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2013
2nd QUARTER

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The Equity Market

All Eyes on the Fed

By Sarah Potter
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If the market had eyes, they would most assuredly be set, unblinkingly, on Federal Reserve Chairman Ben Bernanke. After casting a blind eye to fiscal issues and policies for most of the start of 2013 and rallying, without hesitation, despite causes for concern that still loomed, all it took was the ever-powerful Federal Reserve Bank to rear its head in June to bring the stock market down. In what has seemingly become the norm, good news is bad news for the markets. The Fed perceived better economic health and enough improvement to simply mention the idea of tapering off on quantitative easing, and the market began to shudder with fear in June.

The Market Took a Turn in June

After months of rallying that led the Dow Jones Industrial Average and S&P 500 Index to new highs towards the end of May, we saw the Fed start to float trial balloons about beginning to pull back on QE3. Even without any clear declarations about when or how much tapering, almost immediately, the market began trying to sort out whether improvements resulting from QE3 are sustainable with the program tapering off, or whether it has been artificially built up. Then, following the Federal Open Market Committee meeting on Wednesday, June 19, and Ben Bernanke's press conference speech to address the Fed's economic outlook and fiscal policy plans, the market took a beating, complete with across the board sell-offs in stocks and bonds.

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Vince Russo,
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The Bond Market

2nd Quarter Overview

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In last quarter's overview, we discussed the potential volatility easy monetary policy can create in the capital markets when market participants begin to anticipate that a change in policy is imminent. Well, that change in expectations is upon us. This quarter's overall performance for bonds was dismal and may have caught many investors by surprise at how quickly the market could change. Most bond funds show negative returns for the year after one of the worst quarterly sell-offs. One would have to go back 2½ years to find a quarter where most bonds lost money. The Barclays Intermediate Government/Credit Index lost 1.7% for the quarter and is down approximately 1.45% year to date as of 6/30/2013. This quarterly performance is the third worst in the last 20 years. Those occurrences that were worse happened at the beginning of tightening monetary policy cycles (March, 1994, and June, 2004). While the Federal Reserve has not yet begun a tightening cycle, the market has certainly begun to price in a change.

We've seen a steepening of the Treasury yield curve, as well as rising interest rates for maturities of 3 to 30 years. The longer maturities have felt the biggest decline. The curve is the steepest it has been since the end of 2010. Treasuries are not the only sector to have lost value over the quarter. Corporate bonds have also lost value due to increasing risk premiums associated with widening spreads to US Treasury notes. Historically, corporate bonds have performed better during periods of rising interest rates because they have a built-in buffer in the form of wide spreads to Treasuries. However, during this cycle, credit spreads have decreased to the point where further appreciation is limited because of the overall low interest rate environment. So, we're seeing pressure on credit spreads, as well. Most high yield (junk bond) sectors, especially those of longer duration, have fared worse than the higher quality investment grade bonds.

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In an attempt to clarify its exact intentions regarding former insinuations about the Fed beginning to taper its buying up of $85 billion in Treasuries and mortgage-backed securities per month, Bernanke drove home the analogy about "letting up on the gas, as opposed to applying pressure to the brake." Bernanke said that while its initial goals of 6.5% unemployment and 2.5% inflation are not in the immediate future, the committee does see the US making significant progress toward those goals by the later part of this year. He suggested that if that does turn out to be the case, the Fed would consider tapering off the current QE, by reducing the amount of US Treasuries purchased each month, but not the amount of mortgage-backed securities. That being said, if economic conditions deteriorate, they could add to the current QE. Further, Bernanke suggested that short-term rates (Fed funds) will remain at zero well into the future, but that longer-term rates could move higher.

The markets struggled to digest this information and re-price to a scenario of higher long-term interest rates leading to a steeper yield curve in the foreseeable future. As a result, not only did longer-term bond prices decline, but bond-substitute stocks were also hit as they became less attractive with higher bond rates. The worst performing sectors following the Fed's press conference were Telecom, Utilities, Staples, and Health Care, or those sectors typically associated with safer, risk-off environments, and higher dividends. The flip side of this is that with Bernanke's suggestion that the economy is improving on its own, economically-sensitive stocks were performing relatively well.

However, by the end of the quarter, the stock market seemed to get back on the horse and recover June losses for the year so far—but with low trading volumes that suggest an overall air of uncertainty. It seems to be prepared to play the waiting game until the next meeting of the FOMC in September.

