StaufferWilliams
ASSET MANAGEMENT · LLC

# JUNE 2013 INVESTMENT COMMENTARY

## A TIME WHEN GOOD = BAD AND SAFE = RISKY

The widely repeated adage of, "don't fight the Fed" has long been sage advice to follow, and according to the way that market participants responded on May 22nd when Fed Chairman Ben Bernanke began to publicly discuss the Fed's tapering back the central bank's latest round of quantitative easing, the psychological influence of the Fed's "easy money" policies was very evident. The broad stock market vacillated wildly throughout Bernanke's MAY 22nd speech, first surging more than 100 Dow points during his prepared remarks, then plummeting when he mentioned the possibility of tapering bond purchases in the next two meetings, and finally rallying when Bernanke adopted a more reassuring tone that hinted at the Fed chairman's belief that the markets were not ready to have the training wheels taken off just yet. The yield on 10-year Treasuries surged past 2%, dropped back to 1.96%, before taking off again to close above the 2% threshold.

Tapering off the Fed's current quantitative easing initiative refers to reducing the monthly purchases of government debt currently amounting to $85 billion per month. Through the remainder of May, after the Fed's mentioning of the tapering of bond purchases, economic releases that would usually be viewed as signifying that the economy was strengthening elicited strong negative market sentiment, while disappointing economic releases caused equity markets to rally. Although leverage in the markets is far less than it was prior to 2008, leverage is still highly utilized by traders and hedge funds, thus higher interest rates equate to financial friction. Better economic performance equates to less Fed intervention and higher interest rates. So for the markets, which are dominated in the short-term by leverage addicted traders and hedge funds, good economic news triggers selling and the continuation of sub-par growth triggers buying. Thus the markets have become conditioned that a reduction of Fed support, and any indication that the Fed is even near winding down or tapering off will cause markets to sell off. The specter that "the taper" might occur sooner rather than later caused the S&P 500 to close May with two consecutive negative weeks, driving many short-term traders to recalibrate their perception of risk, resulting in a flood of money flow from a wide variety of risk assets. Meanwhile, longer-term fundamental investors like StaufferWilliams see just the opposite, as taping of QE signals a stronger economy resulting in better corporate earnings performance.

It's no secret that the global financial markets have been riding a seemingly endless wave of central bank liquidity since the financial crisis several years ago. The recovery in the capital markets since the trough of the 2008-09 market crash has propelled U.S. equity markets beyond pre-crisis peaks. Cynics of Fed policy attribute much of this recovery to easy money policies, but at least as much, if not more credit has to be given to the rapid implementation of fiscal stimulus and government backstops. To act like the rise is solely due to Fed activity diminishes the fact that real fundamental

economic recovery is taking place. This very real, but stubbornly sluggish economic recovery is what we at StaufferWilliams have been focused on over the last several years.

Brian Wesbury, Chief Economist of First Trust and a vocal critic of continued Fed intervention, in a recent piece entitled, "Is QE Really THAT Important?" wrote:

> "The punditry has decided that anything good happening is actually bad. It is all just a sugar high – based on Quantitative Easing and government stimulus – and that talk of winding down or tapering QE is negative. So the latest fear is that any good data on growth is actually bad, because it means the Fed will wind down QE. They say "the economy can't possibly grow on its own—without support from the Fed and Ben Bernanke." Wesbury goes on to write, "but the Fed did not invent fracking, or the cloud, or the smartphone, or 3-D printing. QE has not lifted P/E ratios. Corporate profits, which the Fed does not control, have risen in tandem with stock prices."

To Wesbury and to longer-term fundamental investors, the Fed's intention to eventually taper its asset purchase program should be a huge positive for the markets, viewed as evidence that continued economic advance is in fact sustainable without ongoing Fed intervention, but current money flow, heavily influenced by short-term traders, clearly does not see it this way.

Free market proponents like Wesbury believe governmental involvement tends to crowd out powerful market forces that if left alone could self-correct imbalances. Extensive involvement like the Fed's ongoing attempts to guide the markets toward eventual sustainability creates a host of potentially negative unintended consequences, such as excessive future inflationary pressures, enhanced market volatility and asset bubbles.

We have written in prior commentaries about some of the more obvious dislocations that have resulted from extremely accommodative monetary policy. The near zero short-term interest rate environment, for instance, has driven many traditional risk averse income oriented investors into equities in search of yield, such as high dividend yielding stocks of utilities, consumer staples and telecom sectors, and this money flow has driven stock prices to historically lofty valuations. But for every obviously recognized asset bubble today, many other potential unknown perils building today will become apparent in due time.

We wrote in last month's commentary about our concern over the substantial outperformance of defensive/high yield equities during the first four months of 2013. In fact, we dispelled the conventional wisdom that we were beginning to hear after six months of consecutive stock market advances that an inflection point was approaching due to the market getting ahead of fundamentals. We stated that "we do agree that the market is nearing an inflection point, but from our perspective it is because the types of stocks that have been leading the market will not be able to sustain the advance much longer."

