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# Interest Rates and the Fed

January 2014

2013 was a year of unexpected divergences: the U.S. stock market soared, while high yield bonds had only moderate gains. U.S. investment grade bonds lost money, but gold, which usually moves inversely to bonds, also dropped more than -26%.[1] In my opinion, the Real Estate market seems to have regained its health, however, this rosy picture is tainted by the fact that the Fed (Federal Reserve Bank) has been the major purchaser of all mortgages for the past 4 years. Most asset classes seem neither dangerously expensive nor extraordinarily cheap only if we ignore the fact that current interest rates are being manipulated by the Fed in an historically unprecedented way. How can we judge fair market values? How will the markets react when the Fed removes their heavy hand? We are already beginning to see signs of excessive risk in the stock market. As a result of this unclear outlook, we are continuing to invest with caution.

**Our Principal Concern: How Long Can the Fed Increase Our Debt?**

Because the economy is recovering, albeit slowly by historical standards, we tend to forget that this recovery is floating on a massive and continuing increase in government debt. Markets have a tendency to over-react at junction points, at a *change in direction*, even if the change itself starts rather small. This past May, Fed Chairman Bernanke created an immediate flurry of panic selling in both bonds and stocks, in the U.S. and around the world, when he simply hinted that in September the Fed might start to taper back its $85 billion a month purchase of bonds. The Fed quickly back-tracked, and when no changes were implemented in September, the markets recovered. Then, late in the year, the Fed cut back on their buying to $75 billion a month and the markets surprised everyone by taking off to the upside to finish with the best year since 1994!

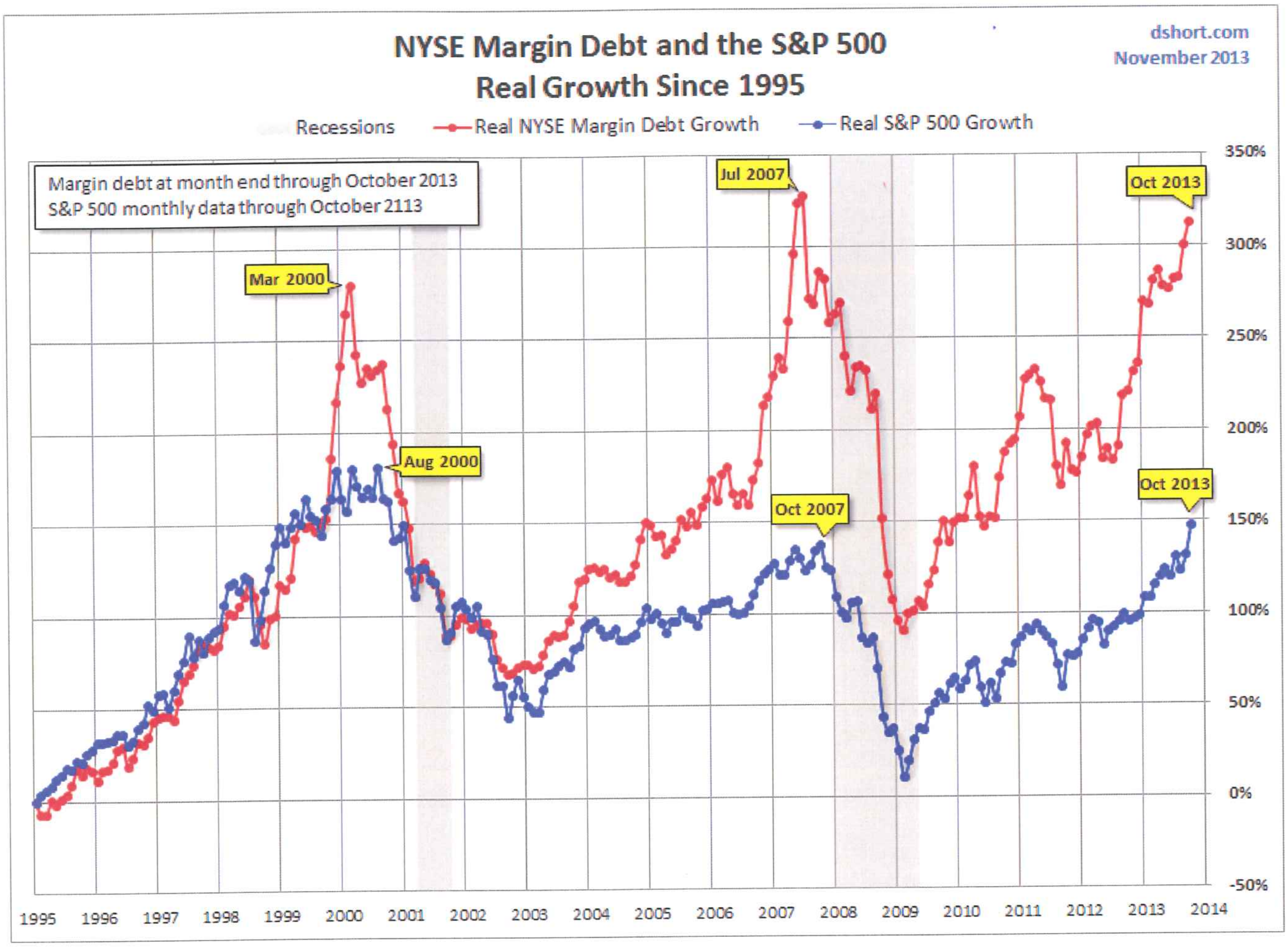
Here is a primer on the mechanics of the Fed's buying. The Fed currently purchases $35 billion in mortgage backed securities and $40 billion in treasuries each month.[2] Where, you might ask, does the money come from for these purchases? A shocking surprise to most people is that it comes out of thin air. The Fed creates $75 billion in new money each month by printing it. This bond buying does two things: on the one hand, it directly increases the money supply; on the other hand, this buying creates "artificial demand" for mortgages and U.S. Treasuries to keep their prices higher and their interest rates lower than they would otherwise be. Because of the Fed's intervention, we have no current way of knowing the "real", i.e. market rate, of interest. How high might interest rates go when the Fed comes to a complete halt? How much volatility might this change cause worldwide? We have no way of knowing in advance, but we strongly believe that this transition will be painful to many market participants.

