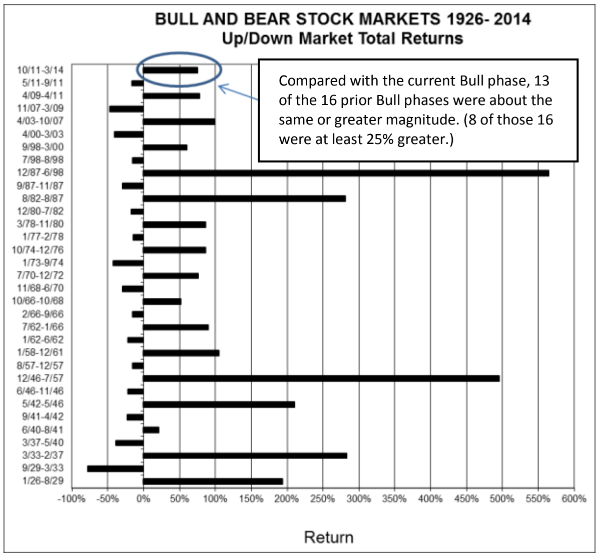
FIDUCIARYVEST
Investment Strategies for Fiduciaries

White Paper **May 2014**

Nothing to fear but fear?

The US stock market is (still) on a roll. At this writing, it has tacked on another 18% in the past 12 months, to deliver 134% since its March 2009 turnaround point. Despite record high index numbers, the market's current riskiness level hasn't reached the point where sandbags are needed to spare us from disastrous flooding. Valuations of stocks do not yet force us to look at them with sunglasses. In addition, there is a comforting presence of market wariness about its own level of Risk. As further support, the Fed is still putting out assurances to banks and market risk-takers that it will continue to brew and distribute its elixir of no-cost money, even though the Fed's zero interest rate policy has already thoroughly bailed the biggest banks and essentially mopped up the entire marketplace of home mortgage securities.


BULL AND BEAR STOCK MARKETS 1926- 2014
Up/Down Market Total Returns

Compared with the current Bull phase, 13 of the 16 prior Bull phases were about the same or greater magnitude. (8 of those 16 were at least 25% greater.)

As this column has reminded readers from time to time, the current price of *any* investment is the present value of its *expected* future return; that present value is primarily driven by the current market rate of interest on the benchmark 10-year US Treasury bond. Despite a significant increase in the 10-year T-bond's interest (discount) rate from a year ago, the stock market's recent 12 month return has been double-digit. Strange? Yes. The main reason is demand. After nearly six years of punishment dealt them by the Fed, savers hoping to earn a 3-to-5% return have folded their tents and walked away from traditional interest-bearing deposits. Instead, they have bought stocks, especially those with healthy dividends. The reasoning goes something like this: While they believe that continuation of recent double-digit returns from stocks is unlikely, many conservative savers think they can still "safely" expect to net at least 5-to-6% from a diversified stock portfolio.

There are multiple factors causing a "buying panic" in the stock market.

What happened?

In addition to the absence of any return at all from savings accounts, there are multiple factors causing what we have called a "buying panic" in the stock market…. so much demand that the market soared by 75% during just the past 28 months, without much help from corporate earnings growth:

- *Low forward interest rates.* After dark clouds appeared during the summer of 2013, stock market players gained encouragement that interest (discount) rates will be held down by the Fed for several more years.
- *Dried-up demand for bonds.* The Fed's gradual winding-down of its annual $1 trillion open-market buying of mortgage-backed securities and long term US Treasury bonds is slated to reach the zero-buying-point around the end of 2014. But, no one seems to be discussing (any more) the original, Ben Bernanke idea that the Fed would actually sell its $4 trillion accumulation of bonds. The likely reason why that talk has stopped is that such bond sales would flood the market which, in turn would

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bring on the higher interest rates that bond buyers would require. (Not only that, but the Fed would be forced to realize a ton of losses on such sales, because, on its books, the investments are valued at their uncollected principal amount.)

- *Continued low-cost money available to more borrowers*. Plentiful mortgage capital will likely fuel the construction of homes and other buildings, as Fed-support for the finance industry further builds its footing and renews its appetite for riskier, more profitable loans, including sub-prime mortgages (yes, again already) which are cropping up this year among small banks.
- *Continued corporate efficiency*. Scrooged-down payrolls made up of part-time job holders, together with other lingering recession-era corporate habits, are paying off at companies' bottom lines; but if sales growth does not amp-up soon, bottom lines will stagnate.
- *Bright outlook on job security*. The people who do have jobs are no longer working under the heat lamp of fear that their boss is still keeping his payroll-axe close by.
- *Pent-up consumer demand*. Gobs of aging automobiles are being replaced, using plentiful, low-interest loans, and housing upgrades are back in vogue.
- *Pent-up housing demand*. Home prices have made a sharp turnaround and haven't looked back. Big news: the inventory of both new and re-sale houses is very low in most local markets.
- *Exciting outlook for energy prices*. US "energy independence" has become a widespread notion, providing surprise and relief from decades of national angst about alleged, sinister Mid-Eastern influence on the US economy.
- *Signs of "core" inflation are hard to find (though food prices are rising). S*alaries and wages are *not* increasing and therefore aren't causing price increases of most goods and services.
- *401(k) accounts are alive again.* People are actually looking forward to opening that envelope, or web page displaying their 401(k) plan account.

