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AGT: America's Got Tapering

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For what seems like an eternity, when I arrive home from work, my children have been glued to the current season of NBC's ***America's Got Talent***, (aka: AGT). And each night while watching them watch with fixation, I've asked my wife: "When is this season going to end? It seems like the same acts have been on forever and we're not even to the quarter finals." Kudos to the programming directors for stretching out the competition and attendant drama, replete with heart-warming stories of the performers and cheeky critiques by the celebrity judges.

Then upon arriving back at the office in the morning, I tune into a different version of AGT – every bit as agonizing with even *more* diverse bits of cheeky critiquing – overshadowing the financial markets that I like to call, ***America's Got Tapering***.

The term "tapering" is in reference to the progressive reduction of asset purchases currently being carried out by the Federal Reserve Bank (Fed) to promote their monetary policy initiatives. When the Fed purchases assets – both US Treasury bonds and mortgage-backed securities (MBS) - they inject capital into the economy and reduce its cost (the greater the supply of dollars, the lesser the incremental value of each) in the form of low interest rates. This provides an incentive for businesses and individuals to borrow money for investment or spending, thereby boosting economic activity.

Such boosted economic activity is intended to catalyze employment growth which is beneficial up until it instigates inflation. It is the measure of employment and inflation (a.k.a. price stability) that the Fed monitors as it crafts its policy initiatives. Finding the sweet spot along the policy continuum is challenging based upon: 1. The breadth and depth of the global business cycle and; 2. The presence or absence of collaborative fiscal policies coming out of Washington.

Since the 4th quarter of 2008, the Fed has been very aggressively, (based on the historically unprecedented scale), purchasing assets[1]. The initial intent was to re-liquefy the floundering banking and housing markets but has transitioned into buoying consumer confidence and compensating for Congressional ineffectiveness.

Until just recently, there was no specific timing mentioned of a course reversal or suspension by the Fed. Conversely, their post-meeting communique had contained references to "targets"[2] – a 6.5% unemployment rate (currently 7.4%[3]) and a 2.0% inflation rate (currently 1.7%[4] using their preferred measure of consumer prices) – along with quasi-commitments of persistence beyond attainment if necessary.

You can imagine then, how dislocating it became when the Fed modified its approach to modification, embracing what can now only be called an anticipatory posture. For almost 5 years, highlighted by a crazy credit crisis, Euro-zone fraying, Arab Spring(s) and political bi-polarity, the Fed has been there, doling out dough, and both bond and stock indices have celebrated (see charts below). So the markets can be forgiven for spastic transitional behavior, invoking comparative imagery among pundits to the withdrawal symptoms experienced by an addict of any elixir. From here, I believe, the transition has 2 parts – the actual and the awaited.

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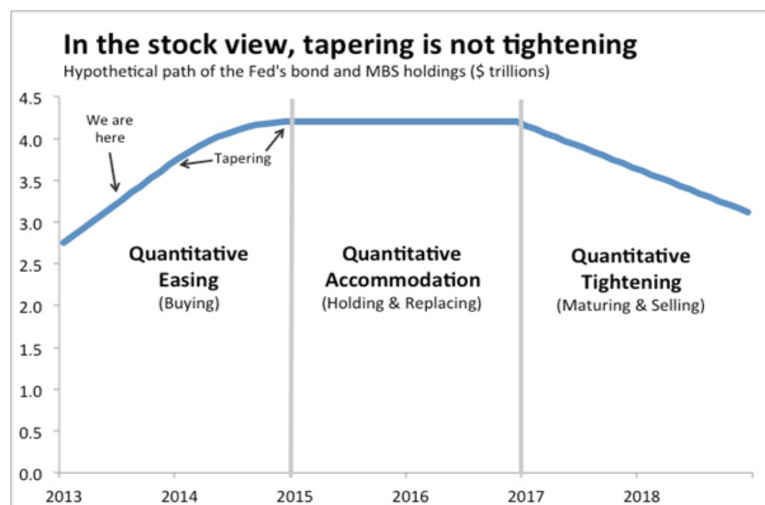
U.S. TREASURY PERFORMANCE DURING FOMC ACTION
MARCH 18, 2009 THROUGH JUNE 3, 2013

Source: Federal Reserve, FactSet Research Systems
Data is assumed to be reliable. Past performance is no guarantee of future results.

S&P 500® INDEX PERFORMANCE DURING FOMC ACTION
MARCH 18, 2009 THROUGH JUNE 3, 2013

Source: Federal Reserve, FactSet Research Systems
Data is assumed to be reliable. Past performance is no guarantee of future results.

The Actual. Much as the Fed has harkened in the wake of uttering the term, "taper," it does not equate to "tightening". See the chart below for a good theoretical graphical interpretation of the logical progression of the Fed's monetary policy, courtesy of dmarron.com.



The Fed has stressed that the "tapering" is merely a reduction in the magnitude of asset purchases, analogous to how an automobile slows its speed when approaching a stop sign, but does not jam on the brakes. Given its clear articulation of this transition, it embeds an expectation of rational market realignment. But nothing resembling rational has taken place.

