TFC Financial Management

TFC Market Update
June 13, 2012

The Perils of Predicting Paradigm Shifts

A few weeks ago in a *Financial Times* article* titled "Out of Stock," the authors took on the assertion that equity investors had only a bleak future to contemplate. Citing experts who manage trillions of dollars' worth of other people's money, the conclusion on the part of many institutional managers seemed to be " . . . ultimately what is going on is the fundamental tenets of capitalist society are being questioned, and . . . this will lead to a big transfer from savers to the profligate and irresponsible." A disturbing contention to say the least, it brought to mind a few other such striking past statements predicting changing paradigms requiring our attention.

In 1992, Francis Fukuyama, in a widely publicized book, The End of History and the Last Man, argued that in *liberal democracy,* the world had achieved the end point in sociocultural evolution and had reached the final form of human government. In early 2000, *The Atlantic* magazine reviewed the then just-published trendy book, The Dow at 36,000, in which the reviewer did not seem to find much fault with the book's title assertion.

Dial back to 1979: with inflation at 12-13%, bonds yielding 11%, mortgages priced at 12+%, single life annuities paying 13%, and individual savings pouring into high-yielding money market funds, *Business Week's* cover proclaimed, "THE END OF EQUITIES." Then, as has been the case more recently for almost the last decade, the flight from stocks to the fixed income side of the risk spectrum seemed a steady, self-evident phenomenon. In the U.S., inflows to bond funds have exceeded stock fund inflows every year since 2007, with net redemptions from equity funds in each of the past five years. On Wall Street, the *Business Week* article in 1979 suggested, "…firms were being *forced* (our emphasis) to push alternative investments hard, thereby drawing still more money from the stock market." Such "…alternate equity investments included mortgage-backed paper, venture capital, indexed bonds, hard assets, options and futures," according to *Business Week.*

Bold pronouncements like these, of course, are driven by the emotions of the moment, stem from a certain amount of hubris and editors' needs to attract attention. Assertions of this nature also invite a contrary response. But when managing other people's money, is taking a stand against the headlines a prudent course?

**Financial Times*, Authors & Burgess, 5/24/12, p. 9.

30 Federal Street | Boston, MA 02110 t 617.210.6700 f 617.210.6750 www.tfcfinancial.com

Shifting Investor Psychology

At the moment, in our fully integrated global financial markets, investor psychology is edgy to say the least. The issues: anemic economic growth, banking system fragility, domestic political gridlock, and worldwide geopolitical impasses are all known and well publicized. The question for investors is whether these concerns are already reflected in today's relatively modest stock market valuation levels?

In the current institutional portfolio management ethos, risk management, risk containment, "risk budgeting," etc. dominate the discussion. But not since 1956 have equities been more attractive relative to bonds. This is in many respects not so much that stock valuations are undeniably compelling, but that bonds are so expensive and yields so low. In fact, U.S. Treasury bond *real* yields today are negative (i.e., purchasers of short-term U.S. Treasury debt today are financing U.S. fiscal deficit spending while also losing personal purchasing power on the capital invested). After thirty years of declining yields and rising bond prices, the bond market is approaching ground zero. Yield-starved investors (individuals, pension funds, insurance companies, bond fund managers alike), by extending maturity and accepting lower quality issues are knowingly, or unsuspectingly, building more risk into the fixed income segment of their portfolios. Inevitably, when rates normalize to higher levels, longer maturity bond owners could experience capital value erosion. Like the plot-lines in ancient Greek tragedies, it could be that the more bond investors seek to avoid the inevitable, the closer they come to their fate.

Deleveraging Continues

Globally, private, corporate and public debt deleveraging continues the dominant driving economic and financial market imperative. As we have mentioned in recent communications, the 2008-2009 near-meltdown required the massive transfer of private bank debt to public ownership. Up to this point in time, the private and corporate sectors in the US have been well ahead of the public sector in the balance sheet restructuring process. But public sector refinancing first requires reformed government fiscal behavior, as well as basic changes in governance and voter expectations. The Wisconsin, San Diego, and San Jose election results could be a signal a reform process at the state and local level has commenced. Can our Federal political class resolve its impasse? Hopefully, November 6th will provide some guidance.

But, before acquiescing to the drumbeat of the "equities are dead" prophets of doom, and retreating to the "risk-off" sidelines so many seem to be joining, the contrary case for equities still seems a valid alternative; one which, despite the prevailing headwinds, would seem to offer the better long-term prospects.

Should you have any questions or comments, please let us know.

Best,

Jim

James L. Joslin
Chairman, CEO & CCO

30 Federal Street | Boston, MA 02110 t 617.210.6700 f 617.210.6750 www.tfcfinancial.com