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Monetary Policy at a Crossroads: Where Is Yogi Now That We Need Him?

That sage etymologist, Yogi Berra, often advised . . . "when you come to a fork in the road, take it." Hobson, Hamlet, and Fed Chairman Ben Bernanke might all have wished Yogi were still available to counsel our central bank's Open Market Committee as to how to manage its way out of the monetary policy corner in which it finds itself today. The rhetorical question requiring clarification: "Whether tis better to *taper now* or *taper later*?" Should the Fed let up on the monetary accelerator beginning this year, or as promised in mid-2015?

The global economy, divided into its three regional components (U.S. and North America, Developed Eurozone and Japan, and Emerging countries), is operating on only one of its three cylinders at the moment. The U.S., having relatively expeditiously faced the very real economic carnage of the '08-'09 financial market meltdown, is seemingly first out of economic crisis mode. Although U.S. GDP growth is still anemic by past recovery phase standards, and unemployment remains in a politically unacceptable range, the indicators are beginning to suggest our economy can be taken off life support. New job creation is starting to surprise on the upside. As housing values increase, household net worth is holding up. Corporate earnings prospects are reasonably sanguine. Consumer sentiment, possibly reserved due to economic and regulatory uncertainty, remains a drag, but gives indication of turning more positive in the near term.

As the financial market debris of the past few years begins to clear, the Fed (our central bank) will have less reason to stand behind its assertion that interest rates will remain at these abnormally low levels until mid-2015. As we have pointed out in previous client notes, the Fed's warranty to hold down rates at these crisis levels will prove to be a contingent promise, as always " . . . subject to the data"—that is, the economic and political realities and how they are tracking toward the 2014 elections. As time unfolds, the justification to taper slowly away from QE4 (the Fed's latest long-dated bond-buying quantitative-easing policy) will seem more compelling.

It's the Bond Market Stupid! (Could Chairman Bernanke actually mean what he means to say he might mean to say?)

Until a few years ago when the Fed embarked on its extraordinarily accommodative, easy money, administered low interest rate monetary policy, the average investor, never mind Main Street, paid little attention to the structure of our banking system; nor for that matter did one have to differentiate between the roles Federal Government *fiscal policy* and central bank *monetary policy* usually play in a normal economic cycle. However, since Congress and the Executive branch have abandoned all pretense of proposing, no less following even a semblance of budgetary discipline, Chairman Bernanke and his fellow central bankers have been forced to fill the void and attempt to manage economic policy through the credit markets. Elsewhere around the globe, this same reliance on monetary policy has also been the result of the political chaos in the developed Eurozone, as well as recently in Japan, and increasingly seems destined to become true in China.

Shifts in central bank monetary policy, therefore, are monitored carefully by short-term investors and are most immediately reflected in price volatility levels in the globally-integrated bond and currency trading markets. So when Chairman Bernanke at his press conference in mid-May seemed to equivocate about the Fed's previous assertions that interest rates would remain as is until mid-2015, bond markets found this troubling. Almost in unison, fixed income security prices around the world went into a swoon, posting an absolute price decline not experienced during the last decade. By the end of last week, the coupon rate of U.S. Treasury 10-Year Notes had increased more than one percentage point to 2.70% (i.e., +100 basis points) since mid-April. To bond dealers a shift of one percentage point upward in the benchmark 10-year rate is important news. As rates rise, the price of bonds declines, and the highly leveraged sophisticates in these touchy information discounting forums often lose big.

The danger of mispricing risk in the bond market is far greater than the average investor probably suspects. The REAL rate for 10-year government debt should probably be within a range around 2% (i.e., nominal rate of 4% minus inflation of 2%). Price vulnerability for bondholders today is palpable. Seemingly oblivious to this, however, during the past 24 months in the scramble for yield, many investors have moved down the quality ladder and extended maturity, in effect heightening risk in the fixed income part of their portfolios.

Mr. Bernanke has signaled that in the U.S. the long retreat has begun from easy money and abnormally low interest rates. Investors ignore at their own peril the high probability that the thirty-one year bull market in bonds is at an end. It's no longer a matter of making money in the fixed income segment, but preserving capital. The path of least resistance for interest rates is upwards. By default, on balance, our position as discussed in recent previous notes continues to be that this environment favors equities over bonds.

China: Real Reform or Short-Term Political Palliatives?

Although anecdotal, recent news that a number of mainland Chinese were buying up residential properties in Brookline, MA for cash caught the eye. To the extent that this is symptomatic of evolving Chinese investors' attitudes, and manifests a lack of domestic opportunities, the implications are concerning. The emerging country equity investment thesis keys off continued strong Chinese growth in the demand for goods and services. If long-term Chinese GDP expansion were to stabilize at 6-7.5% per year, then the cornerstone of the dependent emerging market hypothesis probably holds. If, in aeronautical terms, as Martin Wolf of the *Financial Times** muses, 6% GDP growth is dangerously close to economic stall speed for China's unique circumstances, then for Chinese central authorities the cautionary flags are rising.

**Financial Times*, July 3, 2013

To date, over the past 30 years, the Chinese "miracle" has cycled through a manufacturing competitive cost advantage, export trade price dominance, and a public and private domestic investment boom, all financed by an expansive monetary policy. In the process, Chinese consumers have been left to find what they need (want) via imports and a fledgling domestic services sector. The Chinese domestic investment boom has reached critical mass, and in some cases, excess. For China's Communist authorities, clearing up the aftermath and laying the foundation for a true consumer-based economy will require a clamp-down on corruption, further closing off state-owned enterprises, and more open financial markets. Bold reform is required. The obstacles are political. A freer economy and more transparent financial markets mean tolerating a private wealth build-up not controlled by the political class. The questions seem obvious. Yet to be determined as Yogi posed it . . . is which fork to take?

Rebalancing Follow-Up

You may recall that in our June 12 Market Update we wrote about rebalancing and how we took the market movements of the first four months of the year as an opportunity to shift some of our gains out of equities and move back to the stock/bond mix cited in your Investment Policy Statement. On the surface this may seem to have been ill-timed, but remember that our fixed income portfolios remain firmly invested in very short maturity and high quality instruments. Essentially what we accomplished with this realignment was to take some risk out of the portfolio and harvest some gains from the first third of the year.

Interestingly, if we dig deep enough into the data of the past eight weeks we have to conclude that the daily barrage we receive from CNBC about market volatility can be very deceptive. VIX, which is a commonly used, and all too often misused, indicator of equity market risk is actually at levels lower than the average of the past 100 years. The real risk over the past eight weeks has been in the bond market, and the price movement of Vanguard's VEDTX fund which invests in 30-year duration U.S. government bond securities is illustrative. The fund is down 19.6% since its high on April 30 of this year. While we may have positioned your portfolios for the turn in interest rates a little early, we feel that this was warranted given the potential storm brewing after the thirty-one year secular bull market in bonds.

In summary, we continue to be cautiously optimistic about emerging and frontier market equities where P/E ratios are well below historic norms. We continue to hold an underweight position in developed market international equities and have redeployed that capital into U.S. equities. Most importantly, we will be holding our short maturity exposure in high quality bonds for the foreseeable future. We will consider increasing risk in the portfolios at a time when Fed action has been clarified and the dark clouds of uncertainty hanging over Europe and China have abated.

As always, we welcome your comments and questions.

Sincerely,

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