Tuesday, April 05, 2016

Welcome to Spring! Wait no; still looks like winter now… repeat as necessary!

January markets, aaaah! February markets, eh. March markets, Ummmmm? Feels like the weather! Those are my observations of what people seem to feel about markets today. Some of you are very bearish, others bullish. Why is this? What is causing such a dichotomy? More importantly… who is right?! Unfortunately, the only way to know, is to wait and see. None of us can predict the future with enough certainty to make it profitable to time the markets consistently over time. But the picture below presents some clues as to what has been going on and may provide some insight as to some of the risks and opportunities that present themselves today. First; whenever investing, we need to remember a couple of things:

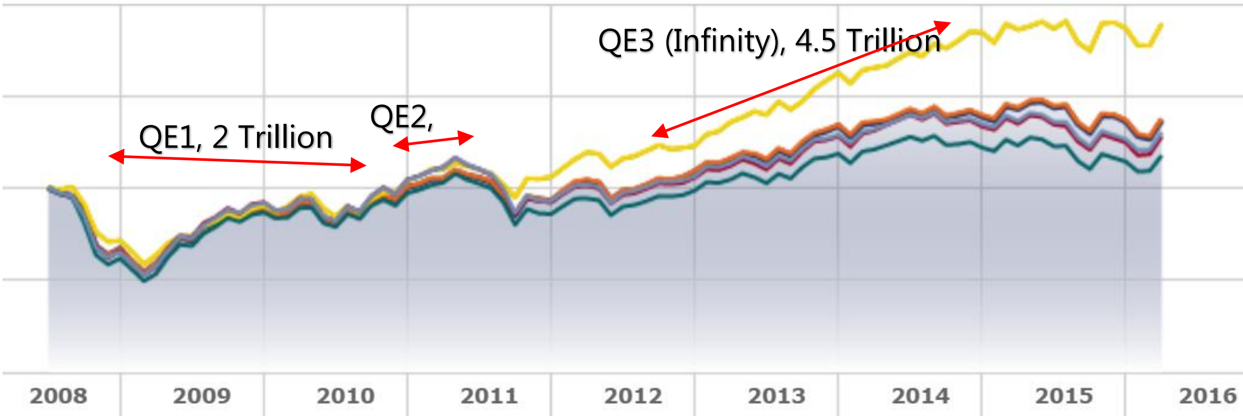
Stocks are way of investing in **Equity, ownership** of real assets or operating entities. The ability to own these assets is pre-supposed upon concept of title or ownership which pre-supposes the rule of law universally enforceable over citizens AND government. Stock ownership creates real risk for the owner who must protect their property and manage it, but real returns as well because should an asset be retained over time its price will reflect any change in prevailing prices of similar assets (inflation or deflation), and in the case of operating entities (companies), profits or losses in addition to the effects of inflation or deflation.

Bonds are a way of investing in **Debt, lending** of currency or assets, for the promise of a specific return, interest, and the repayment of principal, either an amortization schedule over time (like a mortgage) or a maturity date like a bond. This ability pre-supposes the sanctity of contracts, legally enforceable contracts which also pre-supposes the rule of law universally enforceable over citizens AND government. In this sense 'citizens' is used broadly to include market participants such as companies.

Thank you western civilization! So why does all this matter? It matters, because while businesses will survive and thrive and capitalism will endure and dominate so long as the rule of law exists, government activity can either make that a little easier or really screw it up.

I believe the chart below illustrates the impact of the US government screwing it up. In it you see at the far right, a bunch of lines grouped together and ending down low, these are different measures of one index of all global stocks, and one security, Vanguard Global Stock (VT – 7,352 stocks), which seeks to own every investable stock in the world in an amount equal to its relative size in the world (capitalization weighted amount). **The yellow line is the S&P 500 Index.** I have drawn on the chart the timing and amount of each of the economic stimulus programs implemented by the US Federal Reserve in its efforts to achieve its mandate of economic stability through low, but not negative inflation, (2% target), and its additional new mandate of full employment. Yes, for you economists out there these can be contradictory goals.

Yellow Line – S&P 500 Other lines – Global Equities (Foreign and US)



So for the simple part of the chart, the beginning where the S&P 500 declined by 58% peak to trough. This was the first example of the government really screwing it up. I blame the government because it sets the table for the behavior of citizens, it stimulated investment banks to make securities out of your mortgage, caused Fannie Mae and Freddy Mac to buy them in a volume they could not manage the risk of, and then allowed mortgage originators to write loans without any consideration of the risk being assumed, and citizens to buy homes they couldn't afford because they could so easily be monetized with more debt or another buyer. The stimulus occurred over the course of at least four presidential terms increasingly pushing law and rules changes to increase the "affordability" of mortgages first, and in the final stage, the "accessibility" of mortgages. This was done to the point of incentivizing unbalanced behavior in the private sector. Essentially government incentives and rules changes tried to eliminate the negative consequences of writing bad loans, (so more loans would be written, and also make it easier to get them, so people who didn't understand what they were doing could get them too. Government did this very well, and the private sector created securities that fed it what it wanted more of until the whole system gorged on it until it vomited. A form of government stimulated private sector economic bulimia.

