



## QUARTERLY COMMENTARY Second Quarter 2013

Clients who have chosen to have us implement our 2-Mode or 3-Mode equity allocation processes have seen a nice boost to the equity portion of portfolios during the first half of the year. Those who elected to employ one of the processes through that entire period realized the full benefit. Those who added one of the processes as the first half progressed earned a portion of the profit. In a dangerous domestic and international environment, we encourage all clients to evaluate the processes as a reduced risk approach to equity participation.

At least in the United States and Japan, stocks are up so far in 2013. Bonds are down around the world. Gold and commodities are down. Risk-free return is non-existent. This is a critically important time for investors to evaluate their asset allocation policies.

Economic growth rates are declining in the United States and China, the world's two largest economies. Europe is still in recession. Emerging market economies are slowing. To counteract the danger of the world economy falling back into recession, central bankers have resorted to unprecedented levels of financial stimulus. In a strikingly non-traditional economic and market environment, investors are faced with the quandary of whether to bet on the success of central bank rescue efforts or to defend against deteriorating fundamental conditions. The stakes are extremely high.

Until very recently, central bankers have succeeded in boosting investor confidence with an aggressive combination of direct bailouts, quantitative easing and copious amounts of verbal cheerleading. Central banks have always intervened in fixed income markets through direct purchases of securities. As financial conditions deteriorated in recent years, however, central banks began to pollute their balance sheets with lower and lower quality securities in categories--like mortgages--never before included.

Most notably in Japan, but certainly in our country as well, central bankers are effectively printing money at unprecedented rates. It is interesting that Japan and the United States are the only two major countries with stock markets appreciably in the profit column so far in 2013. Central bank efforts are being applauded. So far, other countries like Korea, whose foreign trade figures are being damaged by Japan's plummeting yen, are complaining but not taking retaliatory monetary measures. The potential for destabilizing currency wars, however, is perilously close. Should they arise, their negative effects would be felt worldwide.

Since the financial crisis in 2008, central bankers have bent massive efforts toward supporting bond markets by directly purchasing fixed income securities at a great variety of maturities and by forcing short rates toward the zero bound. Until recently, that intervention has rewarded bond market investors, especially those willing to accept the greatest risks in duration and credit

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quality. The world has changed, however, this year. Despite ongoing central bank efforts to keep interest rates near the floor, investor fears of upcoming higher rates have led to extensive

bond market losses. Whereas the allure of consistent bond profits drew billions per month from risk-averse investors, the sudden realization that bonds can lose money has produced a torrent of withdrawals from fixed income mutual funds and ETFs. Many of those with no stomach for investment losses rue the day they let the Fed's zero interest rate policy force them to accept investment risk to earn a prospective return. Even for those who have not experienced losses, investment returns from fixed income securities have been meager, with the yields on 10- and 30-year Treasury debt higher today than at the height of the crisis in late 2008, despite massive central bank intervention since then. Over that period of time, we have maintained that the level of risk is disproportionate to the potential for return.

So far in this country the Fed has successfully promoted profits in stocks, despite the slowest economic recovery from recession in modern U.S. history. Many speculate that stock prices will continue to climb so long as the Fed keeps expanding its balance sheet with more debt. Two weeks ago the growth of first quarter GDP was revised down to a barely rising 1.8%. And last week's far worse-than-expected trade deficit report leads to expectations of a mere 1% GDP figure for quarter two. Perhaps it doesn't matter, however. Some leading research firms now believe we're in a win/win situation. Good economic news is good; less than good economic news is also good, because it diminishes potential that the Fed will take its foot off the stimulus gas pedal. Nobody seems to be asking: What horror does the Fed fear that it would continue to pile more debt on an already bloated balance sheet more than four years into an economic recovery? It must be tremendously scary.