Looking Abroad

These visceral responses by the market have also been multiplied by other global factors that have been at play throughout the quarter, mainly regarding China and concerns about the health of its economy. Most recently, we've seen heightened fears over China's cash shortage in banks. At the end of June, the benchmark interest rate used in lending between Chinese banks, known as the Shanghai Interbank Offered Rate (SHIBOR), had surged from 3.3% to 7.7%. This was likely an attempt by the People's Bank of China to hurt the "shadow" banks by only providing cash to China's legitimate banks, for the underlying goal of bank reform. However, we have not seen, nor do we believe we will see, a liquidity crisis or Chinese banking system collapse. The risk, then, is of policy mismanagement, and also the more macro risk of economic re-acceleration dropping lower on China's priority list. In other words, China's economy is continuing to slow, although not yet disastrously so, especially compared to the growth it experienced in 2010, and then before that from 2005-2007.

The euro zone is very slowly improving, and at the end of June there were several positive data releases for Europe, including retail sales, composite PMI, housing PMI in the UK, and an unchanged unemployment rate in Spain for a seventh month in a row, which is a positive development in the sense that it did not increase.

At Midyear, Still Asking About a Growth Problem

Throughout April and May, the question being asked (and answered) domestically was whether the United States would avoid a "Growth Problem" like those that had plagued 2010, 2011, and 2012, with sell-offs in May that for each of those years brought the S&P 500 Index down to unchanged year to date. It seems there is still the possibility given that overall, the US is neither accelerating nor slowing, but our guess is that we should be in the clear. This should be sufficient, then, for the strong possibility that the Fed will decide to begin tapering come September.

As of July 1, the S&P 500 Index was up about 130 points year to date from where it was, on average, at the same point in 2010, 2011, and 2012, indexed to 2013. When we look at the economy in comparison to the past few years, many factors are in the best shape they have been since the recession began. However, the most unbiased conclusion is that although things could clearly be worse, and were much worse at this time for the past three years, they could certainly be better. In other words, when comparing the current economic environment to what we had seen prior to 2008, we are still far from performing at our full potential.

The Good, the Bad, and the Ugly– Fundamentals

In terms of positive data, housing continues to improve with increased housing prices. There was a 3.9% surge in existing house prices in May, and it is likely house prices continued to increase in June. This came after surges in February, March, and April, as well, equating to about 10% cumulatively for all four months. Existing house sales also increased in May, adding to the forward momentum being felt in the housing market.

Further, the jobs picture is slightly better, and estimates say the unemployment rate probably dropped to 7.5% in June, from 7.6% in May. Temporary employment, which tends to be a leading indicator, is at a 13 year high, having gained 10,000 in June. Payroll employment rose an impressive 195,000 in June, and average hourly earnings also increased. That being said, unemployment remains a primary concern and a crucial piece of the economic puzzle going forward, as this positive data is only a tiny portion of the employment pie.

On a more negative note, GDP for the second quarter is on track for an uninspiring 1.0%, after 1.8% real GDP growth in the first quarter. Furthermore, the composite PMI, another leading indicator, fell to 52.1% in June, against a recent high of 55.6%. In terms of the housing market, *International Strategy & Investment*'s homebuilders survey fell sharply through the last couple weeks of the quarter and into July.

