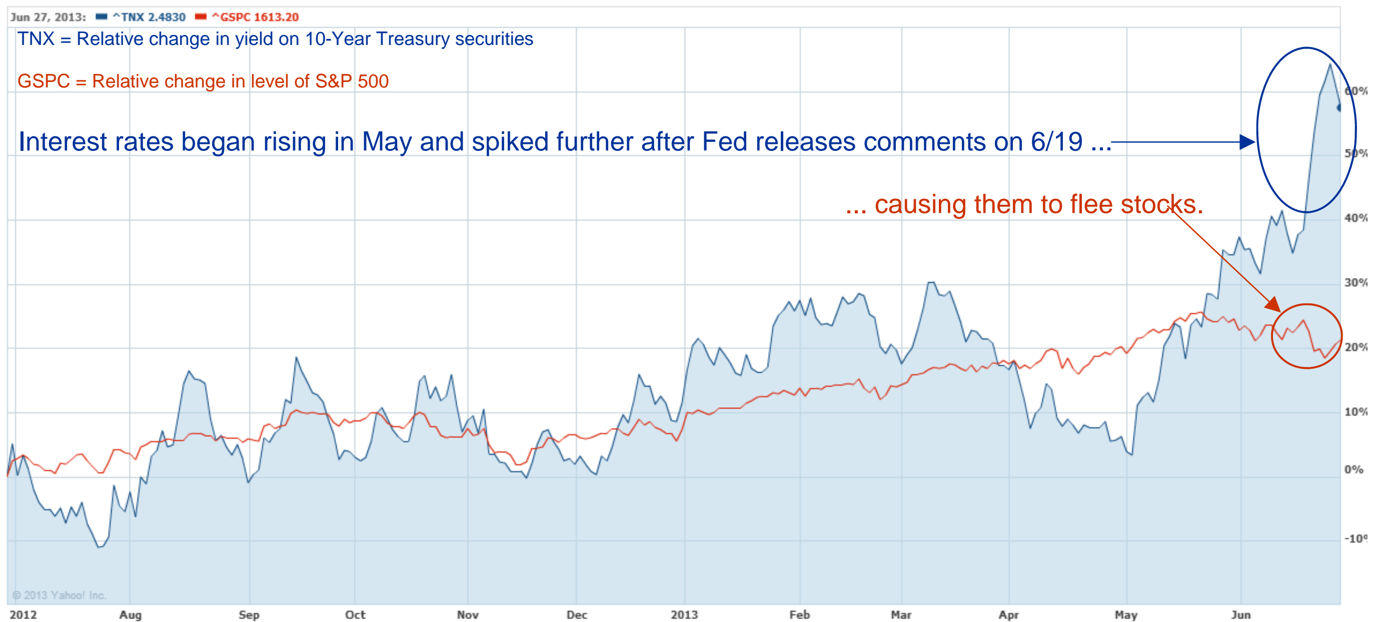
POSITIVE NEWS SPOOKS THE MARKETS

INTEREST RATES SPIKE

10-year Treasury securities serve as a good barometer for the general level of interest rates. Before the economic collapse began in the fall of 2008, 10-year Treasury securities offered investors a yield of about 4%. By July of 2012, the flood of stimulus (new money) from the Federal Reserve had driven that yield down to less than 1.5%. Since bond values vary inversely with bond yields, bond values rose. And because longer-term bond issues are much more sensitive to changes in interest rates, values of longer-term bonds soared. Rates have drifted higher over the past year and have spiked in earnest since April so fixed income investors must now play some defense.



Rising interest rates generally represent a headwind for all asset values because the value of future cash flows from any given investment become worth less in today's dollars. So while it makes perfect sense that bond values tend to fall when interest rates rise, it may seem somewhat counterintuitive that the cause of the recent spike in interest rates and decline in stock and bond prices can be traced to *positive* statements the Fed Chairman made about the progress of the U.S. economy. Since rising-rates are especially tough on longer-term bonds, we are favoring shorter-term securities to shed interest-rate risk. To replace some of the yield we must necessarily give up by owning shorter-term securities, we are also tolerating somewhat more credit risk. We think this is the right move because corporate balance sheets are healthy and there's no expectation of a recession.

