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Don't Fight the Fed

The rollercoaster ride that the stock market has witnessed over the past 6 months continued in the third quarter, but this time, with an upward bias. Despite growing fears of a double-dip recession, the S&P 500 was up 11% in the quarter, and up 2% for the year. The rise was initially the result of the Federal Reserve discussing the possibility of "QE2", a second round of quantitative easing. Once this card was on the table, there was an inverse relationship between 'unusually uncertain' economic data, and the probability of QE2. Since the stock market is a discounting mechanism, stock prices rose on the expectation of a boost to near-term growth. The rally then was further supported by an expectation of a change in Congress. In order to make this a truly sustainable recovery, we still need a return of animal spirits, leading to higher spending for both consumers and corporations.

The Federal Reserve is gearing up for action. According to William Dudley, president of the New York Federal Reserve Bank, "Viewed through the lens of the Federal Reserve's dual mandate – the pursuit of the highest level of employment consistent with price stability, the current situation is wholly unsatisfactory. Given the outlook that the upturn appears likely to strengthen only gradually, it will likely be several years before employment and inflation return to levels consistent with the Federal Reserve's dual mandate." The FED needs to reflate. Quantitative easing is one of the few tools left at their disposal. While a second round of QE is potentially less effective than a reduction in the federal funds rate, it is, nonetheless, better than taking no action.

But despite having the monetary spigots wide open, confidence has been declining. The gloomy headlines consist of the sovereign debt crisis in Europe, the uncertainties coming from healthcare, financial, and tax reform in the US, the lowering of GDP growth estimates, and persistently high unemployment. Corporations have yet to feel comfortable enough to put to work the $2 trillion of cash that is on their balance sheets. Consumers are timid about buying a new home with mortgage rates at a record low of 4.27%, and home prices off some 30% from their highs. What else can be done to raise confidence and help the job market? There are two primary options on the fiscal side of the table. First, government could put in place a new round of fiscal stimulus such as tax cuts, business tax breaks, and infrastructure spending. Second, consider creating a credible longer-term deficit reduction program. Why not do both? Unfortunately nothing will get done until after the November elections, and then we'll see who has the power and whether stimulus, austerity, or deadlock will be the marching orders.

We are a global economy, and the actions we take domestically, affect the world. A side benefit of quantitative easing is a decline in our currency, which should help bolster our exports. However, we are not the only country experiencing a slowing economy. Japan wants to actively weaken its currency, and Europe, in the midst of its own debt crisis, is unhappy to see its exports become more expensive. Then there is China. Due to its strong growth, countries around the world have been asking China to allow its currency to appreciate. However, since the yuan is linked to the dollar, whenever the dollar weakens, so does China in relation to the rest of the world. What is emerging is the possibility of currency wars. The global central banks worked very well together in 2007/8/9. We can only hope that they have the courage to do so again.

In the end, we believe it is likely that we will receive more stimulus, whether it be monetary or fiscal, or some combination thereof. This will provide a positive near-term boost to economic growth. But what we really need is a return of animal spirits, and it is unclear at this point how and when they return. But once things start improving again, watch out for tightening of monetary policy, tax increases, and spending cuts. We have trillions of debt to pay off. Hence, expect the roller coaster ride to continue for a while yet.

During the past six months we have taken the opportunity to rebalance your portfolios in the expectation of this volatile environment. The stock market is being driven by traders, and thus we have been more proactive in adding to or trimming from positions. Our strategy has been to focus more on total return (companies with high dividend yields), and more on those companies selling at a reasonable price relative to their growth rate. Through this strategy we have a foot in each camp – both defensive and offensive. Early in the second quarter we raised cash.

We find the bond market to be completely frustrating. Yields have fallen to historic lows, prompting many to think that we are in a bond market bubble. However, what we find frustrating corporate America finds enticing. IBM issued a 3-year note at 1% and a few months later Microsoft issued at under 1%. We are hopeful that all this money will soon find its way into the hands of investors in the form of dividends or buybacks, or in the form of capital spending. Nonetheless, when possible, and where appropriate, we are looking elsewhere for yield – either in stocks, MLPs, preferred shares, or REITs.

We believe the time we're spending slogging along at the bottom is time we're spending healing our ills. We're building a base from which we can advance with confidence as consumers learn to behave more rationally. Good businesses use times of uncertainty to restructure and reposition themselves for the eventual rebound. Rebounds always happen, just not as fast as we'd always like them to occur.

Please feel free to contact us with any questions or comments. Thank you, again, for entrusting us with the management of your money.

Sincerely,

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