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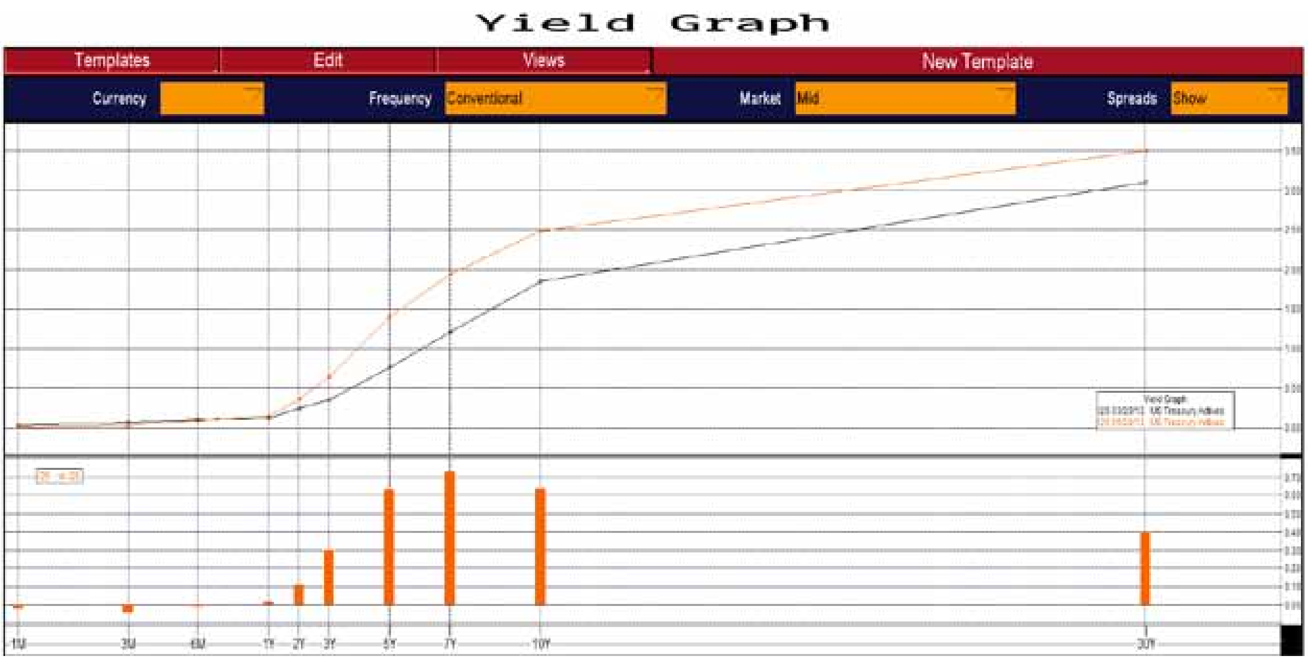

For the Intermediate Government/Credit Index, performance by maturity sector was substantially worse on the longer end of the intermediate range; 5 – 7 years lost 3.09%, while 7 – 10 years lost 4.45% in the second quarter. And, as mentioned above, lower credit quality did not perform better, even for investment grade bonds. The lowest quality sector of investment grade (which had performed the best for such a long period of time) reversed course in the second quarter. Baa bonds had a negative 2.67% return, while Aaa bonds only lost 1.37%. We would expect this trend to reverse if the economy is truly improving. Once again, the quarter was one of the worst in close to 20 years and there were no places to hide. We had begun to take a more defensive approach with respect to lowering duration targets and asset allocation mix in client portfolios where appropriate. We will continue to monitor the economic data and adjust our strategy going forward. We do believe, however, that some of the market reaction is a bit overdone in the intermediate term. We simply do not have enough data to conclude that it's nothing but "clear sailing" from here on.

The Fed Giveth, and the Fed Taketh Away

For months now, the markets have been gauging the effectiveness of the Federal Reserve's monetary policy on two very important variables: employment and inflation. Ever since the Federal Reserve announced that it was amending its asset purchase program on September 13, 2012, to one that had no end date and which was dependant on attaining a 6.5% unemployment rate while keeping inflation expectations below 2.5%, the equity markets have been enjoying the gift of limited downside risk. The bond market, on the other hand, was dealing with the burden of limited upside potential. There has been some uncertainty since November of last year regarding how long easy monetary policy would be in place given the moderately improving labor market and renewed improvement in housing prices. Now that we know that quantitative easing will not continue in perpetuity, it's time to see if the economy can progress on its own.

The FOMC (Federal Open Market Committee) statement on June 19 was not terribly different from what was said in May. The general themes have been:

- Improving labor markets (but still elevated levels of unemployment)
- Improving household spending and business investment
- Strengthening housing sector
- Restraining fiscal policy (i.e. – government spending)
- Lower than targeted inflation

