KAVAR Canvas

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January 2013
Issue XI

How to Fight when the Fed is Fighting

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Maybe it's because I'm a parent of 3 young children, or maybe as a middle child myself I have a deep desire for harmony in my daily dealings. Regardless of the reason, I've been increasingly agitated by the recent cacophonous crowing inside, and spilling out of, the Federal Reserve Bank. It began a couple weeks ago, on January 3rd, with the release of the minutes from December's Federal Open Market Committee (FOMC) meeting and some of the headlines that followed:

Fed Minutes Show 'Greater' Degree of QE Uncertainty, RBS Says – Bloomberg Newswires
Fed Split Over When to Halt QE3 – Financial Times
Federal Reserve minutes expose rift on when to end stimulus – LA Times

Wait a minute….headlines about the Federal Reserve Bank laced with the words: "uncertainty," "split" and "rift"? These aren't the Kardashians for crying out loud – this is the Fearless Fed! The same Fearless Fed that tossed the weak economy on its back in 2007, 2008 and 2009 by lending money where no other central bank would….by accepting collateral that no central bank should….and by globally coordinating liquidity as only they could. For his innovative efforts, Fed Chairman Ben Bernanke was even named Time Magazine's Man of the Year in 2009! And in a country gone politically mad (I'll suppress the list of headlines ascribing to this point in an effort to keep this newsletter under 1,000 pages) the Fed's cohesion has been comforting. So maybe this infighting was intentional, you know, some good wonkish wordsmithing to expose the investor populace to some non-neutral neuron-firing? Maybe, but then it continued:

1/11/13: Fed's Plosser Says Stimulus May Backfire, Fuel Inflation – Bloomberg Newswires
1/14/13: Fed's Evans: Conditions to Raise Rates Could be in Place by 2015 – Wall Street Journal
1/15/13: Fed's Kocherlakota Says Monetary Policy Not Aggressive Enough – Wall Street Journal
1/16/13: Fed's Kocherlakota: Fiscal 'Uncertainty' Constraining Investment – Bloomberg Newswires

OK, this is unsettling. For decades, traders and investors (there is a difference) have been adhering to a specific and succinct saw - one that aligns asset allocations with opportunities consistent with the central bank's communique, and it goes like this: "Don't Fight the Fed."

A quick clarification tangent: When the Fed enacts monetary policy, it is with the intent of being either accommodative or restrictive. Both typically involve something called "open market operations" whereby the Fed purchases (accommodative) or sells (restrictive) government securities in the open market. These operations alternatively expand or reduce the supply of money in circulation. This flow chart may make the intent of each more clear:

Accommodative Monetary Policy	Restrictive Monetary Policy
Fed purchases government bonds from banks;	Fed sells government bonds to banks;
Money supply increases;	Money supply decreases;
Banks lend money in excess of reserve requirements;	Banks lend less money so they can comply with reserve requirements;
Lending rates decline to stimulate demand;	Lending rates rise to deter demand;
Borrowers are confident that they can invest at rates of return higher than their cost;	Borrowers have a harder time investing at rates of return higher than their cost;
Economic expansion transpires!	Economic contraction transpires.

