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KAVAR Canvas

The science of investing. The art of integration.

Carried Away

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I guess that there are worse things to worry about than the persistent strength of the stock market these days, right? With the Dow Jones Industrial Average hitting a new record last week -closing above 15,000 for the first time - worry would seem wasteful, huh? I mean, mutual fund flows are now finally biased toward equities[1] – a recent reversal of course. Warren Buffet has proclaimed that bonds are, "terrible investments today[2]." And recall that Finance 101 teaches low interest rates raise the present value of future cash flows. So really, when you see headlines like those below, their relevance must already be fully reflected in stock prices since, as the Efficient Market Hypothesis tells us, "existing share prices always incorporate and reflect all relevant information."[3] To wit:

"[US Economic] Growth falls short of forecasts, weakness ahead." – Reuters, 4/26/13[4]
"Drop in labor participation rate is distress signal." – USA Today, 4/7/13[5]
"Record Number of Households on Food Stamps-- 1 out of Every 5." – CBS News, 4/25/13[6]
"Sequestration Debate Shows How Legislative Gridlock Has Not Eased Post-Election." – Huffington Post, 2/26/13[7]

To put this in equation form: sub-par economic growth + weak labor markets + social dislocation + toxic legislative environments = new stock market highs. Hmmmm…..somehow seems non-linear on the surface.

You are by now certainly sensing some cynicism in the start to this newsletter – a function of my failure to see the sense behind new stock market highs in the face of such intense impediments. And while the financial landscape has not been completely void of vitality, the decisive empirical evidences point more toward incrimination than exoneration.

So how can the formula above be modified or reverse-engineered to account for the ascendency in stock prices? Pretty simply apparently: by adding one variable to the existing string as succinctly stated in another headline below:

"Fed Bridges Gap to Earnings Pickup in Modest U.S. Growth." – Bloomberg, 5/9/13[8]

Yes, the Fed, the Federal Reserve Bank of the United States and their merry band of bond buyers. They have adapted a mantra initially put forth by the British government at the start of World War II, encouraging investors to: "Keep Calm and ***Carry*** On!" How does Fed bond buying calm financial markets? Primarily in three ways:

1. The Fed has been purchasing approximately $85 billion of Treasury bonds and mortgage bonds each month since September of 2012. This provides resources to the Federal government to finance the operations of our country – including but limited to its entitlement program obligations and fiscal stimulants. It also provides liquidity to the housing market to assist in clearing inventory and catalyzing the cottage industries that feed off of this host;
2. Demand for bonds (through the aforementioned purchasing process) pushes up prices while lowering yields – bond prices move inverse to their rates of interest. Such low yields serve as reference rates for pricing loans, essentially determining the cost of borrowing money. In the hallowed halls of high finance this is

Carried Away

known as the "cost of ***carry***." If the cost of carry is low, theoretically, the ability to earn a return in excess of its cost should improve, which has a natural attraction to those in pursuit of profit;
3. Lastly, when the Fed trades dollars for debt as it's done, the number of dollars in the financial system goes up a lot. Fundamentally, every additional dollar in circulation is worth incrementally less, requiring more dollars to maintain level purchasing power. For companies with sales to foreign buyers, the incrementally weaker currency makes purchases of U.S. goods cheaper (all currencies are priced relative to other currencies so if, for instance, there are more dollars in the global financial system than Euros, products priced in dollars will be cheaper, all things being equal). So, as depicted in any supply and demand model, cheaper goods result in increased demand, which equates to an increase in profitability for the selling company and improvement in both capital markets and economic conditions.

So the Fed "carrying on" as they have provides a double-benefit for the US economy– a low cost of financing and a higher repatriation of profits! This is obviously great news, right? So great in fact, other countries seem to now be getting a little "carried away" themselves.

"European Stocks Advance as ECB Lowers Interest Rates," – Bloomberg, 5/2/13[9]
"The Bank of Japan's Aggressive Monetary Policy Yielding Results," – FX Empire, 5/1/13[10]
"India's Factory Output Growth Quickens on Interest Rate Cuts," – Bloomberg, 5/10/13[11]

Much as a crowded dance floor heightens the risk of a stubbed toe, the economic self-interests pursued by each bond-buying central bank could dosey-doe its trading partners, Gangnam-style! The globally-intertwined nature of the financial system demands cross-border consideration and ultimately determines whether the world economy experiences an Electric Slide. (No more dancing references, seriously.)

And herein lay my worries and agitation, as opposed to excitement and jubilation about new stock market records being attained this year: the prospect of a currency war and the ultimate unwind of such a globally accommodative monetary policy.

