June 2012 Newsletter
Which Straw Breaks the Camel's Back?

From the desk of Matt Brennan

I have a bad back. I can't recall exactly when the pain began, but I know that by the fall of 2008 I had reached a point where no combination of sitting, standing, or laying could alleviate it. It was at that time that I bit the bullet and went to see a Chiropractor. At first it was terrific. One crack on the right, one crack on the left and I was good to go, at least for 24 hours or so. From 2008 to 2009 I visited the Chiropractor 3 times a week at $40 a crack and the best I ever got from it was temporarily relief. It was around the 1 year mark that someone referred me to Physical Therapist. One month later (3 total visits) and I was pain free and walked away with a stretching regiment that I do first thing every morning. Sure it takes time and discipline to adhere to, but it's worth the work in the short-term in order to make sure I avoid long-term pain.

I'm going to assume that you can already see where this is headed. At the time of this writing, our Federal Reserve Board is meeting behind closed doors and debating whether they need to once again rush to our rescue and provide a 3rd Round of stimulus in the form of further Quantitative Easing (QE3). If you're keeping track at home, this would technically be our 5th round of stimulus since 2008: Qualitative Easing (slashing the Fed funds rate to 0.00%-0.25%), Quantitative Easing 1, Quantitative Easing 2, and Operation Twist. It's an overused quote, but I'll print it any: "The true definition of insanity is doing the same thing over and over again and expecting different results."

As we've noted in this space previously, Government intervention in investment markets (money printing and debt leverage) tend to shorten economic cycles and dramatically increase market volatility. It is difficult to reconcile these 2 outcomes with what the primary objectives of the Federal Reserve Board actually are: 1) Maintain Full Employment and 2) Maintain Price Stability. (Keith McCullough – HedgEye 6/11/12). Money printing drives U.S. commodity prices (such as oil) which are denominated in dollars. This price inflation slows economic growth. The gains we have seen in the markets over the past few years have been largely due to government stimulus as opposed to traditional economic growth and expansion.

Just take a look at market performance over the past few years during periods of stimulus and the periods in between the announcements of even more stimulus:

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	QE-1	No QE	QE-2	No QE	Operation Twist
S&P500	36.4%	-9.0%	24.1%	-5.6%	12.9%

The result? A 97% correlation between government stimulus and S&P 500 performance (Source: Jim Lunney – Seven Signs/ April 2012)

The latest round of stimulus, Operation Twist, is set to expire at the end of June. What option does the Fed have expect to continue to try and buoy investment markets in the short-term? Piling debt upon debt is not the way to "fix" the economy.

Today, **net interest** expense paid on our federal debt accounts for 7% of all Federal Government spending. This expense is projected to rise to 27% of all federal outlays in the next 25 years. (Source: Congressional Budget Office). While we've built this pile of debt, we've also seen the amount of Americans on Food stamps double from 2008 to 2012 (23 million to 46 million) to 15% of the population. (Source: Treasury Department).

As we saw back in May, unemployment ticked upward once again to 8.2%. The consensus estimate of economists for new jobs added was 150,000. This number came in at 69,000. The market dropped 2% in a day. This is the part of the lesson where we reiterate the earlier concept: Government intervention in investment markets *increases market volatility.* Consider that in 2010, the best and worst day for the S&P 500 occurred only 10 days apart (5/10/10 and 5/20/10). The best and worst day in 2011 occurred back to back (8/8/11 and 8/9/11). For this year, the best and worst day (so far) occurred only 5 days apart (6/1 and 6/6) (Source: BTN Research). Roller coasters are for children and people with good backs. Our preference is to stay off the ride.

We continue to maintain a high percentage weighting to short-term and diversified bond funds across most portfolios. While they are not needle movers, the 2-4% in dividend yield we are generating is decent compensation for being able to protect values. One of our only remaining stock allocations, Consumer Staples, is also providing close to 3% in dividend income. The plan is to remain conservative for the time being and to wait for the global economic slowdown to drive down stock prices so that we can buy at a discount. We are confident and comfortable owning bonds at this time since our expectation is that further stimulus will keep interest rates low for the time being. Keep in mind, when interest rates rise, the value of a bond goes down.

Regarding the potential for a market "Bubble" in bonds:

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“You’re not taking about a bubble because a bubble is about greed. That’s not a reflection of ‘I expect prices to go higher and I have to jump in,’ that’s a reflection of ‘I want to preserve my principal.’ Negative yields reflect fear.” – Jeffrey Rosenberg – BlackRock, Inc (6/6/12)

Government bonds have seen returns of almost 3% since mid-March. Over this same period of time, global stocks have fallen 9% (as measured by the MSCI All-Country World Index).

We are anticipating another summer of volatility. Our quick synopsis of the global economic landscape leads us to believe that now is not the time to be a stock picker.

- Slowing Growth in China (decline in manufacturing)
- Future risk of default in Japan
- Rising unemployment and increased borrowing costs in the Euro Zone
- Australian manufacturing slowdown (recession)
- India posting its slowest growth in 9 years

(Source: Mauldin – Thoughts from The Frontline, 6/2/12)

Here, in the U.S., we are in an election year. While this may mean a lot for a 24 hour news cycle, it means we can expect very little in terms of actual progress from a policy perspective. Time is running out between now and year-end when we reach what is being dubbed the “fiscal cliff.” The Bush Tax Cuts are expiring and we are once again faced with the issue of raising the debt ceiling (Recall how smoothly that went last summer?). While politicians and central bankers continuously try crack our backs with stimulus upon stimulus, we will continue to use caution, manage risk, and do our stretching exercises on the sideline.

Best Regards,

Matt

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