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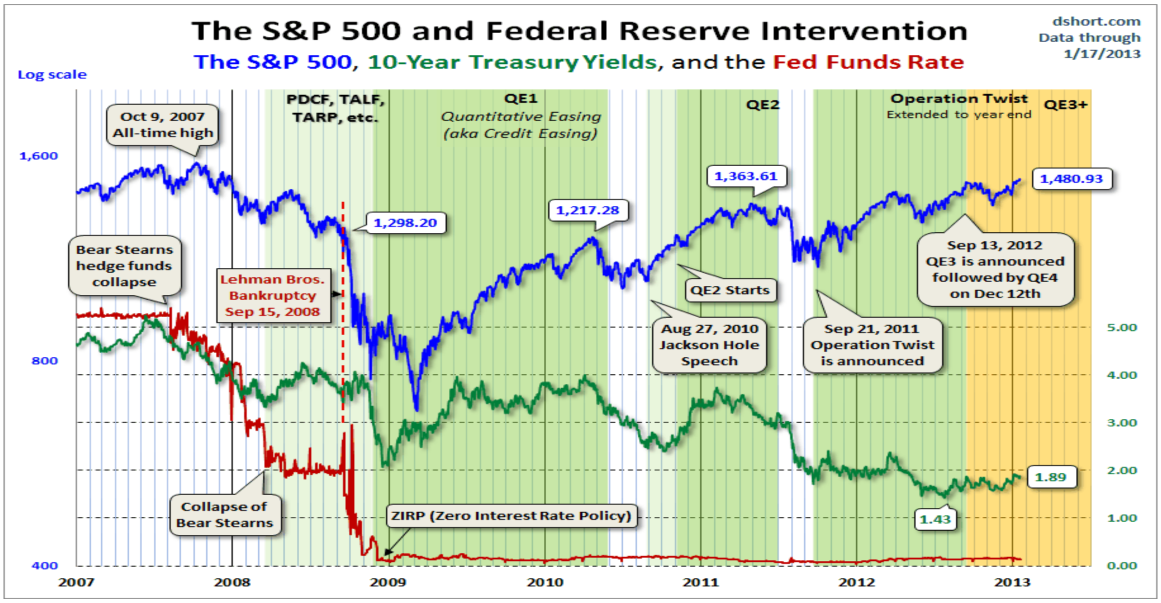
And as the graph below indicates, going back to 2007 the Fed has been abundantly accommodative – keeping interest rates low by enacting open market operations under the pet names of Quantitative Easing (QE) 1, 2 & 3 and even something we wrote about last year, fashionably referred to as Operation Twist. In response to these policies, stocks prices have been in a positive trend and bond yields have been in a negative trend (keep in mind that bond yields move inversely to bond prices). Could it really be this simple, the Fed engages in accommodative monetary policy and both stock and bond prices just go up? Perhaps it can be, but only until it isn't.



And so the question becomes: ***how does an investor not fight the Fed when the Fed is fighting?!?*** In a word: defensively and diligently. Wait, that was two words. That's correct, which seems appropriate as we contemplate what is known as the Fed's ***dual mandate***. Back in 1977, Congress christened the concept of the dual mandate when they amended the Federal Reserve Act, defining the monetary policy priorities of the Federal Reserve as:

> "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of (1) maximum employment, (2) stable prices and (3) moderate long-term interest rates."[1]

Far be it from Congress to get bogged down in the details, like counting (last we checked, dual meant two) and there are many sub-mandates embedded within each of those 3 stated. But perhaps the internal sniping is a by-product of the pressure attendant to a prospective policy transition as the underlying economy has advanced toward the Fed's goals. To wit: the unemployment rate has dropped[2], inflation has moderated in areas like commodities[3] and interest rates are well below historical averages[4]. There certainly is a risk of being overly accommodative. There is also a risk of a growth reversal should the Fed become too restrictive too soon. The lack of unanimity among the Fed governors on the data interpretation may be prompting the verbal sparring.

Think of this tension in the context of a common New Year's resolution – getting in better shape/being healthier. I'm no fitness guru, but fundamentally, getting in shape consists of both eating well and exercising. A balance is critical though rife with rigidity. While weight loss is customarily associated with being in better shape, its presence can be deceiving. Starving oneself may assist in shedding unwanted pounds, but a lack of nourishment is nullifying. Certainly quick fixes are available on any infomercial, but their sustainability is suspect. Much as in monetary policy, an effective fitness plan considers the natural

