Third Quarter 2014

Economic and Market Commentary

By Ray L. Lent, Owner, The Putney Financial Group; Chairman, Portsmouth Financial Services

By most people's standards, it is an average size room. Eyeballing it, I'd say it's no more than

12 x 15. Its nine-foot ceilings lend it good proportions. A door to a small private bath is off to one side of the room, and across from it is a door that leads to the front garden. The carpeting is a tasteful brown and black check bordered in black. A double pedestal rosewood desk is tucked off to one corner with a desk lamp on it made out of a small statue of Frederick Kellerman, the Hessian soldier who served under Washington during the Revolutionary War.

Two of the walls are covered with photos, memorabilia and sailing pennants. There's a photo of me as a young man riding a camel named Jodie at a friend's wedding, and a rakish photo of my dad wearing a pith helmet while serving in Burma during World War II hangs next to it. Photos of sailing crews I've been part of, along with awards and paintings fill every square inch of wall space. The walls are painted a muted green. It was a custom color when I picked it out, and I remember the painters nicknaming it "money green" because it reminded them of the color of money. How appropriate, since this is my study, and once a quarter I hole up in this room for several days to write about money and markets and history. It's now the end of a quarter, and Kellerman and I have renewed our long friendship.

Perhaps this room's most striking feature is the bookshelves that occupy two entire walls. Yes, I'll admit it, I'm a packrat, and I throw nothing away. As an old English major, I figure I've now read some 2000+ books in my lifetime, and it seems that most of them are still here with me in this room. With the past quarter's market activity being what it was, there's a small volume hiding somewhere in here that I want to share with you a little later on. I think it will lend perspective to both the current market conditions as well as the strategies we're employing to prosper from them.

Crosscurrent

The word is Old English in its origin and is most often used in a nautical context to describe a turbulent stretch of water caused by multiple currents. In modern English, it's morphed by extension to mean a situation in which there are conflicting opinions. Third quarter equity markets' activity along with October's volatility without a doubt demonstrate that strong cross currents are at play in the markets.

Third quarter portfolio results throughout my client base were relatively neutral. Depending on the client's age and risk preference, they could have been up a percent or two or down a percent or two. Basically, a cruel and volatile September wiped out our portfolio gains from July and August. It's been more than three years since the market has seen a 10% or more correction, and since the average over the last hundred years is that one occurs every two years or less, for many one seemed overdue. Yet with such a conflicting body of data out there, can one really say which direction the market will now turn? Has October served as an opportunity to reboot a secular bull market with years left to run, or is it the bellwether for a deep equities market decline?

Confluence

The word dates back to 15th century France and came to represent two or more distinct bodies of water meeting and then flowing together at a particular point. It could be two streams, two rivers, or a river and a stream. In modern times, the definition has broadened to reflect an act or process of merging. And that's precisely what we've seen this past quarter. Investors watching the confluence of conflicting data.

Think about it for a minute. Two bodies of information flowing into a point of intersection. That point of intersection for our purposes is squarely in the center of "Equityville." Just like the ancient marketplaces of the Fertile Crescent, "Equityville" is where willing buyers and willing sellers come together from around the globe to make an exchange. An exchange of cash for goods.

There's Been a Sale Going On

Today is Saturday. As of two days ago, every single stock (all 30 of them) in the blue-chip Dow Jones Industrial Average has dropped in the month of October. Was it a coincidence? Had they all reported negative news at once? Certainly not. In fact, many of them are reporting increased sales and increased revenues over last year, and yet companies as different as Disney to DuPont all went down. Now why is that? The question can be answered with one word: "Correlation." Correlation is the measure of a tendency for securities to move in the same direction at the same time. It's a clear indicator of indiscriminate selling, dumping good stocks with bad at discount prices.

We haven't seen it since last year when the Federal Reserve announced their tapering policy which resulted in a sharp decline across the entire S&P 500 over the course of just several weeks. It didn't last long. Stocks came back with a vengeance and ended the year with a stellar fourth quarter. But that type of rebound can't be taken for granted. Thoughtful analysis is never a wasted exercise, and it helps to eliminate emotions from the decision process.