**Update: The U.S. Stock Market**

To give you a good perspective on the U.S. Stock Market, I have included two charts. The first chart looks backward at the last 14 years, and the second chart may give some clues of what is yet to come. The chart below shows the total returns of the stock market, as measured by the S&P 500 with dividends reinvested, from the beginning of this century to the date I printed this letter. On the chart you will see a flat blue line which marks where the stock market stood on January 1, 2000. With that line in place you should be able to easily see that over 14 years returns have been abysmal! Ten of the fourteen years have been spent trying to "get back to even." Only in 2013 do we finally have positive returns. Anyone who retired in January 2000 and depended on the stock market to grow their assets, or to give them a predictable income, is in a sorry state today.


The hypothetical illustration above does not reflect any real investment results.
The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general. Investors cannot directly invest in an index.

This is what is known as a "Secular Bear Market", meaning a significantly long time with no net gains. Although is it possible that 2014 marks the beginning of a new long-term profitable phase, it is also possible that these gains will be reversed once again. The chart on the next page shows the same data in a slightly different way. The blue dotted line shows the monthly changes adjusted for inflation. Based on the actual buying power of the dollar, it shows that the stock market is not yet, even now, back to even. However, what is of interest to me is the red line which shows the amount of margin being used to buy stocks. (Primer: "margin" means buying stock with borrowed money.) As you can see, we are approaching an all time high in the use of borrowed money to buy stocks. In addition, you can see that twice in the past, margin helped to create a bubble which ultimately ended badly. Margin (borrowed money) multiplies one's gains in the up market; margin creates additional demand which can cause prices to go up more quickly; but margin also creates a fragile condition which can accelerate a down market; margin multiplies one's losses on the way down. When the Fed starts to "taper," could this cause a flurry of selling to cover margin debt and accelerate a down market?




## Update: U.S. High Yield Bonds

Generally high yield bonds tend to move in concert with stocks, usually with less volatility. For the years 2008 through 2012 our over-allocation to high yield bonds helped our returns: high yield bonds as measured by the ML US High Yield Master II Index had an annualized yield of 10.01% which far exceeded the S&P 500 Index's annualized yield of 1.66% for this period.[3] In 2014, the S&P 500 Index far outperformed High Yield bonds, with an annual yield of 29.6%[4], compared to the Bloomberg USD High Yield Corporation Bond Index 6.46%.[5] However, even with this recent outperformance of stocks over high yield bonds, based on these indexes high yield bonds still outperformed stocks over the past 6 years, with an average annualized yield of 8.71% versus a 6.16% annualized yield for the S&P 500.[6] Past performance is no guarantee of future results.

Currently in many of the accounts that I manage I am continuing to over-allocate to high yield bonds, and to under-allocate to stocks in spite of the latter's recent run up. We no longer think that high yield bonds are underpriced; rather we are seeking reasonable yields at much lower risk. Our sell discipline on high yield bonds so far has preserved our gains early in down markets. Of course, past performance is no guarantee of future results. Due to the much higher volatility of the stock market, we have not yet been able to design a sell discipline that can protect us soon enough in a down market. It is our core strategy to protect your portfolio, at all times, from excessive losses in down markets. If you feel the need to have greater exposure to the stock market, please call me and we can discuss the options as well as the risks.

**Update: Protecting You When I am Gone**

"What happens to my account if you get hit by a truck?" I am always happy to hear a question like this because it implies that you value my service. I am pleased to announce that I have finally created a plan to take care of that contingency and several others. I recently signed a contract euphemistically called a "Continuity Agreement," which gives my long-time colleague Randy Hinton[7] the right to take over my business if I become disabled, incapacitated, or if I die suddenly. Randy and I have been members of the same study group for 8 years and we have traded "best ideas" about business and investments. He has a similar investment philosophy and uses the same insurance companies and outside money managers as I do. Although he has been in business for over 25 years, he is 20 years younger than I am. In the coming months, you will get to know him better. I think you will like him as much as I do. With this contract in place, I may just stay around for a long, long time.

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[1] As of Dec 7, 2013. Spot Gold on www.StockCharts.com
[2] **Forbes**. "The Federal Reserve Is Making A Big Mistake." 9-20-2013
[3] Morningstar Principia 12-31-2012
[4] www.USAToday, "Investors Cheer Record Setting Year." 12/31/2013
[5] http://www.bloomberg.com/markets/rates-bonds/benchmark-bond-indexes/
[6] www.StockCharts.com
[7] Randy Hinton is affiliated with United Planners Financial Services of America as a Registered Representative and Investment Advisor.