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Protecting the Downside

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As we look back over the past seven months we are reminded of the old adage: "Be careful what you wish for, lest it come true." All eyes are now on the Fed (Federal Reserve Bank). For more than six years the Fed has been pursuing a policy to radically lower interest rates, and to keep them low, with all the tools available to them. Their goal: to re-inflate the stock and real estate markets.[1] It appears that they are getting what they wished for.

Has the Fed Succeeded?

After more than 5 years, on March 28, 2013, the S&P 500 finally exceeded its prior high mark, which was set on October 9, 2007. However, unless you own a lot of stocks, you may not have felt overly euphoric to finally "get back to even." Although the economy is improving, it is still in worse shape than it was in October 2007. Unemployment remains at 7.6% versus 4.7% in October 2007, meaning nearly 5,000,000 more people are now unemployed. At the same time our deficit has increased from 1.7% of GDP (2007) to 7.0% of GDP (2012), and our national debt has more than doubled![2]

The S&P 500 continues to achieve new highs amid high volatility. One of the Fed's regional Presidents, Narayana Kocherlakota admits that keeping interest rates "unusually low" could set the stage for "unusual" events in financial markets such as inflating asset prices and accelerating volatility. The risk of creating "another destructive bubble" is there, but he doesn't see it as "imminent."[3] He said, "The Fed's current state of surveillance is vastly superior to what it was before the financial crisis," and he believes that they will be able to anticipate, or at least mitigate, any dangers.[4] I would feel more confident if I could just forget the actual history of the Fed's foresight the last time they lowered interest rates and created bubbles.

Typically the stock market has been considered a "leading indicator" of economic activity, and new S&P records would be hailed as signs of better times ahead. However, today "many market observers say it's mainly a result of the Federal Reserve's unprecedented monetary intervention. By keeping short-term interest rates near zero… it has been pushing investors out of safe havens into riskier assets like stocks… And by purchasing $85 billion per month in Treasury and mortgage bonds, a tactic known as quantitative easing, it is creating money to buy those assets."[5]

Is the Real Estate Recovery "Healthy"?

Just six months ago we could wonder if the Real Estate market had bottomed out. Recently, on July 29, 2013, the ***Los Angeles Times*** reported that "Home flipping frenzy returns to Southland

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real estate market."[6] While this is certainly better than a deflationary "death spiral," it is probably not yet indicative of a healthy recovery. A subsequent article states, "The chances of finding an affordable home in California are fading fast as prices and interest rates rise – slamming the door shut on many would-be buyers." Just 44% of the Golden State's residents are now able to afford the median priced home.[7]

As I wrote in a prior letter, every economic policy has winners and losers.[8] Real estate has undergone a massive shift in ownership, away from private ownership and into the hands of huge investment firms. Blackstone group has spent more than $5 billion to purchase 30,000 homes, and billionaire B. Wayne Hughes has spent $3.1 billion on a portfolio of nearly 18,000 homes.[9] The foreclosure crisis enabled the firms to buy distressed properties en masse often at bargain prices. Now they are intending to rent them out and create asset backed bonds to sell in the financial markets to retire the debt they raised in buying them. Once again, Wall Street is the winner.

Potential Volatility Ahead

To be successful investors, we must always be alert to managing our emotions of fear, greed and boredom. We must not forget our past investment experience. Specifically, this means that sometimes there is a "price" for safety. This year we are paying that price with our investments in conservative, as opposed to risky, assets. The returns on most of your portfolios under our management are only moderate year to date, while the stock market and some other risky assets are soaring in value. It is our belief that current prices are heavily influenced by the unprecedented liquidity provided by the Fed, and the Fed is now indicating that they may begin to reverse their policy as early as September 2013. In June, just the suggestion caused the markets to swoon, though they quickly recovered. When the Fed starts to remove the stimulus, we expect an increase in short-term volatility, even though we believe that such a change is both necessary and welcome in the long run. Please give us a call if you want to discuss your specific portfolio and its investment strategy.

The views expressed are those of the author as of the date noted, and are subject to change based on market & other various conditions. They may not reflect the views of United Planners Financial Services of America. Certain risks exist with any type of investment & should be considered carefully before making any investment decisions. Keep in mind that current & historical facts may not necessarily be indicative of future results.

[1] Ben Bernanke speech, Jackson Hole Wyoming, August 31, 2012.
[2] "Does Fed Action Inflate stock value?" **San Francisco Chronicle**, April 2, 2013
[3] "The Fed Is Inflating Asset Prices And Increasing Volatility, And It Should Do More, Kocherlakota Says," **Forbes**, April 18, 2013
[4] ***Ibid.***
[5] ***Ibid.***
[6] "Home flipping frenzy returns to Southland real estate market." **L.A. Times**. July 29, 2013.
[7] "Home prices still rising at a torrid pace." **L.A. Times.** July 31, 2013.
[8] http://www.michaelcolemanphd.com/Economic Update 2013
[9] "Wall Street Firms become Landlords." **L.A. Times.** August 1, 2013.