Quantitative Easing as it is now called worked. But I believe it may also represent another example of the government screwing it up. We don't know the end of this story yet. It stimulated the indices the government uses to gauge the health of the economy. Unfortunately, those measures, since they are designed to measure the whole economy work most easily when the things they measure are huge, not small. So bigger companies have a bigger effect on the measures and those with bigger incomes have a bigger effect as well. Little companies and little incomes don't show up well. So while it worked, there is a good chance it didn't float your boat so much as it did others. Quantitative Easing, is like most government programs, not at all what it sounds like. Meaning it isn't "easing" anything for us! It should be called *creating trillion of dollars to buy bonds Treasury issues to spend money we don't have while driving down interest costs by keeping interest rates on your savings criminally low*. It is the process of the Federal Reserve using its ability to create new money, and using that ability to buy from the Treasury Department and the open market (where you and I buy bonds), both federal and mortgage backed bonds. The reasoning at the start was that in a crisis it helped "save" bondholders by increasing demand for bonds and in economics 101, increased demand equals higher prices for the bonds! Yea! Win-win! Oh, but wait a minute, these are bonds, so when bond prices go up, or are artificially held up, doesn't that mean that the yield on the bond goes down? Or at least never goes up? **So the first QE makes sense then doesn't it?** We really were worried about the collapse of the US economy, markets and much of the global economy. **The second QE also seems to make some sense,** because it did look like the economy could slip back into the crisis again. **BUT QE3, or QE Infinity!?** That looks a bit like the behavior of a junkie. More and more stimulus when the economy was growing, and jobs were growing, and markets were growing! The proof is in the chart, look at the market and recall the economy during that time. Compare the US to the world (and that is including the US!), and you can see what happened here happened nowhere else. But what happened here didn't actually happen for most of us did it? Maybe a bit in our 401(k)'s and IRA's. The Trump and Sanders phenomenon in this year's election cycle is proof that this wonderful chart only floated oh, maybe 1% of the boats.

So what? The so what is that your money is riding that yellow line. The junkie is trying to get clean, raise interest rates, and someday start letting that balance sheet mature away over 30 or 50 years. But look what it did, monetary operations created 7 trillion of debt (the currency to buy those bonds into the federal reserve) in 7 years! That is essentially in addition to the annual budget deficits (fiscal operations)! Do you think that it is likely to allow the cost of that debt, meaning the yields you earn on the few bonds you own, go up? Maybe not anytime soon.

The rest of the world has taken this brilliant strategy and adopted it for its own over the last year. Federal reserve banks have begun buying their own and even commercial debt on the open markets with "new" money they create. They want those lower lines on the chart to catch up with ours! But like junkies they have (with but one exception) juiced their QE efforts with another awesome tool! Negative interest rates on their reserves, and in some case even on bonds being issued! Meaning if you buy their bonds, or save in their banks holding negative rate reserves, you have to pay them for the privilege of accepting their debt as a place to preserve the purchasing power of your (their) currency! Of the global reserve banks, the US, Canada and UK have set their rates at 0.5% currently, EVERY other reserve bank's reserve rates are negative!

Keep in mind when you review the chart, that historically, foreign growth rates have been higher than the US. Primarily due to the later development of modern economies elsewhere producing the higher risk and higher growth rates that come with early stages of development. Keep in mind also that US markets are currently fairly to over-valued, implying higher risk of decline, and are more highly priced on a raw basis than are foreign markets. However, systemic risks in foreign do still seem greater than US markets particularly emanating from the middle east, China, and Russia. Then, while US markets have recently experienced a peak to trough decline of more than 10% they did not reach 20% or bear market territory. On the other hand, foreign markets have been in decline for an extended period (1-3 years and more) and have seen declines from 20% to 40+% indicating potentially valuable buying opportunities (remember 'buy-low, sell-high'?). Troubles everywhere. Same old stuff, different day, there are always troubles, so....

What we are doing:

Each of our portfolios has a strategic structural allocation. **We allocate in three sleeves, Debt or Bonds, Equity or Stocks, and Hybrid.** The latter includes global asset allocation and multi-strategy Managed Futures managers. In the Equity sleeve, at least one half of the strategic target of the model (for example 25% of the balanced model's equity allocation) will be in the most globally diversified index or index like security affording that exposure. The 2 securities we now use interchangeably here actually hold 7,000+ and 9,000+ stocks respectively! Both offer extraordinary equity diversification at a very low cost and serve to reduce the need to trade immensely. We allocate 15% to 30% in the Hybrid sleeve which provides the most of the active element as well as the sliding exposures to equity, debt and trading strategies deemed effective by the very best managers we can find in that role. This slice generally consists of three equally weighted securities, two very different global asset allocation managers and a multi-strategy Managed Futures manager. We expect almost equity level returns from these managers over a 7-10 year cycle, and a strategic equity exposure of 50-67% of their assets. These three different managers have recently all reduced the equity exposure of this part of the portfolios by ½ to 2/3s! I trust the judgement of these managers a great deal. They are each investing your dollars as though they are their own as each has substantial dollars invested in their own strategies.

Currently, primarily due to the Hybrid sleeve managers, the equity allocation of our portfolios is lower by 10-15% (that is a 2-5% reduction in stocks) in our Capital Preservation and Conservative models, 10-12% lower (that is a 5-9% reduction in stocks), in our Balanced and Moderate models, about 9% lower (6-8% reduction in stocks) in our Opportunity Models and about a 5% reduction in our Max-Equity models.

I welcome your comments and questions. Please contact me with any changes in your financial profile or life and if you have not worked with Trevore or me to see just what the expected risk is of your actual portfolio in a typical environment or in an extreme scenario, we can show you and we can help you to adjust your return and risk elements of your portfolio to one that is more suitable. Sometimes we are able to use unique and non-investment planning techniques to assist you in both reducing volatility to within your comfort zone while still identifying appropriate sources of return. Have a great spring (soon I hope!)

Sincerely,

Benjamin G. Baldwin III, CFP®, ChFC
President