DOWNSIDE RISKS DIMINISH

The Fed is still guarded in its assessment of the U.S. economy, but Fed optimism is becoming more and more apparent. In a press release from the Fed at the conclusion of its June 19th meeting, the Fed indicated that it sees less downside risk to the outlook for the U.S. economy and the labor market than it did last fall. Since the stock market nadir in March of 2009, domestic stock prices have risen well over 100%, the unemployment rate has declined considerably (admittedly aided due to some discouraged job seekers having given up), the health of the housing market has improved, consumer confidence is now as high as it was in 2008, and businesses sport much improved balance sheets. The Fed's assessment seems reasonable, so it's not surprising that the Fed has begun to signal that it is getting closer to trimming the $85 billion it has been injecting into the U.S. economy each month. The Fed has characterized this potential reduction in stimulus as "tapering."

FED DESERVES PAT ON BACK

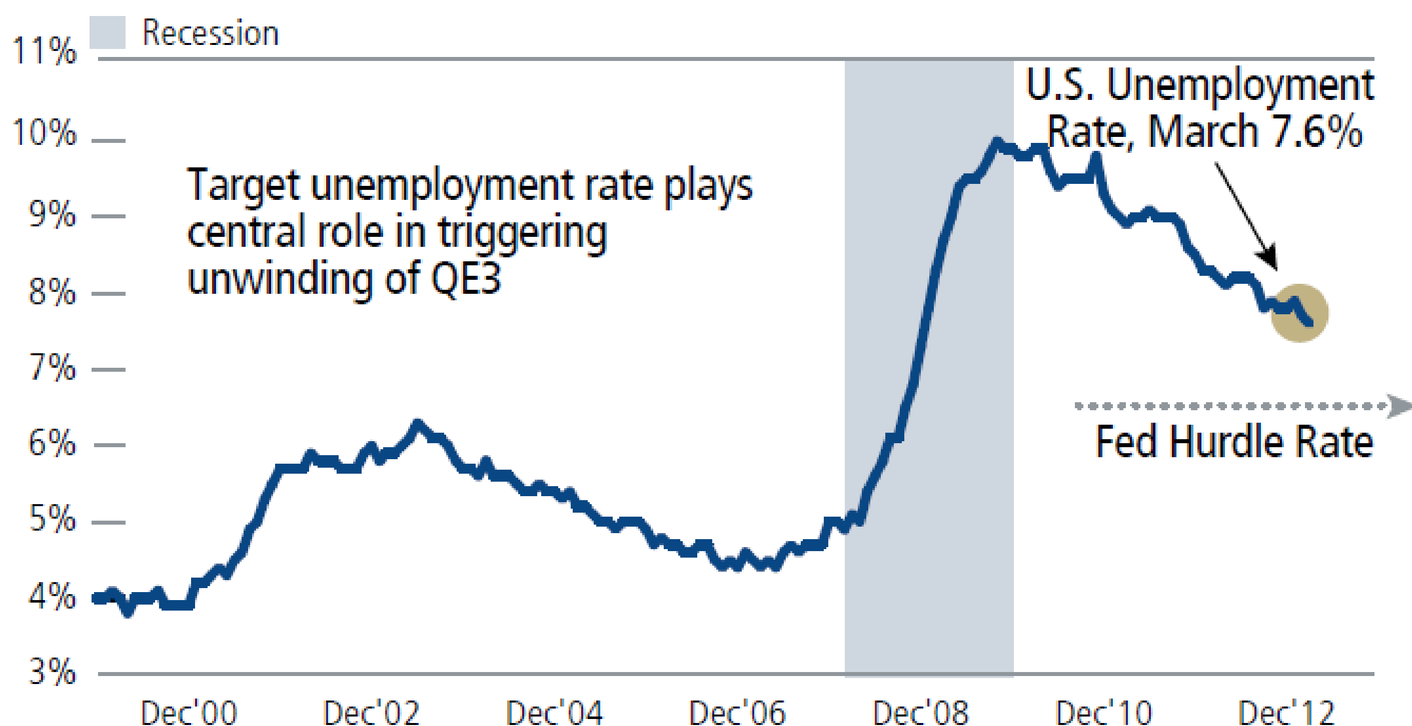
Although certain forecasters and analysts continue to argue that Fed stimulus has been ineffective or even counterproductive, the historical record suggests otherwise. In fact, that record includes a downturn during which the Fed chose to not stimulate or lend a helping hand to a distressed banking system and eventually allowed some 10,000 banks (40% of all banks) to fail. Meanwhile, Congress buckled to pressure from the short-sighted masses who understandably wanted to protect domestic industry. Congress consequently increased tariffs on over 20,000 imported goods to record levels. U.S. imports declined as intended, but the incremental domestic demand that was envisioned for American-made goods was offset by reduced demand by foreign governments as a result of the imposition of retaliatory tariffs on those same American-made goods. Even though total U.S. economic output had already contracted by almost one-third, Congress further exacerbated the downturn by raising the top income tax rate from 25% to an astounding 63% in the myopic pursuit of a balanced budget. You may have guessed that the confluence of these upside-down policies resulted in the horrendous decade that is The Great Depression.

