

## Rally Fatigue

Following comments from Fed Chairman Bernanke on May 22<sup>nd</sup>, in which he hinted at gradually slowing (“tapering,” in financial newspeak) the Fed’s \$85 billion of monthly bond purchases, the US stock market has come off the boil. Investors are concerned that we remain challenged with a fragile economy needing continuing Fed support. As a quick refresh on Fed policy, the Fed’s QE3 bond buying program is intended to suppress longer-term interest rates, such as those that figure in auto loans and mortgages, helping to provide cheap credit to qualifying consumers and stimulate demand within the economy.

Has Fed policy helped? Well, by some measures, low rates have helped the economy to mend. The housing and auto sectors have been prime beneficiaries of low rates. Over the last year-plus, housing has undergone a refinancing wave, freeing up household cash flow. More recently, home sales and prices paid have shown broad-based strength, amid tight supply. Auto sales have posted steady gains from their recession lows, and are tracking at about 15 million units annually. Encouragingly, both the housing and auto sectors have substantial multiplier effects within the broad economy.

More generally, though, the Fed’s bond buying has *injected liquidity* into the capital market system, and a good deal of this money has leaked into the stock market, bidding stocks higher.

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Mostly, the higher market has come from expanded price-earnings (P/E) ratios, and not from markedly higher corporate profits per se. Earnings growth has been uninspiring, and top-line revenue growth, especially, has been tepid for most companies. Corporate managements, ever resourceful, are supplementing organic growth with continued expense restraint, lawful tax avoidance, and share buybacks.

## The Fed Isn’t Going Anywhere Fast

Fears of reduced Fed liquidity have the market anxious as we wonder, collectively, if the economy can reach a self-sustaining growth cycle without heavy central bank involvement. On that question, the data are mixed. Our economy has continued to grow out of the depths of the 2008-09 recession, but at a slower pace than anyone would like. Especially troubling is the lack of employment growth. The following chart highlights a few key data points on the economy, and jobs. We included 2007 as a baseline year, prior to the recession, and draw your attention to the following:

	2007	2010	2011	2012	2013 (1Q)
<b>GDP Growth</b>	1.9%	2.4%	1.8%	2.2%	2.4%
<b>Unemployment Rate (YE)</b>	5.0%	9.3%	8.5%	7.8%	7.6%
<b>Labor Force Participation Rate (YE)</b>	66.0%	64.3%	64.0%	63.6%	63.3%
<b>Civilian Jobs (YE)</b>	146.3	139.3	140.9	143.3	143.3

Source: US Commerce Department, US Bureau of Labor Statistics

- The domestic economy is about to begin its fifth year of expansion (growth turned positive in the last half of 2009), but we remain stuck with an approximate 2% growth rate;
- The unemployment rate has dropped from its 2010 highs, but remains elevated, and above the Fed's stated target of 6.5%;
- Fewer able-bodied folk are participating (i.e., working or looking for work) in the workforce, helping to lower the unemployment rate artificially;
- Despite a growing population, there are three million fewer people working in jobs than there were five years ago.

Absent employment and income gains, the economy will continue its muddle-along. Our considered view at Ascent is that, given the numbers above, **the Fed will be with us for a good while yet**. Helping to return people to work has become Job One at the Fed. It is likely, though, that the Fed *will* commence a tapering process, wherein it gradually removes itself from buying longer-term bonds, sometime later this year. In anticipation of the Fed, rates have begun to normalize to a higher level, and those car loans and mortgages will get a bit more expensive.

As a reference point, and sanity check, the benchmark 10-year Treasury bond yields slightly more than 2% at present, approximately the rate of inflation. Rates can and need to go higher, as the distortions to rates driven by QE3 are cutting across a host of markets. Directly or indirectly, virtually every asset market (e.g., stock, bond, derivative) discovers its price using the cost of money as an input. *When the cost of money is unnaturally low, the price of almost everything else is unnaturally high.* An orderly return of money rates to natural levels is highly desirable over the longer term.

Importantly, tapering does not imply the end of easy money from the Fed. There are no indications that its zero interest rate policy, or ZIRP, is in danger of reversal. ZIRP holds down the level of shorter term rates to zero, or something close.

### A Brief Update on Our Strategy

With the market up in mid-teen percentage terms for the year with hardly a pause, a pullback is inevitable. So far in 2013, selloffs have been brief and shallow, and not greater than 5%. We have remained fully invested to client equity targets through the year. In fact, our biggest challenge has been maintaining the patience to put fresh cash to work, without mindlessly buying stocks, regardless of their price and value. Following are thoughts to guide us as we consider the balance of the year.

**The economic recovery continues to take root.** We expect continued fits and starts in the economic data, but we believe the overall path is toward economic betterment, aided by an accommodative Fed, which has almost no obstacles in its way for continued easy money.

There are few signs of excess in the economy (e.g., investment bubbles and misallocated capital), and also few pinch points (bottlenecks). Inflation, as measured by the CPI, remains in check.

Consumer demand has shown better strength than the overall economic aggregates. In the first quarter, personal consumer expenditures gained 3.4% on an annualized basis, a full percentage point better than GDP as a whole.

We have increased our ownership stake in high-quality financial companies, and to select industrial names, as our preferred way to gain exposure to acceleration in the economy. We continue to favor stock exposures combining income *with* growth, for an attractive total return potential.

**Be careful of so-called “bond proxies.”** The market’s rally through the Spring was led, in large measure, by defensively-tilted equities from the utility, telecom, and consumer staple sectors, pushing valuations among many of these companies to unrealistic levels. Wall Street is forever attaching a narrative to any market, and thus we were told that high-dividend companies with excessive valuations were in fact substitutes for bonds, and investors were smart to own them for their dividend streams.

As an example, AT&T was changing hands in the high \$38s in April, and at least one unlucky soul top-ticked the stock at \$39.00, all to own it for its \$1.80 annual dividend payment. The stock is currently changing hands at \$36. Investors buying Ma Bell at those levels have had over a year’s worth of dividends offset by share price decline.

Slow-growing, high-dividend stocks are best considered as long-duration bonds. Long bonds

are especially sensitive to any backup in rates, and share prices can correct sharply at any whiff of higher rates.

**Expect Volatility.** We select and own stocks based on the durability of their business models, their prospects for earnings and dividend growth, and their appropriateness for the current stage of the business cycle. We define risk in simple terms, as the potential to lose money *permanently*, and not the potential that an investment’s value may fluctuate from day to day.

Think of volatility as the speed of movement (up and down) in asset prices. We expect market swings in both the stock and bond markets to pick up pace as we enter the summer months, and the Fed begins its lengthy process to lessen its accommodative stance on monetary policy. We remain optimistic that we can take advantage of market volatility to take profits in certain stocks, and own companies we like, only at better prices. To borrow from Mr. Buffett, our goal is to be greedy when others are fearful, and fearful when others are greedy.

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