Should investors disregard weak and deteriorating domestic and world economic growth and simply put their faith in a market under the Fed's protective guidance? That trust has worked up to now. On the other hand, that blind faith worked in the bond market as well – until it didn't. And that faith was similarly rewarded throughout much of the world in stocks until this year. Despite still aggressive central bank support, most world stock markets are down so far in 2013. In fact, of the 16 major countries regularly profiled in Investor's Business Daily, only the U.S. and Japan are up appreciably so far this year, with three European markets essentially flat and the remaining 11 country markets down. Declines exceed 20% in Brazil, South Africa and China. Correlations are far from perfect from one country to the next, but it's rare for one or two major markets to climb significantly when the vast majority are in decline. Especially in a weak economic environment, international market weakness introduces much greater risk to our domestic market. It is important not to lose sight of the fact that the Fed doesn't always win. Notwithstanding recent years' stock market progress, the lesson of history is not encouraging. In the past, when nations have built debt edifices similar to today's in the U.S., Japan, the Euro nations and many more, resolutions have extended for a decade or more, with serious economic dislocations and, most typically, significant inflation erasing much of the debt. That scenario may or may not provide an accurate roadmap for our current situation. At very least, however, it should highlight the extreme level of risk that attends today's investment scene.

In a highly risky environment, in which the Fed has dramatically altered traditional fundamental considerations, we have been encouraging clients to adopt our formularized 2-Mode or 3-Mode equity allocation processes for the equity segments of their portfolios. These processes have outperformed the S&P 500 over the past 32 years. Most important to us, however, is that they have been able to do that with fewer and smaller losses than the index. Those who have been in the processes since the beginning of the year have realized an 8.85% return on the money so deployed with an exposure to equity risk just 52% of the time. While no process eliminates all risk, we strongly believe that these processes remove major portions of that risk.

Because the Fed and other major central banks around the world remain deeply committed to ongoing money creation, we have begun to build a small hedge in gold. When we initiated the position, we made clear that it was not based on a belief that gold would necessarily continue its multi-year rise immediately. We firmly believe that gold rises and falls with investor sentiment, with fear and greed the prime movers. We said at the time that if gold prices continued to surge, we would earn a nice profit on a small position. Greater profit in the long run, however, would come only if we could build a larger position at lower prices. With the sharp decline in June, we brought the gold position to a still small 4% of portfolio value. Should prices decline further from here, we will be able to build a more significant position at lower levels. If central banks continue to inflate away current massive debts and ongoing annual deficits, this position should ultimately prove to be a profitable hedge.

With portfolio assets not immediately needed for longer-term positions, we have negotiated multi-year certificates of deposit at far better than current rates to provide a safe income base to the portfolio. Having negotiated minimal prepayment penalties, we retain the option of holding the CDs so long as they remain more attractive than current alternatives. Should short rates rise or more attractive long-term alternatives appear, we can exit the CDs on our chosen timetable.

## **Summary**

U.S. and Japanese stock markets continue to respond favorably to massive central bank stimulus. Most major world stock markets have declined so far in 2013. Most world markets also remain below their 2000 and 2007 highs. Virtually all bond markets around the world have produced losses this year, despite aggressive central bank efforts to support those markets. It is an open question whether or not central bank efforts will be successful in rekindling economic growth and preventing substantial stock market declines. Over several centuries, history demonstrates that the ultimate resolution of problems brought on by excessive debt has typically taken a decade or more in length and involved significant economic disruption. Substantial inflation has often been the ultimate result. In such an environment, a permanent position in bonds is dangerous. Warren Buffett recently categorized such a fixed position under current conditions as “silly.”

Equities offer additional gains so long as investors remain confident about the success of central bank rescue efforts. Should that confidence wane, the consequences of excessive debt will likely do similar damage to equity prices as in 2000-03 and 2007-09. We began to warn of a pending long weak cycle in stocks at the end of the 1990s because of excessive debt and historically high valuations. Valuations are less extreme today, but still very high. Overall debt conditions are even worse than they were at the turn of the century. We caution against large permanent equity positions in the current high-risk environment. We believe that our formularized equity allocation processes are safer alternatives to permanent equity allocations.

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