To avoid a repeat 4½ years ago, the Fed adopted historically expansive monetary policies and Congress, despite its relative ineffectiveness, extended the Bush-era tax cuts for an overwhelming majority of taxpayers while implementing certain other temporary tax breaks along the way.

Consequently, investors have grown accustomed to investing in an environment where a persistent tailwind from policymakers was a foregone conclusion so it makes sense that the Fed's recent statements about an eventual stimulus tapering would cause some investor angst. However, my sense is that this recent angst will fade, especially since the Fed has indicated that it plans to *continue* injecting funds into the U.S. economy at the same rate of $85 billion per month in the near term and has not yet signaled that it has any definitive plans to actually *reverse* the existing stimulus.

FURTHER WIGGLE ROOM WITHIN FED'S DUAL MANDATE

In general, the Fed has the dual mandate of maintaining full employment while keeping inflation in relative check. With the unemployment rate at around 7.6%, the Fed is hoping that continued expansive monetary policy will reduce that figure to about 6.5% before it eases off the proverbial accelerator.



The wrinkle in this dual mandate is that while expansive monetary policies can certainly stimulate good things like economic growth and higher employment levels, they can also lead to excessive

inflation. So, the Fed must strike a balance between providing aid to an ailing economy and over-stimulating it which could lead to eventual problems with inflation.

Although the Fed is on record as saying that downside risks to economic growth have diminished, the Fed is still wary about the strength of the U.S. recovery. With inflation plodding along well beneath the Fed's maximum long-term limit of 2.5%, the Fed does appear to have some room to continue injecting stimulus into the economy without jeopardizing long-term inflation constraints.

GOOD NEWS FEELS LIKE BAD NEWS

For several years since the meltdown, the economy had been operating at such a low level of capacity that positive economic news caused no real worry that the Fed would end its stimulus program. Furthermore, investors tolerated negative economic news since it virtually guaranteed that the Fed would continue to provide economic stimulus. If investors agree on one thing, it's that central bank stimulus drives asset prices higher — especially so-called "risk" assets such as stocks and real estate since their traditionally lower yields present less relative disincentive for investors to own them in an environment where yields on competing assets such as bonds and CDs are also low.

Now that the economy is far healthier and closer to being able to sustain itself with less Fed assistance, investors have begun to fret over a possible reduction of Fed stimulus the same way a recovering drug addict might fret a reduction of methadone. As such, investors must now recalibrate their minds so that positive economic news is met with something other than fear and lament. Expect the markets to exhibit some DTs ("delirium tremens" ... I finally looked it up) in the near-term, though.

