January 2013 Newsletter
Want to "Save" the Economy? Take More Risk

From the desk of Matt Brennan

Happy New Year! We hope you and yours had a wonderful holiday season. This month we are going to (attempt to) avoid discussion of falling over fiscal cliffs or bumping our heads against debt ceilings. When clients inquire as to "what the impact will be on the investment markets," we can answer with the utmost certainty that the answer is uncertain. Markets hate uncertainty, and in the short-term this leads to price volatility. Therefore, it would be rationale to anticipate more volatility in the short-term. Our role as your advisor is to manage risk long-term and to make sure you succeed. We are focused on the big picture and how to protect and grow your wealth over time. You have incentivized us to do so. And that is what we'll be focusing on in this newsletter – the concept of incentives.

Economics, in my experience, is all about incentives. An economic incentive is simply a motivation that prompts an individual to perform a particular action. Incentives can be positive or negative depending on the behavior they are trying to inspire or curb. A bonus can be used as a way of incentivizing an employee to perform at a very high level, just as a traffic ticket can be used to incentivize compliance with the posted speed limits. In a vacuum, the cause & effect relationships that exist in incentives are straightforward and logical. The global economy does not operate in a vacuum, and therefore we are forced to confront the unintended consequences of certain economic policy incentives.

The Federal Reserve Board has gone to great lengths over the past few years to stimulate our sluggish economy. Their primary focus has been keeping interest rates as low as possible. They are doing this in order to "ease credit", or to prompt consumers and businesses to borrow money and to spend that money in a way that leads to a revival in economic growth (Recall consumption is 70% of GDP). If businesses can access credit easily and cheaply, then presumably they'll be incentivized to hire. This will reduce unemployment and give Joe American more disposable income to spend. For a while, the Fed's main focus was to continuously slash key lending rates in order to spur lending. Of course, you can't cut rates to less than zero, or else you'd be paying someone for the privilege of also lending them money.

Then the Fed turned to asset purchases. Under the current policy, each month the Fed creates $85 billion out of thin air and then uses it to purchase Treasury Bonds and Mortgage Backed Securities

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from banks, directly putting money into the accounts of the institutions that are selling them the assets. This is meant to accomplish a few things. First, it helps keep rates artificially low. Why offer to pay someone a higher rate of interest for their money when you know you have a guaranteed buyer each month with $85 billion burning a hole in his pocket? The second goal of this policy is to incentivize capital to chase risk and hopefully stimulate the stock and credit markets. The assumption is that if the financial markets are booming, this will rejuvenate the consumer and the "wealth effect" will prompt them to spend their money.

Let me restate that incentive once more. Simply put **– "If we print money and keep rates low, investors will be forced out of safe investments and will have to buy riskier stocks and bonds. This will cause markets to go up. When markets are up, people are confident. When people are confident, they spend. When people spend, we have growth."**

It is quite common to hear people voice concerns about long-term inflation. When your Federal Reserve is crediting itself $85 billion per month and injecting it into the economy, it is difficult to see how this will not create long-term price inflation. Given the bolded statement above, is it not possible that we are already witnessing inflation in the stock market? To repeat, <investors> **will have to buy riskier stocks and bonds. This will cause markets to go up.** Asset price inflation is not economic growth.

But if we are to use the price of the S&P 500 as a report card to determine if the Fed's policy is working, it would be difficult to argue that it is ineffective. Step 1 of the plan is working. Investment markets are rising. Now, how about Step 2 – Rely on the "wealth effect" to rejuvenate personal consumption?

We would argue that this is where the Fed's plan is flawed and ineffective. The Great Recession was mostly a balance sheet recession. In the years leading up to the '08/'09 credit market collapse, we experienced a period of unprecedented economic growth and personal consumption. Bubbles built out of the credit and real estate markets enabled people to live well outside of their means. The bursting of these bubbles then led to significant personal deleveraging and plans for personal balance sheet improvement. While economic growth has been slowing/sluggish, the personal savings rate in this country is approaching 4% as of late 2012. This is up from its all-time low of 1.5% in 2005. Overall household debt still stands at 113% of disposable income, but this is down from a high of 134% in mid-2007. Americans are hard at work trying to rebuild retirement savings and to pay down debt. These two actions do not contribute to economic growth. (Project Syndicate – S. Roach, 9/12)

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The Fed is purchasing these assets at a rate of about $1 trillion per year. By year end, it is estimated that the Federal Reserve's own balance sheet will be close to $3 trillion (Craig Torres – Bloomberg 1/17/2013)
"We must not ignore the possibility that the low interest rate policy may be creating incentives that lead to future financial imbalances" – Kansas City Fed President, Esther George.

It's all about incentives.

Based on current pricing data, if you own 10-year treasury notes yielding between 1.75% and 1.85%, you are essentially paying around 50 times the value of this income stream just to own the notes. To compare, if you simply buy the S&P 500 index you would be paying just 14.8 times earnings. This further strengthens the incentive to own stocks rather than bonds. It also encourages people to buy bonds with longer maturities. An index created by Credit Suisse has recently measured the demand for speculative-grade bonds (junk bonds) at an "unprecedented level." (Craig Torres, Bloomberg 1/17/13)

Farmland prices set records in 2012 in Missouri, Nebraska, Kansas, Oklahoma, Wyoming, Colorado and northern New Mexico. (Fed bank survey: 10th District Agricultural Credit Conditions)

Eventually, the credit easing policies of the Federal Reserve Board will have to cease because you can't spend what you don't have infinitely. At that time, banks will lose that guaranteed monthly bond buyer. Who will step in to take the Fed's place? Whoever it is, they'll most likely demand a higher rate of interest for turning over their money. As a result, interest rates will naturally rise, and this may happen very quickly. Recall, when interest rates rise, the value of bonds fall. What will happen to all of those investors who were incentivized to buy bonds with longer maturities? Disgusted by less than 2% on 10-year treasuries, many investors now own speculative and long-term corporate bonds with maturities in the 20-30 year range. Crude math would tell you that with just a 1% rise in interest rates, a 30-year bond could experience a loss in value of somewhere between -20% to -40%.

When rates eventually do rise (and they're currently resting at 100 year lows) what will happen? This of course brings us back to uncertainty. The Fed is engaged in a race against time. Can they continue to buy bonds at a rate that will boost markets, reduce unemployment, revive spending, and improve growth, all before Congress takes real action on addressing our debt and deficits? If rising investment markets and cheap money aren't enough to convince people to spend at rates that they did before the recession, what will it take if taxes increase significantly and the government begins reforming entitlements?

As an advisory firm, Dominion Wealth's core value is "Everything we do is for the well being of our clients." Our holistic approach to financial planning and investment management means that we create customized solutions for all our clients' objectives. At the portfolio level, this means making sure that you are investing in an age-appropriate and risk-appropriate portfolio. Our economic outlook is used to guide our investment policy in general, but equally important is your input. A portfolio needs to be reflective of both the objective and subjective data. Objectively, we know your time horizon, your income needs, and the economic environment within which you're investing. We rely on you for the subjective. Your investment experience, your personal biases, and your tolerance for risk are important things that we want to make certain we are discussing regularly with you. As your needs or your risk tolerance change over time, so too should the composition of your portfolio. Our goal is the same as your goal – Namely, your long-term financial success and happiness. In economics, this means our incentives are properly aligned.

We look forward to discussing this in greater detail with you soon.

Best Regards,

Matt

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