

# INVESTMENT QUARTERLY

## SHAKE, RATTLE & ROLL

I won't lie; there are periods in the financial markets such as we have faced recently that lead me to ponder whatever possessed me to pursue a career in security analysis and wealth management. (And, I know with certainty, I am not alone.) But I usually reflect on three strengths one must possess and practice to persevere successfully in this field that were engraved in my mind by early mentors and, which I subsequently engraved in the minds of those I trained. Patience, Humility and Confidence.....

Patience for me has been a difficult one; my mother continually commented during my childhood that "patience is a virtue, and not one I possessed"; I'm still working on that one. Humility in our profession, is omnipresent (or should be); because no one, regardless of what they profess, avoids missteps over the short term. There are simply too many obstacles and too many "rear view mirrors". Confidence, when properly expended, eases the pain of humility and fosters patience, as well as an open mind, leading one to continually reassess his position as to whether a modification is appropriate or, whether staying the course is in fact the most judicious "active decision".

Following a solid performance year in 2010, the financial markets rolled on during the first two months of 2011 seemingly without glancing back. The early days of January were peppered with headlines warning of creeping inflation, weak dollar, rising debt, structural unemployment, and numerous other threats that would surely upend the equity markets. But the equity markets remained focused on positive corporate earnings comparisons and general global economic progress, albeit at a slow rate. And, regardless of investors' long term opinion of the Federal Reserve's Quantitative Easing - Chapter 2 (QE2), the commitment to an accommodating money policy through the second quarter, kept rates low and thus the bond market in check while simultaneously providing liquidity for investors and business.

Two months into the quarter, March arrived with indeed a "shake, rattle and roll" as the Middle East and Northern Africa began to tremble with pent up anger at restrictive government, suggesting that the unrest that simmered in February was only the beginning. The markets quickly translated these happenings to a scenario of unknowns and the volatility increased. But the disastrous earth quake in Japan sent the equity markets tumbling as investors feared the impact on global economic growth. The markets however settled, turned the corner and rolled back onto the previous upward path with positive results for the quarter in most all developed global markets except Japan. The resilience of the U. S. markets tested the humility of many who had proffered headlines such as "*Why I Don't Believe In This Santa Rally*" (WSJ 12/29/10), as a buoyant 2010 rolled into 2011. We, among others, have continued to acknowledge the progress of the recovery whilst also expressing concern that the road back is long with many challenges. It is the concerns that have directed us to exercise caution in fully underwriting the rally, opting instead to participate but maintain equity reserves where we deem appropriate for our clients.

What is driving the equity markets and maintaining low rates in the fixed income markets? Why were investors cheering a recovery that appears far less hardy than history would suggest it should be? Why as oil prices gushed through the feared \$100/bbl mark and commodity prices surged did investors seem to not care? And what might change it?

Enter QE1, followed by QE2. The Federal Reserve kept no secrets about the intent of their latest accommodative actions (QE2) with the expectation that it would provide money to the system to offset the deleveraging process, maintain a low interest environment to boost the housing/mortgage market while pushing moneys into investments that offered potentially higher returns (stock markets), counter the risk of deflation by raising inflation expectations and, pollinate the wealth effect through the equity markets which would then jump start the private sector's contribution to economic expansion.

And as Bill Gross (PIMCO) noted, “so far so good”. But in his March Investment Outlook he makes a valid point, one about which those who have seemingly erred on the cautious camp have been mulling and pontificating for months. He writes “*Many critics, though, including yours truly, would wonder whether Quantitative Easing policies actually heal, as opposed to cover up, symptoms of an unhealthy economy. They might at the same time ask simplistically whether it is possible to cure a debt crisis with more debt.*” Or, put another way, if a significant percentage of GDP growth is funded by deficit spending, (aka debt) is it really a recovery, never mind a sustainable recovery? Sandy Leeds, a professor at University of Texas says it reminds him “of a person who makes \$60k, borrows \$20k and says that he made \$80k this year”. He goes on to say “*It’s pure lunacy*”.

QE2 has been accompanied by a simultaneous increase in the value of financial assets. Although there is clearly an element of supply and demand in the rise of commodity prices, it is cash that has powered the stock market. Thus the Fed’s wealth effect goal has taken hold and data suggests one positive result is that the private sector is investing and slowly adding jobs. The economy is growing at a moderate pace. But QE2 purportedly comes to a halt on June 30<sup>th</sup> and the proverbial question is whether the private sector is able to step up to the plate and replace the \$1.5 trillion cash inflows donated by the Fed to keep the economy rolling. And, without the influx of cash from QE2 that likely drove the stock market rally, is there now a built in element of excessive risk at current levels. Then, there is the matter of the deficit and the Fed’s balance sheet that has ballooned to \$3 trillion from its pre-crisis level of \$1 trillion. Shrinking the balance sheet requires taking money out of the system with the expectation that the private sector will be feeding money into it. It will also require buyers of U.S. Treasuries other than the Fed. Since the beginning of QE2, 70% of the Treasury debt issued has been purchased by the Fed. Bill Gross concludes his March Outlook noting that “*bond yields and stock prices are resting on an artificial foundation of QE2 credit*”. Kansas City Fed President Thomas Hoenig, in a speech at the London School of Economics recently observed that although the goals of the FOMC’s QE were worthy, their policies have created risk and that their job must require they look beyond short-term goals to long term consequences once they have prevented a financial crisis.

We are not of the opinion that there is a deep, dark sinkhole lurking for investors come July 1<sup>st</sup>. Neither do we subscribe to the theory that fundamentals alone have driven the markets to their current levels; the cash infusion to the economy has clearly been a factor. We are confident the equity market will go down; at some point the market always heads down after an extended rally. We are also confident that there are significant issues with which the investment community must wrestle over the next several quarters and many of them may impact the willingness to maintain their current level of risk exposure, never mind increase it. The unemployment picture remains murky; the headline revelry over a monthly addition of 200,000 jobs is tempered when one realizes that pace will take 5 years to simply return to a 6% unemployment figure. Consumer sentiment has dropped precipitously, partly no doubt due to rising fuel costs but also the ongoing issues of employment and wage pressure. Capacity utilization remains low, suggesting there is certainly room for expansion but, also indicating that the pace of growth remains less than dynamic. Inflation concerns abound as rising commodity prices leave one wondering whether the consumer will get squeezed or, corporate margins shrink when they are unable to pass on increased costs. That said there are many positives. GDP growth continues, 1.5 million jobs have been added in the last year, interest rates are low providing an impetus for the housing market recovery and business borrowing and, the consumer has reduced debt and increased savings which at some point will be reflected in more positive spending behavior.

As Bob Needham wrote in his last quarterly, we have yet to see the broad strength a recovering economy should offer. Thus the recent stretching of the equity markets seems tenuous and fueled by the Fed’s tinkering, rather than fundamentals. We continue to believe that maintaining diversification and larger than normal reserves is a reasonable option to reign in portfolio risk.

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DJIA (3/31/11)	12319.73
S&P 500 (3/31/11)	1325.83