So What's Driving The Market of Late?

Over the past five years, a complacency had come into the marketplace that resulted in many investors having very short memories. They seemed to be able to shrug off quickly whatever negative news came their way. Wars, government shutdowns, it didn't seem to matter. Volatility seemed to be a thing of the past. No significant pullbacks or corrections. For many, the markets seem to be a one-way street named capital gains, but as is so often the case, excesses in one direction will lead to excesses in the opposite direction. That's exactly what started happening in late summer.

The market had been dealing with a host of concerns: A hard landing for China, a weak Euro, the Ukraine, the Middle East, the end of Quantitative Easing (QE) and earnings. Take your pick. The straw that seemed to break the camel's back came from a most unexpected place. It came from the villages of West Africa and its name was Ebola. As politicians seized on the threat of the virus and news reporting became ever more sensational, anxiety and volatility returned to the market that hadn't been seen since 2008.

So Just How Bad Is It?

To answer that question, let's look at the pending challenges through a dispassionate lens one by one.

Energy

Much has been made of the fact that crude oil prices have fallen more than 20% in mid-July to a recent level of low $80s per barrel. Gas prices in many parts of the country are below $3.30 a gallon. Sure, the oil companies and many of the service providers have been hammered (e.g., Schlumberger is down 20% in the past three months).

My Take

Falling energy prices have been largely ignored. For the average American, lower gas prices are like a tax cut, which results in more discretionary spending. A plus for American business, a plus for the American economy. Furthermore, the fact that American natural gas production is up over 40% over the last 5 years, and American oil production is up 70%, has gone a long way in dampening the effect we would have felt from geopolitical pressures around the globe.

Europe

In the last several weeks, the markets have reacted quite negatively to the GDP numbers coming out of Europe, particularly Germany. Back in 2010 and 2011, Europe's economic troubles sparked a sell off in U.S. equities. There is fear that this could happen again.

My Take

As large as the German economy is, it pales by comparison to the size of the U.S. economy (16 trillion dollars to 4 trillion dollars). We're not dependent on our exports to Europe. Less than 14% of American production is exported. Our economy is much stronger today than it was in 2010, 2011. An American economy less dependent on foreign oil, leading the world in biotechnology and social media makes American equities a compelling alternative for global investors.

Ebola

An insipid disease first discovered in West Africa in 1976, with outbreaks earlier this year in the countries of Liberia, Sierra Leone and Guyana. The U. N. and the World Health Organization admittedly mishandled the early stages of the outbreak (to date, more than 4,500 people have died). Recently, two healthcare workers who treated a Liberian man with Ebola in Texas tested positive for the virus. One had flown between Dallas and Cleveland just as symptoms were appearing after she had received approval to travel from the Centers for Disease Control (CDC).

The CDC and the administration both admitted that they had misjudged American preparedness for such an occurrence. Politicians debate travel bans, and the President appoints an Ebola "Czar."

My Take

In human terms, the disease is a nightmare with horrendous mortality rates. Americans need to be able to have their trust and confidence restored by a capable and responsive administration and government. There is significant reason to believe a successful outcome is well within our reach.

Originally, there were five West African countries affected; along with Liberia, Sierra Leone and Guyana, Senegal and Nigeria had their own isolated cases. Through aggressive tracking of Ebola contacts, isolation of patients and strict protocols on travel, the last two Third World nations successfully beat the potential epidemic and have not had any new cases in over two months. I firmly believe we too will rise to the occasion and eliminate this threat from our shores.

Monetary Policy

For many strategists, perhaps the most significant risk to the equity markets is rising interest rates. Global monetary policy has been extremely aggressive over the past 5+ years. The Bank of Japan, the Bank of England, and the European Central Bank have all adopted policies similar to those pursued by the U.S. Federal Reserve. The U.S. Federal Reserve is the first of these four banks to begin to exit from these historically accommodative policies. With the tapering of their Quantitative Easing program (QE) scheduled to conclude this month, QE was aimed at keeping interest rates low by having the Federal Reserve buy long-term government bonds on a monthly basis. Many economists have seen QE as an important support for the equity rally of the past several years.

