



QUARTERLY COMMENTARY Third Quarter 2013

Funds that clients have allocated to our formularized equity allocation process have grown by low double digits so far this year, although third quarter results were essentially flat. Those assets were exposed to equity risk just 39% of the time year-to-date. With interest rates having risen substantially since mid-2012, most bond returns have been negative for more than a year. We have avoided those losses by holding most non-equity portfolio assets in long-dated certificates of deposit with coupons near 2%. When attractive, low-risk alternatives materialize, we have the right to cash out of those CDs with minimal prepayment penalties. In the meantime, they improve the portfolio's income return in a historically low rate environment. Our small gold hedge improved in the quarter but is down from earlier highs. As long as central bankers remain intent on aggressively growing their money supplies, we will increase our gold hedge if we can do so at progressively lower prices.

The next few years present very difficult prospects for individual investors and fiduciaries of institutional funds. Risk-free investments provide essentially no return, and the Federal Reserve has expressed its intention to maintain that condition for the foreseeable future. All but the shortest investment grade fixed income securities have lost money over the past five quarters as rates have risen. The Fed and most analysts have forecast a continuation of rate increases over the next couple of years. Should rates rise aggressively for any reason, bond portfolios will be punished. Equities have continued their upward march in much of the world, especially in the United States and Japan, the two most aggressive money printers.

Simply ignoring risk and holding stocks would have been the most profitable course over the past few years. Equity investors today, however, are confronted with a highly unhealthy environment. Reaction to the weak September employment report demonstrated clearly that investors are largely ignoring weak fundamentals and are celebrating the likelihood that such conditions will defer the date when the Fed will slow its monthly stimulus. Investor behavior around the world has mirrored that response. When Fed Chairman Ben Bernanke first hinted that tapering of the stimulus was likely soon, markets around the world fell--some precipitously. Caught apparently by surprise, Bernanke quickly committed a cadre of Fed governors to the task of calming the markets. Most world markets were then in negative territory for the year. When the Fed began to indicate that economic conditions were sufficiently weak to warrant continued full-bore stimulus, markets again began to rise. The subsequent presidential appointment of Janet Yellen as the next Fed Chairman seems to have reassured equity investors that their monetary drug of choice will continue to flow. Bad economic news incongruously remains good stock market news. That puts the true investor in a severe quandary. Should he/she just keep betting that the Fed's unprecedented monetary policy will continue to work, or do weak fundamentals actually matter?

Seemingly lost in investors' obsessive concentration on the free flow of massive monetary stimulus is the burgeoning level of debt that is the inevitable result. In a mere five years, the Federal Reserve has quadrupled its balance sheet. Notwithstanding reassuring words from Bernanke and others, many analysts, including some members of the Fed itself, express grave misgivings about how the Fed will ever be able to unwind its bloated balance sheet. No central bank has ever faced such a gargantuan task, so there is no blueprint for success. What evidence there is from much smaller endeavors of a similar nature is far from reassuring. Severe indebtedness is most typically resolved through significant inflation. That

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doesn't appear to be an imminent risk, but it certainly remains a long-term concern. That Japan and the Eurozone have even more egregious debt loads relative to their economic output merely adds to the background risk for all investors.

Unless one takes the position that the debt bill will never come due, retaining equity gains is likely dependent on investors' ability to step away before confidence dissipates in central bankers' capacity to control financial and economic outcomes. Such gambling is a far cry from traditional investment analysis.

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