



KAVAR Canvas

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More Than a Feeling

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We are nearly 5 months into 2014 and it is difficult to determine a theme by which we can characterize the capital markets this year.

Undoubtedly last year was about the Soaring Stocks. And years 2009 – 2012 could have been coined the QE (Quantitative Easing) Cavalries. But 2014 lacks an identity.

I'm reminded of a classic exchange from a 1993 Seinfeld episode¹ that captures the lethargy and listlessness of the broad financial markets these days:

Kramer: What's today?

Newman: It's Thursday.

Kramer: Really? Feels like Tuesday.

Newman: Tuesday has no feel. Monday has a feel, Friday has a feel, Sunday has a feel....

Kramer: I feel Tuesday and Wednesday....

Some would say this market is a bit like Tuesday - it too, has no feel.

As a testimony to this tepidness, (as of this writing, year-to-date), the Dow Jones Industrial Average has gained just 0.179% and the Russell 2000 Small Company Index is down 3.21%, while the bond market has staged a modest rally of 2.63%². More on those bonds in a bit.

Further, as pointed out in the Wall Street Journal this morning, "the sideways action for the past five months is rare. Only twice before, in 1980 and 2010, have all three [US Stock] indexes been up or down less than 3% this far into a new year, according to Bespoke Investment Group, which tracked data going back to the Nasdaq Composite's first full year in 1972." The indexes being referenced here are: once again the Dow Jones Industrial Average as well as the S&P 500 and the Nasdaq.³

Granted, the financial news networks are not hurting for storylines and the average investor would probably describe this year as reasonably volatile, given the absence of a straight-line ascendancy in stocks.

However, the major measure of market volatility, the VIX (CBOE Volatility Index)⁴ sits near an all-time low², despite some large intra-day price swings in the first 2 quarters – already this year the Dow Jones Industrial Average has closed up or down more than 100 points 39 times²!

So why do things seem so disjointed when the measures of such are so muted? And can you stay in good financial shape when the markets only seem to be running in place?

Sources of Disjointedness (it actually is a word!)

The situation in the Ukraine. We've been riveted to the news coming out of Russia and the appetite for empire-building proffered by Putin. The sanctions imposed by the G-7 countries, economic and otherwise - as a demon-



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stration of displeasure for his annexation of Crimea and military aggressions - possess slim shear to his ambitions.

Russia's main stock market has been the primary causality of Putin's plundering, (down 10% YTD as of this writing²) but quick calibrations of Russia's global economic impact cushion catastrophic concerns, particularly in light of the European Central Bank's (ECB) contemplation of monetary stimulus.

ECB's Contemplation of Monetary Stimulus. In attempt to jumpstart the Euro region's disparate economies, and to offset any drag from the Russian renegades, Central Bank President Mario Draghi has foreshadowed a little of QE of his own⁵. The essence of QE will be the trading Euros for EuroBonds - simultaneously infusing cash into the banking system and pushing interest rates lower. More Euros equals cheaper Euros which is good for European exports. Low rates translate into loan demand, which should be good for the (Euro) domestic economy.

A comparatively more attractive international investing environment could divert attention from the US, particularly in light of our Federal Reserve Bank's commitment to "tapering" its asset purchases.

US Federal Reserve Bank's Commitment to "Tapering". By now, you've almost certainly eavesdropped on some "taper-talk." In each of the last 5 months, the US Federal Reserve Open Market Committee has reduced its outlay of bucks for bonds by \$10 billion in recognition of 2 things: 1. The underlying economic landscape has improved and needs a monetary policy reflective of such and; 2. The diminishing returns of expanding the Fed's balance sheet to the currently bloated level of \$4Trillion⁶ (with a "T") are undeniable. To wit: savers are not saving less, the mortgage market has moderated and loan demand is docile.

"Tapering is not tightening..." is a distinction drummed out by the Fed's band of governors. Maybe not, but it is certainly a precursor. When tightening (a.k.a. raising interest rates) occurs, the discounted values of future cash flows compress. This is a fancy way of saying that stock prices may be susceptible to declines if there is not profit growth sufficient to sustain or exceed current levels. Concern around such sustainability elevates around quarterly profit-reporting periods that do not demonstrate strong broad-based growth.