A further concern to market strategists is a rise in short-term rates. The Fed funds rate is the overnight lending rate depository. Institutions charge one another to borrow money stored at the Fed. Since December 2008, the Fed has targeted this rate at 0% to 0.25%, Draconian low rates by historic standards. A rise in these rates will affect other short-term rates.

My Take

The unwinding of the Fed's extraordinarily easy monetary policy will be a multistep, multiyear process which ultimately will lead Fed policy back to a normalized state. The timing of these increases will be dictated by the economy's rate of recovery, with Fed board members very sensitive to not wanting to choke off the slow recovery still underway.

To reinforce this point, I would remind you that one of the Federal Reserve Board's chief architects for Quantitative Easing, St. Louis' Fed president James Bullard, said, "The Fed should consider delay in ending QE, given the decline in inflation expectations." He blamed this and the market turmoil on the outlook in Europe, saying that U. S. economic fundamentals remain strong. Powerful testimony that the Fed will remain accommodative and is concerned about asset prices and volatility.

When rates eventually do rise, perhaps as early as mid-2015, they will be modest and measured. The increases will actually help savers and retirees and restore ammunition to the Federal Reserve's monetary arsenal, enabling them to help stimulate the economy when the next real recession hits.

Geopolitical Unrest

Exactly 100 years ago, French and German forces dug opposing trenches from the English Channel to the Swiss border in the war to end all wars. We know how that turned out. War and destruction are unfortunately as old as humankind and regrettably a fact of life.

My Take

Political unrest and military conflicts continue to afflict the world. Whether it's fighting in the Middle East, troops on the Ukrainian border or artillery exchanges between Pakistan and India, global risks like these rarely go away for long. Although they're tragedies to those involved and can certainly add to market anxiety and volatility, they seldom lead to prolonged downward trends.

Perhaps a deeper long-term risk to our country is the effect these global conflicts have by causing diaspora. Think of the mass migrations North by desperate El Salvadorans and Guatemalans trying to escape juntas, poverty and oppression. The United States needs to maintain secure borders but must also maintain sensible and compassionate immigration policies to ensure our vibrancy and competitiveness in a global economy. Japan and many Western European countries have an aged population that isn't reproducing at a sustainable replacement rate. For a large and developed nation, we have maintained a relatively young work force, not through our reproduction rate, but by continuing to be the bright and shining light on the hill to much of the world where people come for opportunity and freedom. A position we can ill afford to lose through poor policy.

Earnings

In most cases, stocks fall for extended periods of time because earnings disappoint, and earnings disappoint because a recession is on its way. Third quarter earnings season began last Wednesday, with Alcoa beating both its top line and bottom line estimates (sales and profits). This was quickly followed by PepsiCo reporting similar results. This week's earnings reports continue in earnest with the likes of Intel, Johnson & Johnson, Citigroup and J.P. Morgan reporting. Most analysts are expecting that somewhere between 70% and 75% of companies reporting will report higher sales and higher profits than in 2013.

My Take

Simply put, corporate profits are rising, top line growth is continuing, and with the recent market sell off, price earnings have come down to levels well below long-term averages. The S&P's year-over-year earnings gains are hovering around 10%. I strongly believe the current emotional instability that gripped the marketplace will be dissipated by the underlying fundamental support that's evident, ultimately resulting in higher stock valuations.

Here It Is

Remember early on in the column I told you there was a small notebook hiding amongst my stacks that I wanted to share with you. Well, I found it tucked in between *The Complete Sherlock Holmes* and *Samuelson's Economics*. It contains notes I took almost 25 years ago when I had a few one-on-one minutes with Bob Farrell, the legendary Wall Street analyst. He had just finished a lecture at Columbia University in New York where he had studied many years prior under Graham and Dodd, authors of the bible on fundamental analysis, *Security Analysis*, first published in 1934.

