MARKET PERSPECTIVE

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Names, numbers and naïveté

Nicknames

I changed my work address when I started managing Strategic Return portfolios. I'm still in downtown Richmond but now in a lively former Morgan Keegan (now Raymond James) office. I've especially enjoyed my close proximity to the bond-trading group, an irreverent – but fortunately welcoming – group. The one downside to the proximity is their propensity to give nicknames. Getting a nickname at 50 is no different than getting one in middle school. Live with it or struggle with it. It really makes no difference: The name sticks.

They appear to be kicking around two nicknames for me. The one I like less is Passbook, as in an old-school passbook savings account. It seems holding cash in a sharply rising market is conspicuous. In my defense, I've been negative on China, Europe and bonds and that's no small amount to scratch off the menu. I will confess that holding cash doesn't seem very sophisticated but the goal of the Strategic Return product isn't sophistication. The goal is to deliver high-single-digit returns over the long term and not fall into any big traps in the short term. In my view, periodic use of the passbook savings account is going to be a big part of fulfilling that goal during these extraordinary times.

That's the other funny thing about nicknames. They often come uncomfortably close to the truth.

Not so fast

The S&P 500 Index's price is compounding at an unsustainable rate. Since the bottom in 2009 and the swoon in August of 2011, the index is compounding 24 percent annually. That's about a double every three years. There's simply no way this continues. Earnings, multiples, interest rates and U.S. Federal Reserve policy are all lining up against this rate of growth in price. Earnings aren't going to meaningfully accelerate given already high margins and sluggish global growth. Multiples, while reasonable, would quickly become unreasonable at this rate of price compounding. Interest rates must rise if economic growth continues to improve and this will hit earnings as well as multiples. And finally, the Fed has said it will begin to remove the extraordinary accommodation, which was targeting financial asset-price appreciation.

The S&P 500 can continue to move higher but it will almost certainly do so at a much slower pace. Of course, I don't have any idea how or when this will manifest but I am certain that we will look back a year from now and see a clear transition to a very different U.S. equity market. At this moment, I'm not changing my 60 percent allocation to U.S. equities but I'm nervous.

June Jobs, Interest Rates, Fed

June jobs, reported July 5, came in stronger than expected at 195,000 and previous months were revised higher. Treasury rates exploded up to 2.725 percent. Markets, both equity and bond, interpreted the numbers as a signal that the economy is indeed stronger and Fed accommodation will ebb.

Backing up a few paces, Chairman Ben Bernanke in his May 22 Congressional testimony strongly suggested a near-term tapering of bond purchases if economic conditions continued to improve, even if slowly. Various Fed watchers have since offered theories as to why he chose that time to mention tapering. They include (the obvious) the economy is stronger and quantitative easing (QE) is unnecessary; (the likely) difficulties with a QE exit; (the plausible) the Fed has decided QE isn't working; (the implausible) QE is counter-productive; and (the ironic) it is worried about bubbles. Frankly, all are good reasons to stop the Fed's manipulation.

Before the testimony, Treasury yields were in the 1.7 percent range and a few weeks later they were touching 2.7 percent before backing off a bit. It's clear from all the post-testimony statements coming from various Fed officials that they were shocked and troubled by the speed of the rise in rates. And on July 10, the Fed released the minutes from its last meeting and that report showed a deeply divided group regarding the tapering of asset purchases. Bernanke came out once again to clarify and he said that extraordinary accommodation would continue. Was he backtracking? I don't believe so. My interpretation is that he wants the world to understand that the extraordinary accommodation will end and naively thought he could jawbone us out of panicking.

It's stupefying that the Fed could orchestrate a massive bond and yield binge (probably a bubble) and then expect participants to sit tight and take losses while rates rise. Losses to bonds and other highly yield-sensitive instruments could be historic if the economy normalizes.

Thank you for taking the time to read this month's Market Perspective. I hope you found it helpful.

Total Return Portfolio	
Equities	63%
Bonds	7%
Gold	2%
Cash	28%
Total	**100%**

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