Quarterly profit-reporting periods are not demonstrating strong broad-based growth. The first quarter reporting period neared a close last week, with 485 of the S&P 500 companies having come to the confessional. Profits gained, on average 1.3%⁷. While all growth is good growth, expectations become embedded in prior-period price moves (the leading indicator characteristic) and can unwind sans corroboration.

Attributions for the feeble fortunes focused on legislative lapses, end-user apathy and global demand disruption, primarily of a slow-down in the purchasing patterns of China and the inflection point of its own economic progression.

The inflection point in China's economic progression. The subject of the sustainability of China's economic growth has been as hotly debated as the integrity of the data by which that growth is measured. It seems almost weekly the market is digesting the latest gauge of fiscal wellness of the world economy's second largest player. And the results have been mixed at best. For example, their national purchasing manager's index teeters between economic expansion and contraction and their GDP estimate of 7.3% is the lowest published figure for that gauge since 1990⁸.

Undeniably, the pace of growth has declined and that serves to make sense – sustaining such a parabolic progression is preposterous. The issue is less with that realization and more with the concern as to who will pick up the slack.

So here we sit, smack dab on the flat line for the year in most all equity categories. Interestingly though, the bond market has proved vibrant these first 5 months- but why?



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I believe that bids have come back (iShares Core Total US Bond Market ETF was down 4.18% in 2013²) in bonds as a manifestation of the aggregate ambiguity inherent in the 5 points above.

I think of bonds as balance sheet investments. By that I mean that making and pricing a loan (buying a bond) drives off of the solvency and liquidity of the borrower. Corporate (and many municipal) coffers are full and their creditworthiness conveys confidence, ultimately dropping their cost of financing.

Additionally, as competing investment alternatives, bonds rise in attraction as an assessment of the stock market's growth becomes less clear.

I think of stocks as income statement investments. And by that I mean that the attractiveness of a stock is directly proportionate to the shareholder's expected claims on its future growth. And if a bond yields more than the underlying growth rate of an economy within which stocks trade, preferential treatment may tilt in favor of bonds. I think we have seen some of that treatment so far in 2014.

So, can you stay in good financial shape when the markets only seem to be running place?

In a word, yes. The challenges that we dissected above are serving to keep the valuation of the stock market in check and I think that is healthy. By valuation, I mean the premium that an investor is willing to pay for a stock above its book value – aspirational vs. evidentiary investing.

Coming out of 2013, one could say that balance had been somewhat abandoned as stocks seemed the only asset class to own. But reacquainting with risk is a beneficial by-product of meek market moves and hopefully emphasizes the importance of total return investing principles.

Investing for the total return emphasizes income and appreciation, and that is a key focus of our investment strategy at Kavar Capital. Such an emphasis demands the consideration of multiple classes of assets, not just any singular, sometimes slippery, sensation.

In consideration of a “flattish” market this year, fundamentally, just as many stocks will be up as down. Refining our filters to ascertain areas of opportunity is challenging but a worthy pursuit in this stock market. Buttressing our biases in equities with the balance sheet benefit of bonds gives comfort in the event that actual volatility accelerates.

So yes, you can stay in good financial shape in markets like those we are confronting - and that can feel good even in a market that has no feel.



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¹<http://www.seinfeldscripts.com/TheSniffingAccountant.htm>

² Source for all quotes market indices is Bloomberg Market Data. Bond Market performance references the iShares Core Total US Bond Market ETF.

³<http://blogs.wsj.com/moneybeat/2014/05/27/morning-moneybeat-record-highs-and-big-round-numbers/>

⁴<http://www.investopedia.com/terms/v/vix.asp>

⁵<http://www.ft.com/cms/s/0/618c410e-bb3b-11e3-b2b7-00144feabdc0.html#axzz32v2xN9FX>

⁶<http://www.bloomberg.com/news/2013-12-19/fed-assets-reach-record-4-trillion-on-unprecedented-bond-buying.html>

⁷<http://www.zacks.com/commentary/32690/another-weak-earnings-season-coming-to-an-end>

⁸<http://www.bloomberg.com/news/2014-05-01/china-april-manufacturing-grows-less-than-economists-forecasts.html>

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