Curb Your Emotions, This Time May Not Be Different (1/17/14)

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With today's elevated Shiller ratio at 25.5, history shows that the expected return of the stock market should be ½% per year over the next 10 years.

Aside from the usual ebb and flow of business, there are powerful long-term shifts that are taking place in the demographic composite of our nation.

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In today's uncertain environment, historical analysis mandates that a disciplined approach to asset allocation is always warranted.

Are Bonds More Risky than Stocks?

Since the global credit crisis of 2008, economic activity has been lackluster, inflation has fallen, and the Federal Reserve's involvement in the bond market has surged to unparalleled levels. Along with the uncertainty of the times, investor sentiment has vacillated markedly. It was only five years ago when some stock market participants viewed the equity market as the most risky sector to deploy their assets. Today, amidst an explosive stock market rally, many investors are categorizing bonds, not stocks, as the biggest threat to their portfolio's stability. In fact, some are questioning the value, wisdom, and safety of high quality fixed income securities. The fourth quarter of 2013 seemed to cap off such a time for fixed income investors, as stock prices surged and interest rates of intermediate and long maturity bonds continued their ascent.

Fed Begins Taper "Light"

After much anticipation, on December 14, 2013, the Federal Reserve finally "tapered" QE3. They announced that they will reduce their purchases to $75 billion from $85 billion. The $10 billion cut was evenly distributed between Treasury bonds ($5 billion) and mortgage-backed securities ($5 billion). Our thoughts on the topic of QE are well known. Not only do we believe that QE has had a minimal effect on economic activity (San Francisco Federal Reserve study estimated that QE enhanced growth by only 0.13%), but the taper is also not as impactful as some may ascribe. The budget deficit has declined by roughly 35% (to an estimated $650 billion from $1 trillion), and with it the pace of Treasury borrowing slowed by the same 35%. So, the Fed will need to cut another $17.25 billion or 23% more in 2014 just to maintain the same level of "stimulus" as 2013's pace.

Only Time is the Cure for Structural Headwinds

Many attributed the rise in yields to the prospect that the Federal Reserve would taper their QE program. At RSW, we believe there was more to the rising rate story than just the fear of a taper. From our vantage point, the 2013 bond sell-off was more broadly based on a perception that the economy would return to the days of the "old normal" and generate sustainable 2.5% to 3% type GDP growth.

The question that remains, however, is: was the bond market right? You already know our answer! To be sure, we are not attempting to minimize the improvements that have taken place in the economy since the crisis began. In fact, we only doubt, as we have since the beginning of the global turmoil, the sustainability of the economy's historical growth rates. There are simply too many structural headwinds.

We have never seen a time when the rate of unemployment was declining because the number of people leaving the workforce was greater than the number of individuals joining it. There is more at work here than just economics. Aside from the usual ebb and flow of business, there are powerful long-term shifts taking place in the demographic composite of our nation:

- Demographic shifts are impinging on future growth (according to the Kansas City Federal Reserve), and account for roughly one-half of the decline in the labor force participation rate. Business cycle factors seem to account for the other half.

- While discussions in the media tend to focus on the pace of hiring, it is important to note that the participation rate was expected to fall irrespective of what happened in the business cycle. It's just math! Increasing life expectancy over time increases the size of the total population at a greater pace relative to those in the labor force.

No matter where one stands on the "safety net" debate, a "graying society" should continue to impose significant financial burdens to care for the elderly. Taxes to pay for government programs come from individuals and their paychecks. Unless the downward trends in the participation rate and the declines in median incomes are reversed, reduced net incomes will tug at growth levels as tax rates are driven higher. There will simply be less income available to be taxed.

While there are several reasons to be optimistic about US economic activity (surge in auto sales, rebound in the housing and manufacturing sectors, etc.), the impact is diluted by the aforementioned structural headwinds such as demographics and declining wages.

It's Just Math!

Given the dramatic shift in investor psychology and higher prices of riskier securities, RSW provided a "blue print" for analyzing the risk of the equity and high yield bond sectors in our "2014 Fixed Income Market Outlook" (www.rswinvestments.com/pdf_commentaries/RSW_2014_Outlook.pdf). The goal was straightforward, as we attempted to provide a "fact-based" analysis, quantifying the "cheapness" or "richness" of each asset class. Out of several market metrics, we chose the Shiller PE (in its simplest form, the ratio is calculated by dividing the 10-year average of inflation-adjusted earnings by the current price of the S&P Index) to value the equity market, and to project future returns, shown in chart below:

	Starting PE		S&P Total Rate of Return		
	Low	High	Avg 10 Yr	Worst 10 Yr	Best 10 Yr
	17.3	18.9	5.3%	-3.9%	13.8%
	18.9	21.1	3.9%	-3.2%	9.9%
	21.1	25.1	0.9%	-4.4%	8.3%
Where we are today →	**25.1**	**46.1**	**0.5%**	**-6.1%**	**6.3%**

With information dating back to 1926, the chart details the return that investors can expect to earn over the next 10-year period, when the Shiller PE starts "year one" at a certain level. Starting at today's elevated Shiller ratio at 25.5, the historical average stock market return is ½% per year over the next 10 years. Furthermore, when PE's were this elevated, the highest return ever recorded during any of those 10-year periods was +6.3% and (-6.10%) was the worst. While equities were pricing themselves for probable future returns of +0.5% per year in the next decade, 10-year Treasury bonds were touching 3%.

Where the Rubber Meets the Road

Concurrent with our observation on the valuation of risk assets, particularly equities, investor sentiment (Investor Intelligence Advisors Survey) in stocks has reached a 27-year high. Predictably, like all bull markets, as optimism surges, investors minimize the importance of keeping risk under control. Risk management becomes an "old school" notion, and is replaced by a need to "perform". Predictably, this coincides with a chorus of people who want us to believe that "this time is different". While the pendulum of investor sentiment has swung hard to "risk on" from "risk off", we believe that metrics that have withstood the test of time such as the Shiller PE shouldn't be ignored. In fact, it is exactly at these emotional times when those "yardsticks" should be embraced.

If 87 years of history tells us that a near zero return (+0.50%) over the next 10 years is what investors can expect in the stock market, then de facto US Treasuries (10-year @ 2.85%), high quality corporates (3.50%; Merrill Lynch AA- rated 7 to 10 yr index) , and municipal bonds (2.70% AA-rated; taxable equivalent yield 4.77%) are currently more attractive. For traders on the other hand, and those whose investment assumptions are based on momentum or recent performance, the outlook may look different. It is important to note that while the quantitative method discussed above has a solid long-term track record, it was not conceived to provide an indication of what returns may look like over shorter time periods. As we have said in the past, what's trading at "rich" levels can get "richer".

For those of us who do not possess "yardsticks" or "crystal balls", it may be an appropriate time for investors to: "**Curb their emotions, as this time may not be different**".

Tax-Exempt Commentary

The fourth quarter marked the end of a very difficult year for fixed income securities overall. Q4 provided little respite for bond investors as the market, as measured by the Barclay's Capital Municipal Bond Index, posted a return of +0.33%. It is important to note that the interest rate movements in the municipal arena have been anything but level. Aside from the absolute level of interest rates, we have been closely monitoring the shape of the yield curve, as we search for opportunities. With short-term yields fluctuating only mildly and the yield of longer maturity bonds changing more rapidly, the yield curve continued its steepening trend. In plain English, this just means that the yield difference between short and longer maturity bonds has grown. In fact, as of this writing, the yield differential between 5 and 10-year maturity tax-exempt bonds is nearing a 25 year wide and stands at 148 basis points (1.48%).

To capitalize on these developments, as the year unfolds, we will seek opportunities to enhance tax-exempt cash flow by extending the average maturity, and/or duration (measurement of interest rate sensitivity) of our client accounts.

A Disciplined Approach to Asset Allocation is Always the Right Strategy

High Net Worth Individuals Should Always Maintain a Diversified Portfolio Which Includes Municipal Bonds

By definition, volatility and uncertainty are part of the investment landscape. Understanding risk and seeking to minimize it is part of a disciplined strategy. As the New Year begins, investors often reassess their portfolios and seek to address allocations with an eye to the future.

Portfolio reviews at this time can prove particularly vexing as equities are reaching new heights after an extended bull run, and as many pundits are anticipating a gradual rise in rates in 2014 and 2015. Investors are focused on various factors that can be conflicting such as capital preservation and gain realization vs. further equity appreciation, and predictable cash flow maintenance vs. "waiting for higher rates".

It is no wonder, therefore, that virtually all diversified investment houses, including full service brokerages and mutual fund managers, seek to provide guidance by publishing "pie charts" that suggest asset allocation mixes for conservative, moderate, and aggressive investors.

With this in mind*, **we recognize that no one model fits all.*** Nevertheless virtually all such conservative and moderate investment allocation models that we have reviewed at this time include allocations to investment grade fixed income that range from 25% to as high as roughly 60% for the most conservative investor. For high net worth investors this allocation typically includes municipal bonds.

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