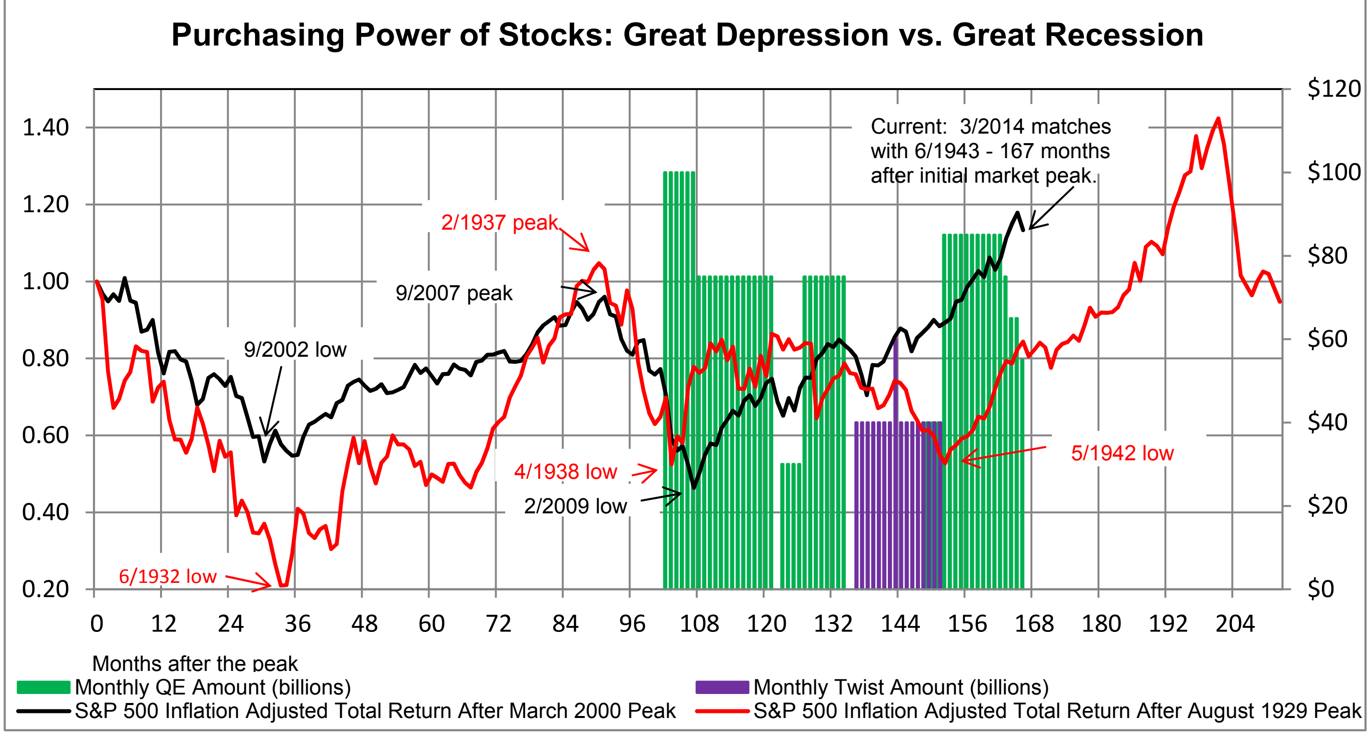
The Long & Short of It
Quarterly Newsletter
First Quarter 2014

Bubbling Up Again

The first quarter of 2014 was a bit of a roller coaster ride from the inside: a sharp 3.5% drop in January, an exciting 4.6% recovery in February, swift rotations out and back into emerging market equities, as well as a steady rotation out and a rapid return to value stocks. The turning point seems to have been Janet Yellen putting a time frame on when interest rates might be raised. Looking back at the full quarter's results, investors basically treaded water. Stock and bond investors ended the quarter generally between 1% and 3% better off than where they started, not too disappointing considering the stock market's strong performance in 2013.

This quarter, we update a chart we first published in the third quarter of 2010, which compares the inflation-adjusted total returns of stocks during the Great Depression (beginning in 1929) with those of our Great Recession (beginning in 2000). Wealth creation in the US can largely be measured through the total return of the stock market (including dividends) after accounting for the impact of inflation. Dividends must be included and inflation's impact must be removed in order to track the purchasing power of a dollar invested in stocks. This analysis will answer the question, "How much can I buy with the proceeds from my investments?"

