The Long & Short of It

Quarterly Newsletter
Second Quarter 2013

A View from the Big Top

Today, Ben Bernanke and crew walk an ever narrower high-wire atop the circus floor. Any misstep on their part could thwart the US economy. Tightening monetary policy too quickly would stall the economic recovery. If deflation takes hold, then servicing the national debt would become very difficult. Over-stimulating the economy would create asset pricing bubbles prone to bursting. Confidence in the dollar could be lost.

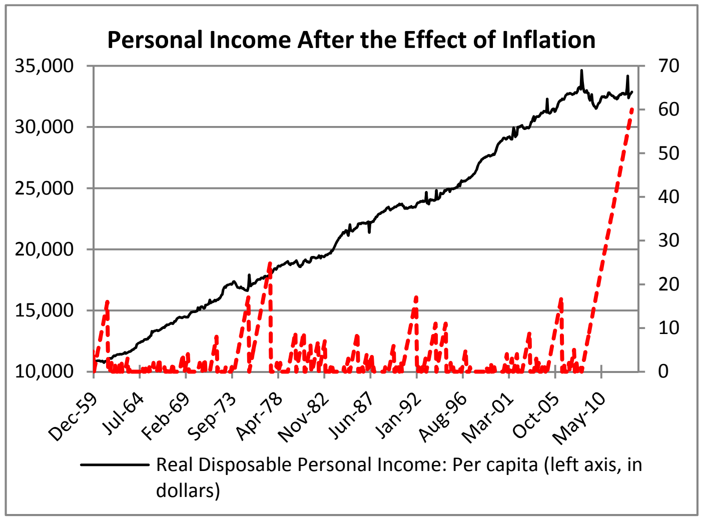
The show must go on, and so it did in the second quarter, with domestic stock indices rising a modest 2% to 3%, outpacing international indices which turned in moderate losses. In a world that only a Fed governor could love, Morningstar reported that the best performing categories of stocks were those swinging from the rafters of their balance sheets: Cyclicals (+4.7%), Speculative Growth (+11.4%) and, best of all, Distressed (+16.7%). With stocks doing well and inflation expectations declining, inflation-hedging Precious Metals took the news poorly, losing 35%. Bond indices were broadly lower—down 1% to 7% depending on risk levels—with Inflation-Protected bonds (-6.6%) and Emerging Market bonds (-6.8%) among the worst performers. In addition, the strength of the US dollar during the first half of the year was remarkable, adding nearly 4% to the purchasing power of Americans in the global marketplace. When it comes to buying domestic products (especially services, i.e. haircut) this makes little difference. But it is welcome relief after the decline in the dollar from 2009-2012 which is largely responsible for the rising cost of food, energy and other products priced on the world's markets during that time.

The yield on the 10-Year US Treasury note, which rose nearly a full percent from 1.61% to 2.60% during the quarter, reflected the tension in the FOMC's balancing act. This rise in interest rates seemed to be what Federal Reserve Chairman, Ben Bernanke, was responding to when he advanced the timetable for potential tightening of monetary stimulus.

Though the equity markets at times seem as chaotic as a circus, Mr. Market has a strong preference for stability and predictability. Happiness is a Federal Reserve that seems to have everything under control. While targeting approximately 2% as the ideal level for inflation, the Federal Reserve keeps Mr. Market happiest when inflation expectations do not deviate much above or below the target. Inflation expectations can be measured using the 5-year US Treasury bond yield less the 5-year Treasury Inflation-Protected Security (TIPS) yield. Inflation expectations stayed very close to the targeted range during late 2012 and the first quarter of 2013, which brought comfort to Mr. Market and a solid performance to stocks. In June 2013, inflation expectations fell below targeted levels, something that usually accompanies a temporary decline in the stock market. Watch inflation expectations carefully. A drop further below the targeted range would damage stock valuations. Returning to a more normal range would accompany a renewed rally in the economy and the stock market.

Walking the High-Wire

For many years now, the headwinds of aging demographics and declining labor force participation have driven slower growth and an increasingly deflationary environment. Debt levels have increased in an effort to sustain growth that cannot be sustained, with the resulting interest burden creating further economic slowing and deflation. While productivity gains—fewer workers producing more goods—have led to some real growth, they are at the same time deflationary. In the 1970s, as Baby Boomers entered the labor force and supported children and built homes, tremendous inflationary forces were unleashed. Monetary policy in the 1970s was very effective at stimulating the economy, yet rather ineffective at slowing or reducing inflation. As the door hits the Boomers on their way out, the inverse is upon us. Because the Boomers had more brothers and sisters than they did children, their retirements suppress the growth of the labor force and reduce the amount of spending per household. Today, monetary policy is very effective at slowing the economy, with the risk that deflation may take hold, but has limited effectiveness when trying to stimulate growth.



Sustainable GDP (i.e., GDP not propped up with extraordinary deficit spending or monetary policies) remains some 10% below current levels. While the economy would be on firmer footing if the government kicked its addiction to debt issuance and money printing, rapid withdrawal from that addiction would be very painful. The pain is already being experienced. Real personal income per capita has been unable to reach a new high for over five years, by far the longest period since such numbers began to be recorded. The question remains: “How long does this go on?”

80% of the liquidity created by the three Quantitative Easing campaigns (about $1.7 trillion) sits nearly idle, earning 0.25% as excess reserves in private banks. This liquidity has yet to find its way into significant lending that would translate into increased hiring and greater economic activity. For some banks, the hesitance to lend more stems from the constraints created by increased capital requirements. For other banks, their desire to lend has yet to meet the demand for new loans. Perhaps the biggest impediment to confidence over the last few years has come from uncertainty regarding fiscal policy. However, the most recent *Senior Loan Officer Opinion Survey on Bank Lending Practices* indicates that confidence may be returning and that bankers are beginning to loosen standards and free up credit a bit. This same confidence may be what is driving the current rare combination of rising expectations for real growth and declining expectations for inflation. For now, it seems, the economy is clearly improving.

Canaries in the Gold Mine

If the moderate recovery will sustain, stocks and real estate will prosper and gold will languish. For gold to reverse its current trend, the economy must push outside of the normal, stable levels of activity and price levels that keep Mr. Market happy. If inflation or deflation gets the upper hand for a period, stocks and real estate will suffer and gold will recover quickly. While we enjoy the improving valuations brought on by increased investor confidence, it remains prudent to endure some temporary pain by continuing to hold gold mining stocks. In time it will again be made clear that sustainable growth rates remain at lower levels. The Fed’s dual mandate will continue to dictate that easy money policies, beneficial to the price of gold, will remain necessary.

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