IMPLICATIONS FOR BOND VALUES

I've already discussed why we have tilted our fixed income portfolios toward shorter-term, lower credit quality instruments. Of course, there's a chance that if/when the Fed does move to raise rates in earnest (the recent rate spike has *not* been caused by the Fed), investor angst could rise high enough to drive them away from riskier asset classes and *toward* fixed income securities. If this were to occur,

bond prices could actually rise, but no such anomaly has occurred with respect to the rise in rates that has already taken place nor are we expecting it to occur. As such, we've structured our fixed income portfolios to better withstand the negative forces that have traditionally been associated with rising interest rates.

SOME ROUGH BOND MATH

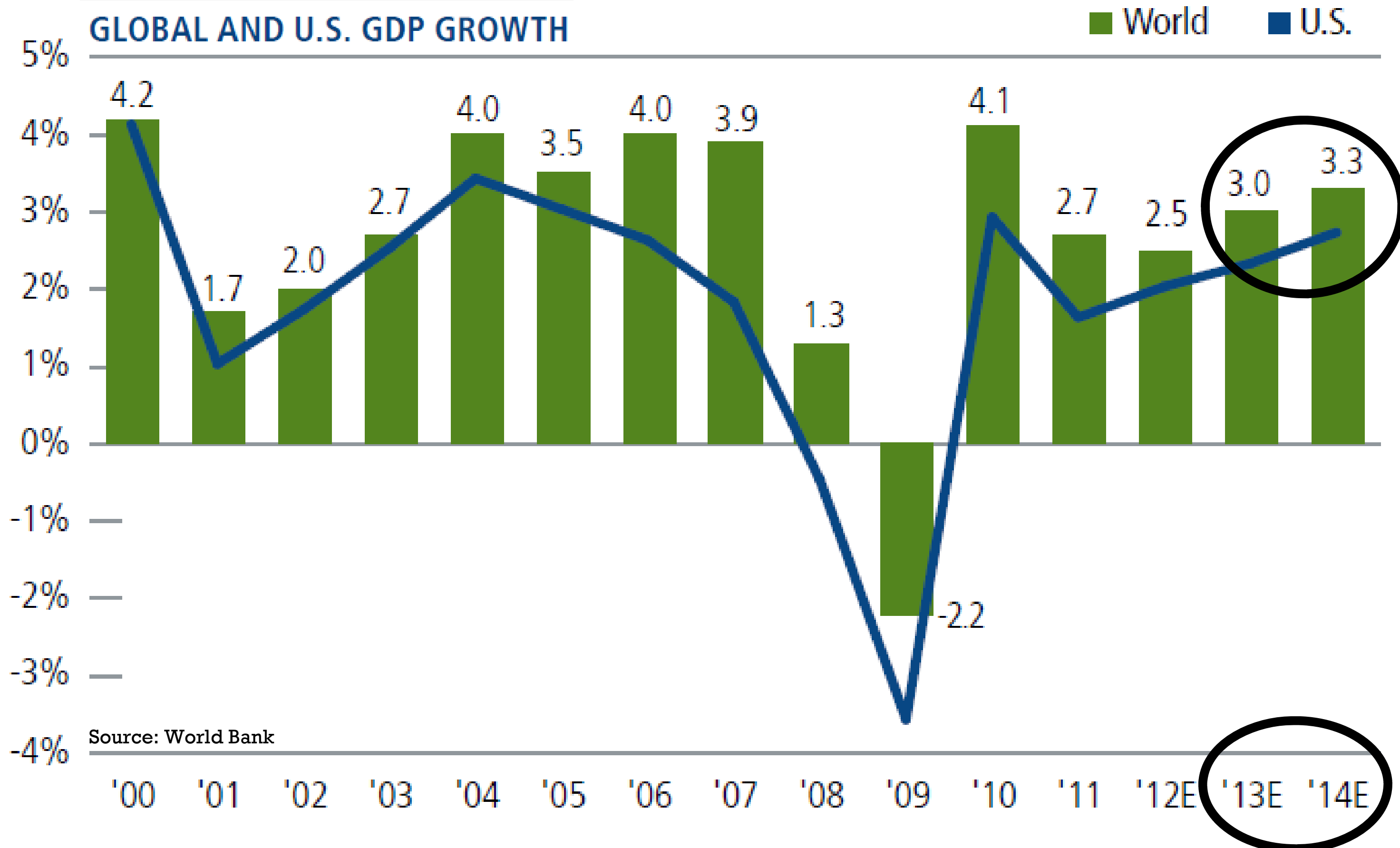
Assume 10-year bonds offer a yield that approximates annual GDP growth in the U.S. plus another 2% to compensate investors for inflation. Assuming GDP growth rises to 3% over the next five years, the yield on 10-year bonds would then be in the 5% range. If those bonds had a 1.5% yield at the beginning of this 5-year period, their yield would have increased by 3.5%. Now, assume that for *each* 1% increase in the general level of interest rates, the value of 10-year bonds were to fall in value by 5%. Over this 5-year period, the value of 10-year bonds would decline by some 17.5%.