Here are indicators of overall market imbalance that will point to elevated riskiness.

Signs to watch for

If we conclude that today's record high water marks are not a risky precipice, then what warning signs should we look for? Although public equity securities are the liquid form of business ownership, they also have a commodity aspect… they each have a supply/demand balance (or imbalance) that can independently make a particular stock more risky, or less risky at a point in time. Here are some primary indicators of overall market imbalance that will point to elevated riskiness, if/when they appear:

- *Retail interest* in active trading of equities begins to hyperventilate. Indicator: rapidly rising popularity of cable TV programming targeted on helping people identify great stocks. Margin accounts and their usage are increasing.
- V. Putin and/or US *politicians make a major miscalculation* about the other's intentions and actions.
- *Small cap and emerging stock markets begin to swoon*, while large cap stock prices remain stable.
- *Bond markets become disorderly*… volatile trading, or indications of low liquidity and perhaps a surprise default or two.
- *Hot, over-leveraged real estate prices*; frequent buying and selling of "trophy" commercial properties. Banks are in stiff competition to lend to "quality" developers.
- High and rising *demand for private equity participation*; private equity funds, including a number of startup ones, are able to turn over investment holdings after only a year or two, making them appear to be a semi-liquid vehicle for investing.

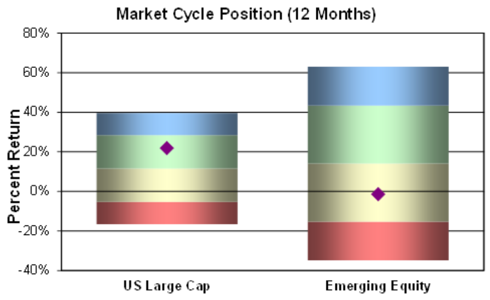
- High and rising *demand for IPOs* and newly created investment partnerships in various sectors.

Flip side of the equities boom: Emerging markets?
One of the sub-categories for investment in common stocks in the non-US investing world is generally known as emerging markets. By definition, the typical emerging markets themselves are relatively small, generally thinly traded and the market cap of the larger companies offered is more aligned with the small cap segment of the US and other developed markets….. a sort of small markets/small cap window. Large investment firms which offer emerging markets investing face a liquidity challenge for portfolios of the size they typically manage; it is therefore common to see them invest in the largest cap companies available, some of which are mid-cap-size. Asian countries dominate the index; its current allocation is about 20% China, 15% Korea, 12% Taiwan, 11% Brazil (top 4 country total: 58%) and the next four index countries make up an additional 25% of the total.

Opportunistic investors have re-focused on emerging markets in 2014

The most widely used benchmark is the MSCI Emerging Markets Index, which covers some 21 countries and 800 stocks. For the past 3 years, 1 year, YTD, etc., there have been few investment products in the emerging category that produced a positive return, but 5-year returns are respectable, double-digit. The index has similar negative results for those periods. Perhaps for that reason, opportunistic investors looking for lagging situations among frothy developed markets have re-focused on emerging markets in 2014 and, although the index returned essentially zero for 2014 through April, the past 3 months were robust, mid-single-digit returns. The Brazil-dominated MSCI Latin America sub-index returned almost 14% for this year, through April, though its trailing 12 months is a worst–by-far index number: minus 11.3%.

The graph below shows a portion of FiduciaryVest's proprietary monthly snapshots of current positions (the red diamond) within the long term historical ranges of two 12-month index returns. The Emerging Markets index is now well below its historical average, while the S&P 500 Index is above its long term average.



The Russian problem
Seasoned analysts of Russian affairs are warning that the festering Russia/Ukraine matter is a deeply serious powder keg of the sort that can predictably bring world investment markets into a daisy-chain type of downdraft. Europe is highly vulnerable to the impact of Russian President Putin's strategy, whatever it is.

Mr. Putin has already activated Ukraine Phase 2… a military infusion into that former Soviet satellite's Russian-speaking eastern provinces. A few weeks before that, Putin's Ukraine Phase 1 involved Russia's outright annexation of the Ukraine's warm-water peninsula on the Black Sea, including its population of mostly Russian-speakers and a location that is of huge naval and commercial importance to a super-size Russian land mass which lacks ice-free seaports during long Siberian winters. The world's reaction to Putin's Ukraine Phase 1 was, more or less, to comment disapprovingly, but in a manner that was clearly without threatening to act.

Russia's economy is poor and getting more so. In fact, if Russia spits out another negative GDP growth number for the current quarter, then the country will be in an "official" recession. Russia is struggling to prove itself to be a credible world influencer and it is struggling to compete in the global economy, from a manufacturing base that produces very little that the world wishes to buy, other than a major supply of oil and gas and the pipelines to deliver it.

While European leaders are saying Putin's explanations of his Ukraine actions are non-sensical, or even delusional, they are dis-inclined to confront him, given that their economies run on Russian oil and gas. [But, note: Russia's own economy is so weak, it cannot consider cutting off its customer base… not even for a short period. While European oil-dependency on Russia is a fact, that dependency could likely be shifted to emergency supplies available from the US and its long-time Middle-Eastern friends, especially during this spring and summer period that requires no home-heating fuel.]