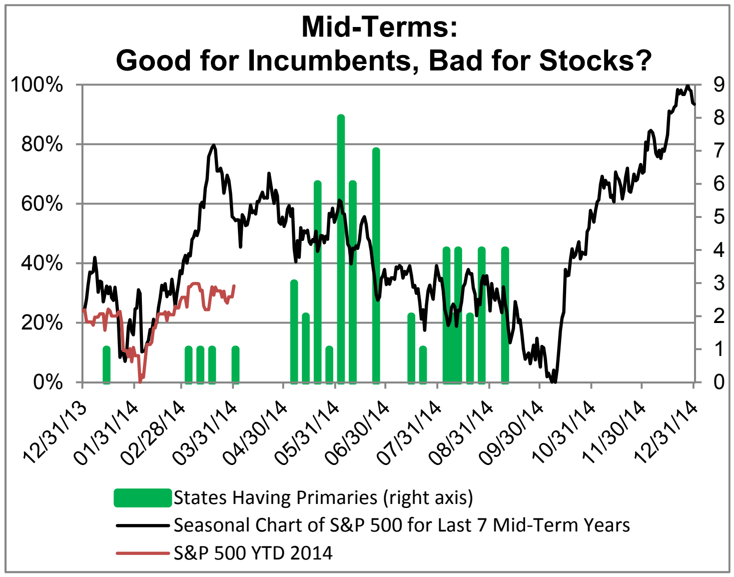


Although the purchasing power of stocks (PPS) fell more precipitously in the first 34 months of the Great Depression than in our Great Recession, it recovered as quickly as it fell behind, catching up by the 77th month. Between months 100 and 130, PPS in our current Great Recession had fallen below that of the Great Depression.

In month 102 (November 2008), facing more bad news than a Fed governor can bear, Quantitative Easing (QE) got the call. QE is the expansionary Fed policy whereby assets are purchased in large scale from commercial banks and other private institutions to stimulate confidence and the economy. Perhaps, in the face of such a severe contraction, QE made sense. What is harder to understand is why it was necessary, after nearly recovering to their lifetime highs in month 150, to initiate a third round of QE. It appears the bubble is being blown again.

Mid-Term Primary Update

For stock market valuations, certainty is good. Mid-term elections typically result in gridlock that helps stocks. As the primaries are now underway, we expect that the usual "Sell in May" market weakness will get an assist from the uncertainties created by the primaries. We are not sure whether this "Primary/Mid-Term Effect" comes from the extremely partisan tone of primary elections, expectations for incumbency, or fear of Congress having a new mandate after the election. The black line on the chart represents an average and as such is not definitive, but the pattern is clear. We will remain somewhat defensive toward stocks for the next few months.



Borrow Much/Spend More

From Janet Yellen's recent speech in Chicago on March 31, it remains clear the Fed will continue to kick the tired horse when deflation threatens. However, between the lines, something has changed. Never before have we seen the Fed so directly state their goal to encourage consumers to *borrow* to enable them to spend more. Little of the speech was dedicated to the need for a stable, predictable economic environment where reasonable and rational risks are measured and taken. Mrs. Yellen emphasized stimulating spending by making homes, cars, and business expansion more affordable through more attractive debt pricing (i.e., lower interest rates all around). Our take: the Fed is doing all it can to compel private citizens and businesses to act in a manner consistent with their elected representatives in Congress—borrow much, spend more.

We estimate that sustainable real GDP remains 5-7% lower than current levels. More borrowing could certainly give the economy a temporary lift. However, any reduction of stimulus (for now, "The Taper") will be surprisingly effective at slowing the economy and giving sway to deflation. If CPI weakens further it will not be good for stocks, though whether or when that might happen is obviously difficult to gauge. Over the last several decades, the largest market movements have increasingly been driven by our willful government as it attempts to manage its own excess. We will continue to respond to opportunities in valuation, placing added emphasis on cyclical shifts in investor sentiment to successfully manage risk in this low-growth, low-interest rate environment.

Amy Abbey Robinson, CIMA
amy@robinsonvalue.com

Charles W. Robinson III, CFA
charles@robinsonvalue.com
