CONWAY• JARVIS LLC
Investment Outlook

Volume 23 Issue 2 June 12, 2013

The View From High on the Wall of Worry

Since November of 2012, we've seen the stock market digest every bit of news, both good and bad, and move inexorably higher to record levels. Many investors are disbelieving of this market's ability to climb what many professional investors traditionally call a "Wall of Worry". This particular one is built upon huge deficits, Europe in recession, unrest in the Mideast, a slowing Chinese economy, and a dearth of constructive fiscal policy in the US. A look behind the headlines and commentary in the media reveals something else at work here. The Fed's been throwing a party and spiking the economy with immense flows of cheap liquidity. Recently, Chairman Bernanke stated what everyone already knew: that there will be an end to Quantitative Easing. That was enough to send traders heading to the exits this past week and setting up what we believe will be a long overdue correction. For some investors, that's good news.

Any News Has Been Good News for US Stocks

Traditional investment models usually find stock investors focusing on the fundamental analysis of companies while taking into account the trajectory of the economy, expectations for interest rates, and impending changes to fiscal and monetary policy. Most of the time, markets integrate all of the above into individual stock pricing and that of the benchmark indices. In 2010 and 2011, the highly publicized ineptitude of bankers and fiscal policy-makers around the world severely tested the stock market, keeping many investors either on the sidelines or in bonds. So what changed in 2012 that set the stage for this year's record-setting stock market performance?

We believe investor expectations for a meaningful fiscal policy assist from Washington have evaporated for this year and perhaps the next several years. That leaves the Fed to go it alone in moving this recovery along its path. That would normally be viewed as "bad" news for the economy. However, investors have figured out that financially healthy companies, combined with a heaping dose of monetary stimulus make a potent recipe for rallying the stock market. The resulting "wealth effect" is the likely reason consumer confidence and sentiment are at high levels and retail sales have shown so much resilience.

We believe we're enjoying one of those rare periods where *all news is good news for the stock market*. Any economic data pointing to negative effects flowing from Sequestration are likely to prompt the Fed to keep their foot on the accelerator. By that we mean the Fed will continue its Quantitative Easing ("QE") program of purchasing billions of US debt securities each month. The stock market "Likes" this. In addition, any good news regarding employment, retail sales, or corporate earnings is taken at face value and will also get a "Like" from stock investors. The net effect has been a record-setting rally in the stock market in spite of data indicating business investment ("CAPEX") and manufacturing are stumbling along at a tepid pace. That's an indication that this recovery remains fragile and still requires significant assistance from the Fed. As much as we enjoy today's stimulus-fueled stock market, it's neither healthy nor sustainable in the long run.

It's All About Investor Perspective

With government employment and spending shrinking as a result of Sequestration, this recovery will present a challenge. In the post-war era, there has not been an economic recovery with government employment in decline. This is one reason why we expect the Fed to continue to "spike the punch" until it sees a requisite level of employment growth along with an increase in demand that in turn spurs an increase in CAPEX spending. These are the classic conditions that typically announce the emergence of a more robust and sustainable economic recovery. We only see that happening several years down the road after the private sector picks up the slack created by a smaller government. Only then will the Fed begin to taper QE and be on track to eliminating it entirely.

In all likelihood, that occurrence will serve as the catalyst for a consolidation or correction in stocks. We've seen hints of this in the past couple of weeks. The mere mention of tapering QE in the Fed minutes in early June cast a pall over the markets, sending both stock and bond markets lower and interest rates higher. To some, this may look like the beginning of a bear market or the second coming of the Crash of '08. We view it as a head-fake that investors should use to move cash from the sidelines and long-term bond funds into equities.

We think it highly unlikely that the Fed tapers QE this year or next and believe the markets will sniff that out fairly soon. Compared to the meager returns currently offered by cash and bonds, productive companies with strong balance sheets look like a pretty good bet these days. If you're an investor holding bond funds or cash, you're probably tired of sub-single digit returns or worse. This quarter will mark the second consecutive quarter where bond fund returns have gone negative as price declines have erased most, if not all, of the very attractive current yields expected this year. Even though we see this recent move in rates as a head fake, we think the long-term bond market has seen its best days and presents a poor risk-reward value proposition since prices almost have nowhere to go but down. Our advice to clients has been to jettison any and all positions in long-term bond funds. For those who must own bonds, the best and safest returns can be found in short-term individual bonds with fixed coupon rates.

The Fed's Second Act

We've said many times before that economic recovery is a *process* rather than an event. Typically, the Fed coordinates its monetary policy with a fiscal policy that promotes growth. In the present case, fiscal policy-makers have been no-shows and the Fed has had to undertake historic and extraordinary measures to avert a depression and buy time for the economy to repair itself. In our view, they had little choice but to flood the US economy with liquidity and convince other central banks to do the same. TARP and QE made for an impressive First Act. However, this story begs for a Second Act as a prelude to a successful recovery for the global economy.

The Fed has signaled the markets that a Second Act is coming. It involves reeling in the stimulus that took us through the dark days following the Crash. TARP has ended and QE will end soon. This will be the result of the Fed seeing improvement in the economy and will probably be received as a temporary headwind for stocks. You can see where this is going: The Fed's Second Act could spell bad news for the equities markets. This is where battling inflation creates a brief period where *all news is bad news for the stock market*. This will pass. And set the stage for the next bull market. This is all part of the process and, though it may challenge investors at times, it doesn't alter what we see today in the markets: ***An overwhelming value proposition that favors returns from equities relative to those from bonds or cash. Any downturn in the stock market should be viewed as an opportunity to increase exposure to equities.***