At the time, I was a much younger money manager with the propensity for plaid suits (I was much thinner then as well) who was baffled by the widely swinging market. The market had not yet started its meteoric rise of the 1990s. Bob had just retired from Merrill Lynch as chief stock analyst after being there for almost 40 years.

We talked for a few minutes about risk, reversion to the mean, and that excesses were never permanent. He reiterated one of his long-held axioms that, "Fear and greed are stronger than long-term resolve,"and then he dropped it on me, seven simple words I never forgot: "Plan your trade and trade your plan." In other words, don't get caught by surprise and react from emotion. Sharp declines can lead to fear, panic, and for many retail investors, selling at the absolute worst time. Big-time advances, on the other hand, can result in overconfidence and deviation from a long-term plan.

Hopefully you'll recall back at the end of the first quarter, I laid out to you my plan to deal with the volatile and widely fluctuating marketplace when I explained what an algorithm is. Remember, it's a "well-defined set of instructions for calculating a function. When the instructions have been followed, an outcome produces the desired ending state." In our case, the desired ending state was a protocol that resulted in the dependable avoidance of overpriced assets and the expectation of timely acquisitions of underpriced assets (in other words, stocks or bonds that went on sale).

It was at this point that I likened our algorithm to setting the dial on our thermostat. To refresh your memory, here's the explanation from the first quarter's commentary:

Yes, I know it's sure not as easy as it seems, but that's where our algorithm comes into play. It is designed to provide a clear and well-defined set of instructions by which we reallocate the portfolio to attain our goal. Avoiding overpriced asset classes and acquiring underpriced asset classes while staying true to our risk preferences, namely avoiding the oversized hit in a down market.

Let me give you an example of just how it would work. Let's say our portfolio model called for the following allocation based on an S&P of 1800: Stocks 60%, preferreds and convertibles 20%, currency and managed futures 8%, with cash, metals and other income alternatives 12%. As the stock market rose to an S&P of 2000, our model might call for 35% stocks, 35% preferreds, 10% cash and metals, with the remaining 20% in income alternatives, e.g., absolute return funds, triple net leases, unit investment trusts.

So what are we effectively doing? We're avoiding overpriced asset classes by selling into strength and harvesting profits. Those profits get banked into more stable, lower volatility asset classes pending future deployment, keeping our powder dry. When do we deploy these banked assets? As the market moves down the left-hand side of the gauge toward an S&P 900, we're buying more stocks at good valuations. Where are we getting the funds to make the buys from? By selling our more stable value, preferreds, convertibles, and managed futures.

Conclusion

So, in order to stay true to our stated plan, it's time to judiciously convert a portion of our more stable value components and take advantage of the significantly discounted blue chips available before they completely rebound. Stocks like United Technologies, General Electric and Gilead are all strong dividend payers that have reported both top line as well as bottom line growth and are currently trading at deep discounts to their 52-week high. It bears stating that we are always looking for other mispriced asset classes to include in our portfolios. Case in point: For many years, 20-year municipal bonds have yielded approximately 85% to 90% of what 20-year Treasuries would yield. At present, 20-year Treasuries are yielding 2.80%, but 20-year investment grade municipals are yielding a robust 3.75%. That's almost a 35% bonus over their historic range. Again, an excellent opportunity to take advantage of a mispriced asset class.

In recent weeks, we've had a return to volatility due to European weakness and anxiety over the end of the Federal Reserve's bond buying. The market got used to lower volatility, and as a result, it has made a relatively mild and long-anticipated pullback feel worse than it is.

Over the next several weeks, investors will have the opportunity to process the changed volatility environment along with the most current earnings data. Once this has been done, fundamentals and valuations will carry the day. Equity share prices have reacted more negatively than the fundamentals have changed, and that has resulted in compelling opportunities to add to positions.

Best Regards,

Ray Lent