On June 2, 2013 MarketWatch posted an article titled "Why Dividend Yield Stocks Are Getting Dumped." Author Wallace Witkowski wrote "Earlier in the year, tech was the least-loved sector as investors chased stocks with traditionally high dividends".

The article included the following Factset chart illustrating the abrupt rotation from defensive/high yield stocks to technology and other cyclical sectors:

Witkowski noted from the above graph that "now it's those sectors with steep payouts, the so-called defensive

plays including utilities and telecom that are the dogs of the market. The telecom sector averages a 5.3% dividend yield and the utilities sector averages a 3.9% dividend yield. In May, the utilities sector dropped 9.6%, the telecom sector dropped 7.4%, and consumer staples fell 2.4%".

"By comparison, financials, industrials, and tech — the best performing sectors in May — have average dividend yields of 2%, 1.8%, and 1.5%, respectively. For the month, financials rose 5.9%, industrials gained 4.6%, and tech rose 4.2%."

As we stated last month, the market is a market of stocks as opposed to a "stock market". Corrections tend to occur when fundamental value measures are ignored and investors instead chase stocks for momentum, speculative growth, defensive posturing, or dividend yield. However, corrections within certain over-valued areas of the market can happen concurrent with advances in the most out of favor areas, while the overall market continues its advance.

In addition to high yielding stocks, excess global liquidity has also found its way into various other corners of the market. Real Estate Investment Trusts (REITS) and emerging markets debt funds have seen major money inflows throughout the recovery, and these money flows have reversed sharply in the most recent couple of weeks.

In the market weakness following Bernanke's comments, with the expectation that interest rates would be heading up, interest rate sensitive assets of all kinds saw sharper declines than the broad markets, and emerging debt funds and emerging equities, especially those more leveraged to commodities markets, were among the asset classes suffering the steepest declines. At this point in time it is too early to know if we are merely at the beginning of a longer-term flight from emerging debt and equity markets, or if like we suspect, we just witnessed a sharp knee jerk over-reaction from short-term traders, unwinding positions they perceive too risky in the short run. If the latter, we'd expect the correction in Emerging markets debt funds to reverse itself through the remainder of the year.

Despite the market reversal of the last two weeks in May, U.S. stocks finished the month higher and have posted impressive year to date results with the S&P 500 up 15.37%., heading into June. More fully diversified, globally oriented investors have not fared as well. Through the end of May, MSCI World ex-US is up 4.49% year to date, while Emerging markets are actually down 3.42% through the same period.

Abrupt corrections by sector or asset class can leave investors dazed and confused if their investment strategy is not guided by an overriding long-term fundamental thesis and value proposition. This adherence to a long-term outlook and value proposition leads us to be boldly stubborn and unfazed by short-term market gyrations.

The current opportunistic positioning of our client's portfolios reflect our view that global economies will continue along the path of improvement, and our allocation to emerging market equity and fixed income is a long-term secular play, based on our continued assessment that we expect to witness significantly faster economic growth rates in emerging market economies than in more developed economies. Additionally, during the past decade, developing nations have reduced their debt loads as a percentage of GDP, while the reverse is true for the developed economies, which now have nearly three times the debt burden of their emerging markets counterparts. Therefore, the risk traditionally associated with emerging markets has diminished significantly compared with those of developed economies.

We believe that other market participants are beginning to see what we have seen for several quarters now—that the recovery is real and slowly but surely is working toward full sustainability, which means the Fed can relax monetary policy and adopt a hands off approach. There of course will be short-term periods of volatility generated by traders who attempt to time market psychology related to the perceptions created by weekly

"Fed speak" or the over-emphasis of monthly economic releases.

Although we generally invest in under-valued securities or avoid investing in over-valued securities, once in a while we identify and invest in a "short" opportunity when risk/return is substantially in our favor. We have recently have begun building positions in an ETF that shorts the price of high yield bonds. This investment thesis begins with the historically narrow interest rate spread between risk free government bonds and below investment grade "high yield" corporate bonds. The price implication for high yield bonds currently is that prices are at historical highs, with yields at historical lows. The obvious short when bond prices are at historical highs, as they are today, is to short Treasury securities. Shorting Treasury securities turns the risk of rising rates on a bond portfolio into a positive investment as the economy improves and yields rise. However, the risk in actually shorting Treasury securities at the present time is if instead of improving, the economy instead falls into a recession over the next two years. Should a recession occur, Treasuries prices will again appreciate in value as investors seek shelter; thus the well intentioned short position will fail. However, with high yield corporate bonds, the short position in those assets, like with Treasuries, will yield gains if the economy improves and interest rates rise, but unlike Treasuries, if we do fall into a recession, high yield corporate bond prices will fall as perceived default risks rise. Therefore, we believe that presently shorting high yield corporate bonds is a unique hedge that will work at either extreme of economic outcomes.

Concurrent with our belief in the long-term fundamentals supporting our emerging markets debt and equity allocations, utilizing tactical investments like shorting high yield debt introduces a unique "all-weather" hedge opportunity into portfolios based upon sound economic principals. As always, we will be watching both economic and capital market fundamentals as they unfold and will not hesitate to take appropriate action to adjust our long-term positioning should the fundamental reality that we monitor begin to develop differently than we envision.

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