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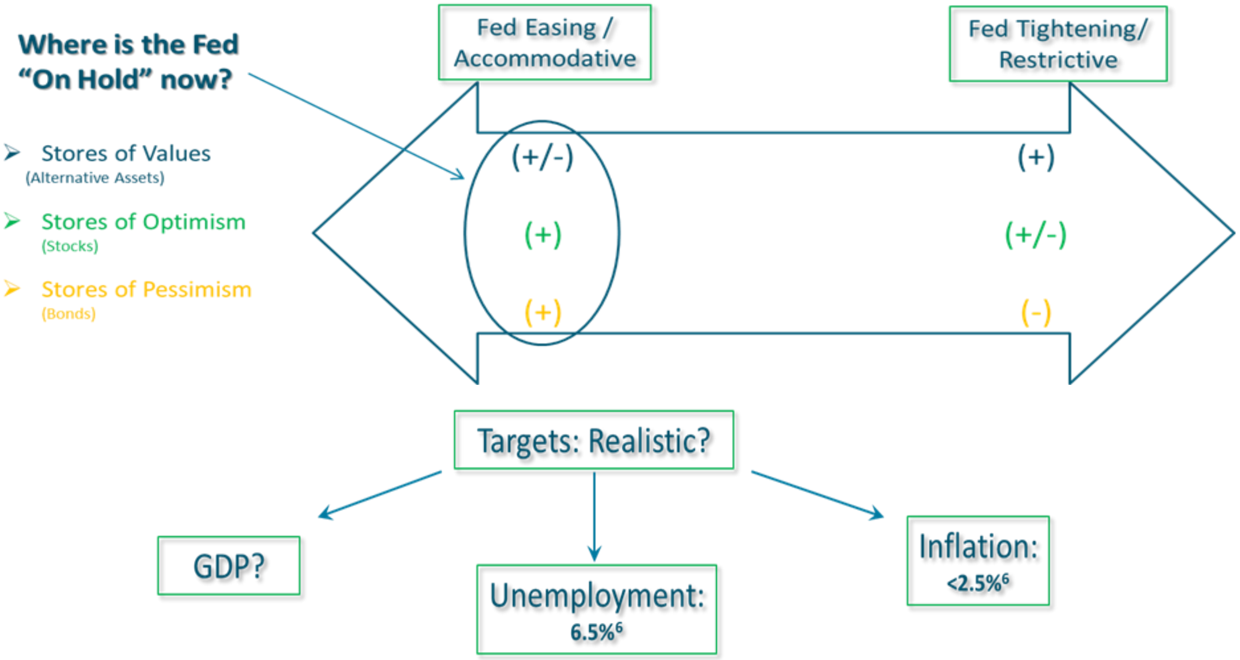
tendencies of the participant in addressing the nuances of implementation and modification. Ideally, the Fed would like to wean the investment community off of its low-rate largesse and migrate into maintenance mode. However, similar in vein to the convincing and cut spokesman for the P-90X Beach Body Work-out, the whole proposition is easier said than done.

So let's go forward and consider our personal dual-mandate for managing portfolios through this monetary policy inflection point. As mentioned above, we intend to act both defensively and diligently.

Defensive. Much as we'd wish that Gross Domestic Product (GDP) growth were somewhere in the 5-7% range, we're hovering at right about 2.5%.[5] While still positive, it is hardly parabolic. Therefore aligning portfolios with investments that can prosper when the economy does not is imperative. We believe that within the equity asset class such an opportunity is present in defensive-sector dividend-paying stocks. Classic defensive sectors are those like consumer staples, utilities and certain healthcare areas. Within the fixed income asset class, we are eyeing opportunities in both: 1) the municipal bond market, whose attractiveness arguably elevates with a percolating though not popping economy, and 2) inflation-adjusting fixed income instruments – both floating rates and those issuers whose collateral is tied to the elevating fortunes of corporations or countries (mostly the convertible debt of companies and the bonds of emerging markets). And within the alternative asset class (what we have long referred to as the "Store of Value " Asset class) we think that hard assets such as gold can be beneficial in the event that the transition is inelegant in its application and spawns volatility that craves some cushioning.

Diligent. As with any effective health and wellness program, a fastidious focus on feedback is critical to making progress. To that end, we have created a matrix to assess the prospective influence(s) of Fed policy amidst the preponderance of public bickering. Less so a scale (which is impersonal and definitive) than a BMI (body mass index - which incorporates more subject-specific criteria) measure, our matrix considers Fed policy and its influence on asset classes as it tracks toward its stated goals. As we move through the New Year, we look forward to updating this matrix as Fed policy unfolds.

Feasibly in the Fed meetings this year, we'll experience some directional coalescing which equates to actionable open market operations and alter our outlook accordingly. Until that point, we'll remain defensive and diligent. Not fighting the Fed has historically seemed a good source of fiscal fitness, but like all adages, (and health-improvement regiments), it can only be proven if rigorously tested.


Where is the Fed "On Hold" now?
Fed Easing / Accommodative
Fed Tightening/ Restrictive
Stores of Values (Alternative Assets)
Stores of Optimism (Stocks)
Stores of Pessimism (Bonds)
(+/-)
(+)
(+)
(+)
(+/-)
(-)
Targets: Realistic?
GDP?
Unemployment: 6.5%6
Inflation: <2.5%6

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[1] http://www.chicagofed.org/webpages/publications/speeches/our_dual_mandate.cfm
[2] *Source: Bloomberg Market Data*
[3] *Source: Bloomberg Market Data*
[4] *Source: Bloomberg Market Data*
[5] *Source: Bloomberg Market Data*
[6] http://money.cnn.com/2012/12/12/news/economy/federal-reserve-stimulus/index.html?iid=EL

IMPORTANT DISCLOSURES:

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