While the chart above may characterize the apathetic advancement of this adaptation, it does not capture the emotional, and financial markets are nothing if not emotional. See the chart below, also from dmarron.com, for a more explanatory and anecdotal assessment of the market's interpretation of the "taper".

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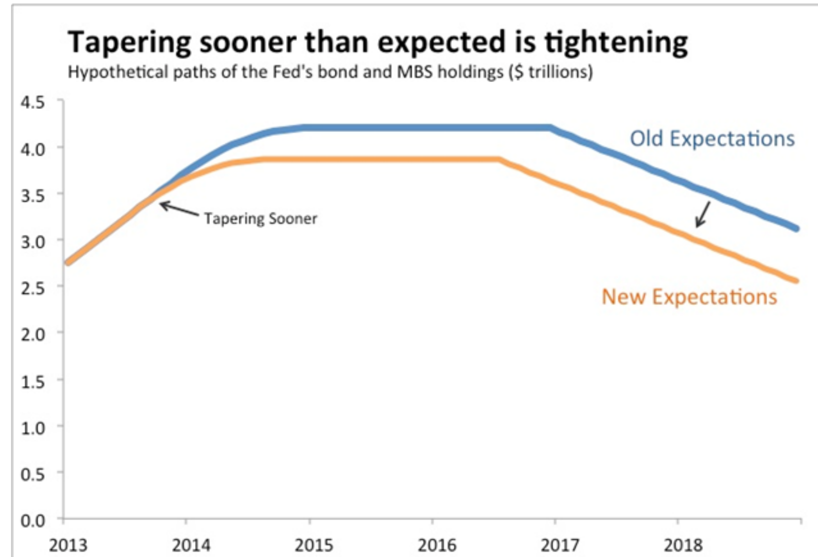

In an attempt to pull-forward the prospective impact of its monetary policy initiatives, the market has essentially attempted to front-run the Fed. Often described as discounting mechanisms, financial markets hurriedly aspire to interpolate the impact of current data into future prices and establish positions preemptively. Such seems to be the case in the "taper" scenario as you recall: both the unemployment and inflation targets are still a decent distance from the Fed-imposed inflection points, yet the market has moved on.

The Awaited. A fundamental principal of asset allocation drives off of the concept of expected return. Regardless of the asset class, the determination process formulaically considers prospective outcomes and their attendant probabilities.

At Kavar Capital, we subdivide all investments/securities into three broad classes of assets: stocks, bonds and alternative assets. The calibrations of the expected return for each asset class possess both macroeconomic and security-specific drivers. And for all three, the state of the Fed's monetary policy weighs in.

To characterize the state of that monetary policy as, "in flux", or, "uncertain", would be apropos, demanding, in our opinion, less speculation, less interest rate sensitive leanings and more "protection" from persistent volatility. I apply these priorities to the aforementioned asset classes below:

For stocks: focus on value-oriented companies (thru direct ownership or thru fund vehicles) that pay dividends and produce high returns on capital[5]. As interest rates increase, so too may a company's cost of capital, potentially skewing growth projections. We favor efficiently profitable operating companies with diverse bases of revenue and proven track records of capable execution.

For bonds: focus on short duration, high-quality bonds may forgo current high-income in exchange for greater principal stability than their longer-dated brethren in the presence of rising rates – recall that bond prices move inversely to interest rates. Bond "surrogates"[6] may experience volatility in their prices as investors look to track back into plain-vanilla bonds at more favorable future yields.

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For alternatives: consider those securities that strategically look to preserve principal through owning stores of value and are wagering that rates will rise – accomplished through fund vehicles. Perhaps best-suited to protect against the threat of future inflation - a transitional Fed, previously intent on boosting inflation (remember the 2.2% target vs. current 1.8% level) could have feasibly over-stimulated - and were the economy to improve, I think it heightens the prospects of more significant inflation.

Not unlike ***America's Got Talent***, the ***Tapering*** version may possess many twists as it approaches its finale. Rare is the case when the market provides foreshadowing like it has when assessing its response to the mere mention of the act of "tapering", perhaps presciently. It is incumbent upon us, as your advisors, to navigate the drama, to adhere to the disciplines of expected return and to allocate consistently with the objectives of each client.

[1] http://www.frbsf.org/economic-research/publications/economic-letter/2012/november/federal-reserve-unconventional-policies/
[2] http://www.foxbusiness.com/economy/2013/07/31/fed-statement/
[3] Source: Bloomberg Market Data
[4] Source: Bloomberg Market Data
[5] (Net income - Dividends) / (Debt + Equity), source: http://www.investinganswers.com/financial-dictionary/ratio-analysis/return-capital-3054
[6]Examples of bond "surrogates" include preferred stocks, closed-end bond funds, convertible bonds, real-estate investment trusts and master limited partnerships. Bond "surrogates" typically possess higher yields than traditional bonds and are often incorporated into portfolios when it may make sense to favor income over principal stability.

IMPORTANT DISCLOSURES:

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