To recap, an investor who buys such a bond at the beginning of this hypothetical 5-year period (which could have already begun) he would have collected 1.5% per year on his original investment each year for five years which would have resulted in total interest earnings of 7.5%. Meanwhile, the market value of his investment would have declined by 17.5%. After five years that unfortunate investor would be underwater by 10%. And unless this hypothetical investment was made within a tax-deferred account such as an IRA, those interest earnings would probably be includible in taxable income.

Not only would this investor have sustained a material loss over this 5-year period, the bond market might not present an opportunity to recoup that loss for many years, if at all. This little vignette illustrates why we've been so keen to limit the interest-rate risk within our fixed-income portfolios.

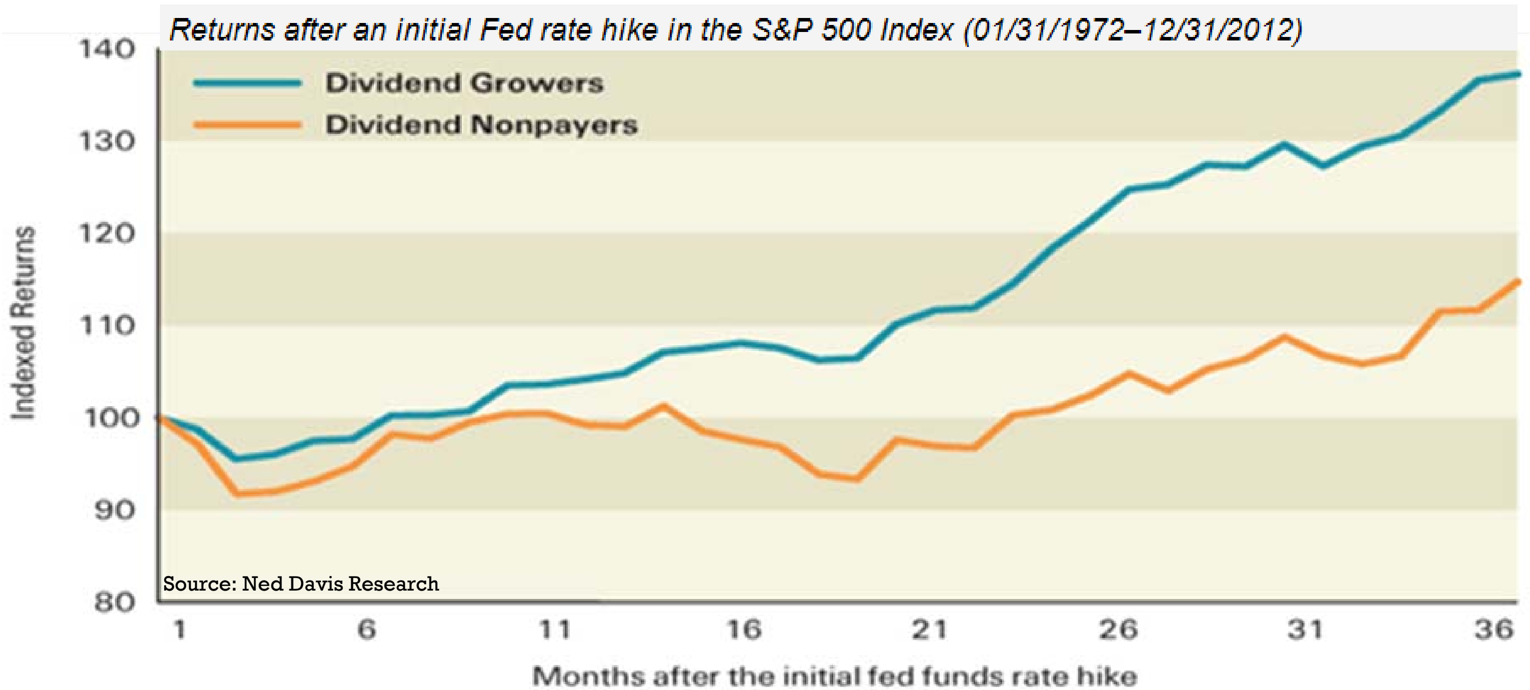
WORLD BANK FORECASTS GLOBAL GROWTH

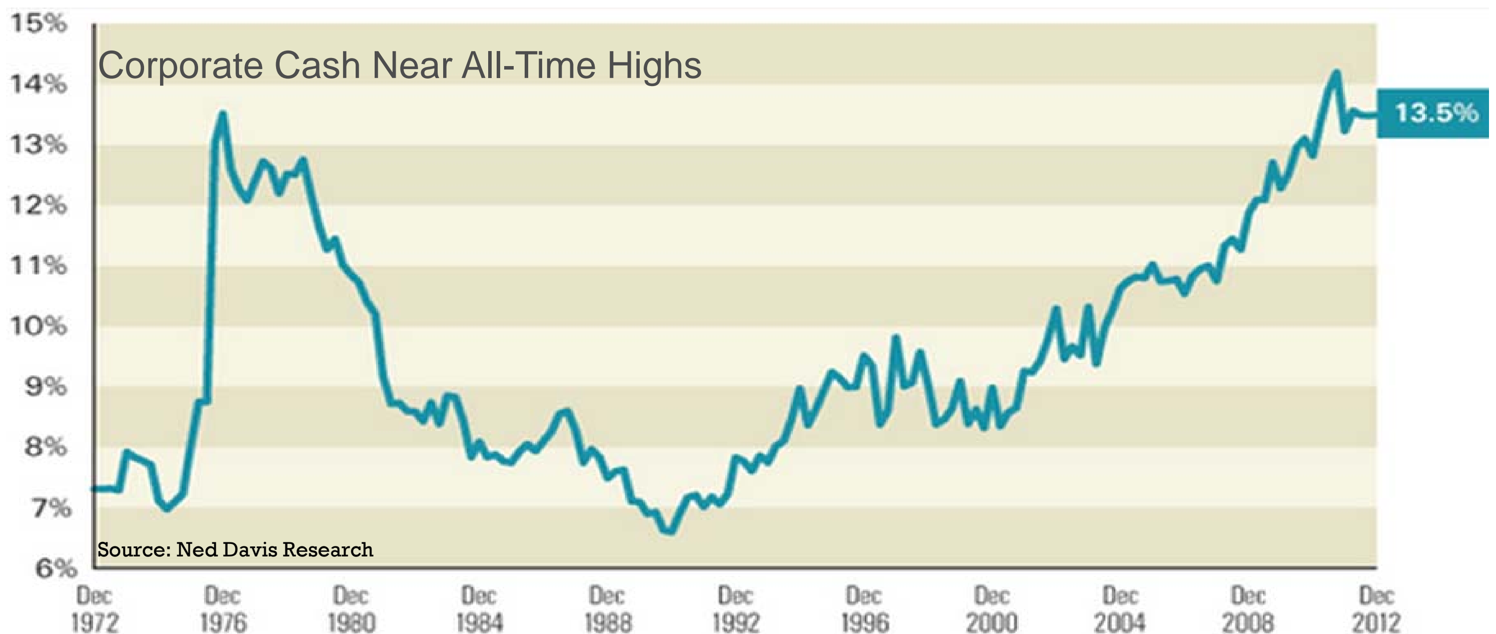
The World Bank expects the rate of GDP growth to advance this year and next, both globally and within the U.S. (chart on next page). Rejoice that these figures are both positive and growing.