In my opinion, and as indicated in the headlines above, we are currently experiencing a currency war. The world has experienced a succession of competitive currency devaluations, each with the goal of elevating the exports of their home country to bolster domestic economic growth. While economics is not a zero sum game, global supply tends to rise to meet demand, the market clearing price will elevate, perhaps dramatically so, in the presence of global monetary easing. It may not happen immediately, but unless there is a directional realignment, I feel that it is imminent. This is a kind way of describing an environment of high inflation which could slow recovery at a delicate point of the business cycle.

Inflationary environments tend to favor commodity investments and hard assets – those that we would characterize as stores of value. They also tend to slow economic growth which can make certain sectors of the bond market compelling – particularly those with short durations and embedded hedges to account for any erosion in the purchasing power of their coupons. While stocks may perform decently in inflationary environments, the sectors are more selective. A 2011 study by Ned Davis Research that was featured in a New York Times article[12] points out, "that stocks fell at an annualized rate of 1.4 percent when inflation jumped to between 4 percent and 9 percent." This fact was buttressed in the same article by Sam Stovall, chief investment strategist at Standard & Poor's when he, "looked at periods since 1970 when the year-over-year change in the Consumer Price Index was accelerating. He found eight such sustained periods, and saw that half of the 10 market sectors, on average, gained ground during those times; the others declined or were flat." To me this speaks to anticipatory (ahead of the onset of inflation) and balanced asset class diversification and selectivity in stocks, not broad index-buying.

Carried Away

Lastly, the US Federal Reserve Bank has increased its asset base (the Treasury and mortgage bonds that it buys) from $900 million in 2007 to over $3.15 trillion[13] (with a "T") as of March of this year and it is still climbing. Additionally, in each of his last two post-Fed meeting press conferences, I have perceived Chairman Ben Bernanke to be exasperated by the lack of any substantive fiscal policy on which he could transfer some of the burden of economic stimulation. As this Congressional affliction seems chronic, I struggle in my search to find any elegance to the Fed's exiting of its asset-purchasing initiative. Some of you may remember the 1983 Lionel Richie smash hit, "Stuck on You." Perhaps oddly, I've found relevance in its lyrics to the Fed conundrum on modifying its policy posture as the capital markets or underlying economy dictates. Lionel soulfully sang [my input in brackets]:

"Stuck on you [cheap money],
I've got this feeling down deep in my soul that I just can't lose, guess I'm on my way…..
Needed a friend [but Congress cannot can get its act together],
And the way I feel now I guess I'll be with you to the end,
Guess I'm on my way……. [The market is] Mighty glad you stayed."

Unfortunately the Fed cannot stay forever, as the day of reckoning will come due, in fact coincident with the maturation of the bonds that they own. I feel strongly that day will be accompanied by some significant volatility and market dislocation. Such an emergent condition argues for incorporating asset classes such as those referenced above to offset the impact of inflation. Balance has not been beneficial to start this year. Biases have favored only equities. I wish I had more optimism on the record stock market's perpetuation or possessed omniscience as to the timing of its transition, but it is evasive as the Fed's policy is without precedent.

I think that this will be a long year. I think that certain stocks in certain sectors will do well, but I think that wholesale index buying into a market at its all-time highs should be reconsidered in light of the weak underlying economic fundamentals that necessitate massive global monetary policy. Most of all, I think balance will be beneficial as we move through 2013 and the bias less asymmetric. We'll keep in close touch as we move through the year and will do our best not to get carried away.

[1] http://www.morningstar.com/invest/articles/736042-morningstar-reports-u-s-mutual-fund-asset-flows-through-march-2013.html
[2] http://www.reuters.com/article/2013/05/06/us-berkshire-buffett-idUSBRE9450AO20130506
[3] http://www.investopedia.com/terms/e/efficientmarkethypothesis.asp
[4] http://www.reuters.com/article/2013/04/26/us-usa-economy-idUSBRE93P04P20130426
[5] http://www.usatoday.com/story/money/business/2013/04/07/march-labor-force-participation/2057887/
[6] http://cnsnews.com/blog/joe-schoffstall/record-number-households-food-stamps-1-out-every-5
[7] http://www.huffingtonpost.com/2013/02/26/sequestration-debate_n_2769412.html
[8] http://www.bloomberg.com/news/2013-05-10/fed-bridges-gap-to-earnings-pickup-in-modest-u-s-growth.html
[9] http://www.bloomberg.com/news/2013-05-02/european-stock-futures-little-changed-before-ecb-decision.html
[10] http://www.fxempire.com/news/forex-news/the-bank-of-japans-aggressive-monetary-policy-yeilding-results/
[11] http://www.bloomberg.com/news/2013-05-10/india-s-factory-output-growth-quickens-on-interest-rate-cuts.html
[12] http://www.nytimes.com/2011/04/10/your-money/10fund.html?_r=0
[13] http://www.econbrowser.com/archives/2013/03/whats_going_to.html

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Carried Away

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