?	Europe?	Oil?	Recovery?	"Overheating?" or "Running Hot?"	
Janet Yellen	Fed Chair	"at some point this year"	2015	5/22/2015	X	X				X	X	http://www.wsj.com/articles/yellen-says-fed-on-track-to-raise-rates-this-year-1432314091
Eric Rosengren	Boston Fed Pres	"I would like to normalize (rates) as soon as possible ... but the conditions haven't been right," "Continued patience..."	?	6/1/2015	X	X	X	X		X		http://blogs.wsj.com/economics/2015/06/01/feds-eric-rosengren-says-it-isnt-the-right-time-to-raise-rates/
Charles Evans	Chicago Fed Pres	"you could imagine a case being made for a rate increase in June" and "meeting-by-meeting" and "It likely will not be appropriate to begin raising the Fed funds rate until some time in early 2016,"	Possibly June 2015 or during 2015 But should be 2016	5/20/2015		X				X		http://www.reuters.com/article/2015/05/20/us-usa-fed-evans-idUSKBN0050KF20150520
Narayana Kocherlakota	Minneapolis Fed Pres	"extraordinarily patient" and "I don't see raising the target range for the fed funds rate above its current low level in 2015 as being consistent with the pursuit of the kind of labor market outcomes that we are charged with delivering," and "it would be a mistake to raise the target range for the fed funds rate in 2015."	Not 2015	5/28/2015	X	X	X			X		http://blogs.wsj.com/economics/2015/05/28/kocherlakota-mistake-for-fed-to-raise-rates-in-2015/
John Williams	San Francisco Fed Pres	"At some point later this year"	2015	5/12/2015	X	X	X				X	http://www.cnn.com/id/102671633
Loretta Mester	Cleveland Fed Pres	"If the data comes in according to my forecasts then the time is near where we're going to be wanting to raise rates," and "We'll get another employment report to look at as well as some other data and we'll make a judgment at that meeting. In my mind every meeting is on the table," and "The Fed's rate-setting committee will go into its June meeting with an "open mind"	Open Mind for June 2015 Every meeting from now on	5/25/2015	X							http://blogs.wsj.com/economics/2015/06/02/feds-brainard-wants-more-economic-progress-before-rate-rises/
James Bullard	St. Louis Fed Pres	"In the framework presented here the forward guidance policy - promising to remain at the zero lower bound beyond the time that the zero lower bound is actually constraining - is not helpful,"	?	5/28/2015			X					http://blogs.wsj.com/economics/2015/05/28/fed-should-consider-new-ways-to-counter-weak-growth-bullard-says/
Lael Brainard	Fed Governor	"But while the case for liftoff may not be immediate, it is coming into clearer view. If continued labor market strengthening is confirmed and inflation readings continue to improve, liftoff could come before the end of the year,"	End of 2015	6/2/2015	X	X						http://blogs.wsj.com/economics/2015/06/02/feds-brainard-wants-more-economic-progress-before-rate-rises/
Dennis Lockhart	Atlanta Fed Pres	"all meetings are in play...including June" and "I'm still of the view that the conditions will be appropriate in the middle of the year, which we are getting closer to," and "I've noticed recently that probabilities as reflected in forward markets, or futures markets for fed funds, seem to have moved from December toward September. I think that's a reasonable alignment with what I think to be the likely policy outlook"	Possibly June 2015 or Sept 2015	5/6/2015	X	X	X					http://blogs.wsj.com/economics/2015/05/06/feds-lockhart-sees-economy-back-on-track-soon-though-wants-more-evidence/
Jeff Lacker	Richmond Fed Pres	"I haven't made up my mind yet about June, I am going to wait and see what the data reveals." and	Possibly June 2015	5/26/2015			X	X		X		http://blogs.wsj.com/economics/2015/05/26/feds-jeffrey-lacker-still-undecided-on-june-rate-rise/