DIVIDEND GROWERS — ESPECIALLY GOOD WHEN RATES RISE

We generally favor equities that sport growing dividends because, historically, they have tended to generate higher returns relative to their level of riskiness. Rising dividends also allow one's income to match or even outpace increases in one's cost of living. According to Ned Davis Research, shares of domestic companies that have a history of increasing their dividend outperformed shares of companies that paid no dividends as well as those that paid relatively high, but static dividends over various three-year periods that followed an initial interest rate hike. Their relative outperformance notwithstanding, it's important to understand that even dividend growers have tended to temporarily decline in value in response to an initial hike (upper chart, next page). Since companies generally find it embarrassing to reduce the dividend rate after it's been increased, dividend hikes are generally not contemplated unless management is confident in the company's ability to continue paying that dividend. The cash is there (lower chart, next page) and so are the cash flows (not shown).

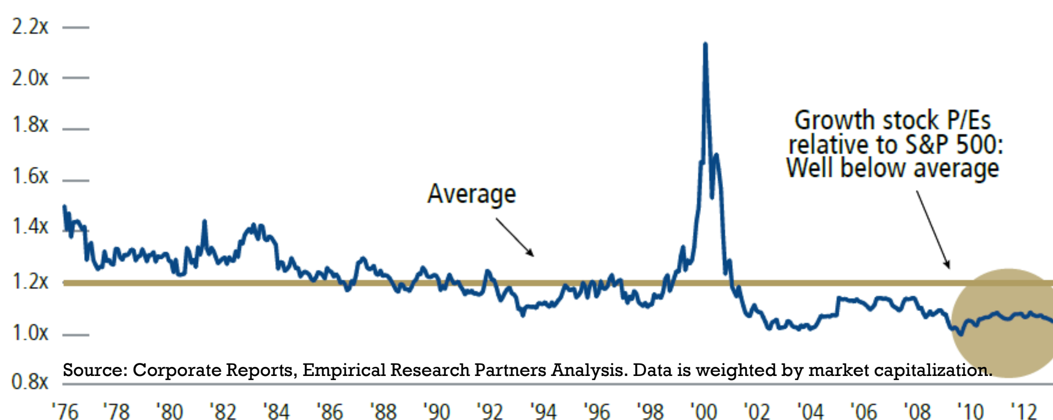




I've already mentioned that we've shed interest-rate risk by favoring shorter-term instruments and that we are trying to recapture some lost yield by favoring lower credit quality instruments. The relatively high level of cash on corporate balance sheets gives us confidence that this is an appropriate time to accept a higher degree of credit risk.

GROWTH STOCKS MAY STILL OFFER VALUE TOO

Due to their inherent volatility and the lack of meaningful dividends, growth stocks are somewhat less attractive to us because they don't fit our typical client profile as well as dividend-payers and dividend-growers do. We also believe growth stocks are not as attractive on a risk-adjusted basis. Nonetheless, it's worth noting that the price-to-earnings ratio of growth stocks as a whole is still relatively low (suggests good investor value) despite their strong price advance over the past 4½ years.



Source: Corporate Reports, Empirical Research Partners Analysis. Data is weighted by market capitalization.

ONE NEAR-TERM WORRY AND A DISTANT ONE

According to FactSet, the number and percentage of companies issuing negative earnings guidance during the second quarter of 2013 are at record highs. Despite the case that can be made for stocks, a reduction in earnings guidance is an unambiguous negative — especially in an environment where interest rates are expected to rise.

At some point, the Federal Reserve will have to begin unwinding the huge amounts of stimulus it has already pumped into the U.S. economy. To put this in perspective, the Fed's balance sheet represented net assets of about $1.2 trillion prior to the collapse in 2008. Today, it stands at about $3 trillion. The Fed's balance sheet represented less than 9% of the U.S.' annual economic output in 2008. That figure is around 18% now and 24% is a possibility by year end. When the Fed does eventually begin removing stimulus, a large chunk of the U.S. economy will vaporize and we all may hate being us.

— Glenn Wessel