However, there was one major change in the statement that reinforces the notion that easy monetary policy is less needed now: *"The committee sees the downside risks to the outlook for the economy and the labor market as having diminished since the fall."* As of May, they continued to see downside risks to the outlook. This change in outlook is not the primary cause for the abrupt market reaction in both bonds and equities. Chairman Bernanke's press conference, which followed the FOMC decision on monetary policy, laid out a framework for when we could expect changes to both the Fed funds rate and quantitative easing programs. He shared the general outlook projections of the 19 committee members. These projections could be interpreted as benchmarks of how the Federal Reserve expects the economy to evolve and the implications for monetary policy. Most tended to estimate economic growth for 2013 to be between 2.3 and 2.6% with improvement to 2.9 to 3.6% by 2015. Additionally, their expectation for the unemployment rate at the end of 2013 was between 7.2 and 7.3% (currently 7.6%), and they estimimated it would decline further to between 5.8 and 6.2% by the end of 2015. Inflation projections for the committee participants were generally around 0.8 to 1.2% for this year and increasing to 1.6 to 2.0% by the end of 2015. Relative to what our economy has experienced over the last 4½ to 5 years, these projections appear to be really good news. However, are they cause for the kind of volatile market reaction that we've seen since those forecasts were made public, even if they should materialize? Let's remember, these are forecasts, not necessarily high probability outcomes.

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Where Do We Stand?

We are not shocked that the market reacted to the Fed's actions at the end of quarter with volatility, and to a large extent, it endured a healthy correction in June from the rallying we've seen this year. Howe & Rusling's Equity and Fixed Income Committees have put a lot of thought and analysis into asset allocation going forward. We are constantly reevaluating and this may change, but we still hold a long-term asset allocation strategy to overweight stocks due to our conviction that the economy is continuing to slowly grow and improve. This long-term strategy may be put on hold at times to accommodate volatility surrounding the Fed's tapering, but right now it remains our underlying goal.

Contrary to last year at this time when so much remained unclear, we have a better idea of our economic health, outlook, and what is on the horizon for fiscal policy. Of course, some things remain unknown, but it is fairly clear that the economy is growing—albeit not very robustly. We've also largely overcome some political hurdles that have been looming over investors' heads for a couple of years, such as the debt ceiling negotiations, the "Fiscal Cliff," and sequestration. We have not surpassed these issues in full, but they are certainly accompanied by much less fear and debilitation than they had been. Sequestration, although still early, has had much less of an impact on consumer confidence and spending than was anticipated.

All of this means one thing for sure—this type of environment is a more positive one for stocks than bonds. Bonds still play a very important role in portfolios for diversification and protecting against risks, but a change in Fed policy may translate to a large impact on bonds. We believe that the rally in stocks we have witnessed for the past several months will continue over the longer term, even if there are a few set backs here and there.

End

With the exception of the 2% inflation expectation which is the longer-term target for the Federal Reserve's "stable prices" mandate, the other projections are historically below full potential. Additionally, in Chairman Bernanke's press conference, he reiterated the Federal Reserve's strategy put forth in 2011 for normalizing monetary policy and the implications for the assets currently on their balance sheet, as well as short-term interest rates. The outright sale of assets that have been purchased during the various quantitative easing programs is of particular interest to the bond market. Obviously, should the Fed decide to sell assets into the market, they would be not only removing liquidity, but also negatively affecting the prices of those particular asset classes directly (mortgage-backed securities, Treasuries, and agency obligations). Of course, this strategy would have indirect negative implications on all other assets, similar to tightening monetary policy. What was clear from his statements is that most committee members don't foresee the need to sell agency mortgage-backed securities. As a matter of policy, given the outlook presented above, actual asset sales are *"unlikely to be relevant to actual policy for quite a while."* What was also made clear is that the two key variables with respect to current monetary policy mentioned above (6.5% unemployment and 2.5% inflation) are not triggers for the automatic removal of the policy, but rather thresholds that would require reconsideration of a change in policy in the event it were justified by the then current economic conditions.

So, why the extreme negative market reaction if indeed the economy is expected to get marginally better and no tightening of monetary policy is currently contemplated? While the market was still guessing as to when we could see the end of asset purchases, the press conference statements made it absolutely clear that as labor markets continue to improve and moderate growth continues to accelerate, the quantitative easing program would be slowly phased out and, if the projections are correct, would be totally eliminated by the middle of 2014. Once again, this framework sounds reasonable and consistent with the intent of these programs to limit the downside risks to the economy. What else could be generating such a negative reaction in the market? It seems that the "gift" of limited downside risk in equities along with the vast amount of liquidity that had gone into both bonds and stocks created a dependency in certain market sectors and asset classes. Without the massive amounts of marginal liquidity ($85 billion monthly) it is somewhat uncertain how those same sectors and asset classes would perform. In the game of musical chairs, everyone is still in the game so long as the music is playing. But, we all know that when the music stops, someone will be eliminated.

End