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The Stock Market vs. the Economy

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Are any of you confused like I am? Corporations are reporting profits, the stock market is soaring to new highs, real estate has recovered, and unemployment is "officially" only 5.8%. If this is the case, then why do I know so many friends with family members who are unemployed? Why am I seeing so many homeless people where I live in Huntington Beach? Why are the schools and colleges hard up for money, and students burdened with debt? Why does this "recovery" seem so far from over?[1] Why are the central banks of the major economic powers -- the U.S., Europe, Japan and China – still quietly worried about deflation?[2] Why are the major Developed Countries keeping their interest rates at or near zero?

Would it surprise you to find out that, right now, 20% of American families are on food stamps? This is up from just 11% in 2007.[3] The average number of people who seek shelter EACH NIGHT at the New York City Shelter in now 53,000! It was only about 35,000 a night in 2008.[4] The official U.S. unemployment rate dropped to 5.8% in October, a 6 year low. However, people who have quit looking for work are not counted in that figure. If we count those who are too discouraged to look for work, by some estimates the unemployment rate is actually greater than 10%.[5]

What's Driving the Stock Market?

If the economy is not doing well, how can the stock market go up? Usually we think that stock market growth and economic growth go hand in hand. I think that if we look closely, we can find several ways that the owners of capital assets (stocks, bonds, real estate and businesses) are able to benefit in this current climate from both low interest rates and favorable taxation while workers continue to suffer.

Most companies get a tremendous boost from extremely low interest rates. Recently a friend of mine was offered a 6 year, no down, no interest loan if he were to buy a new car. This is a great boon for owners of automobile stocks. Homeowners and owners of commercial real estate have been able to refinance their mortgages at record low rates, which give them record low payments. However, at the same time, rents are increasing due to greater demand for housing.

Some brands sell to the super-rich, and some sell to the middle class. "Jaguar, Land Rover, Mercedes-Benz, Maserati, Rolls-Royce, BMW, Porsche and Lexus delivered a host of record results in 2013" read a recent headline.[6] The stocks of high end retailers like Tiffany's, Coach,

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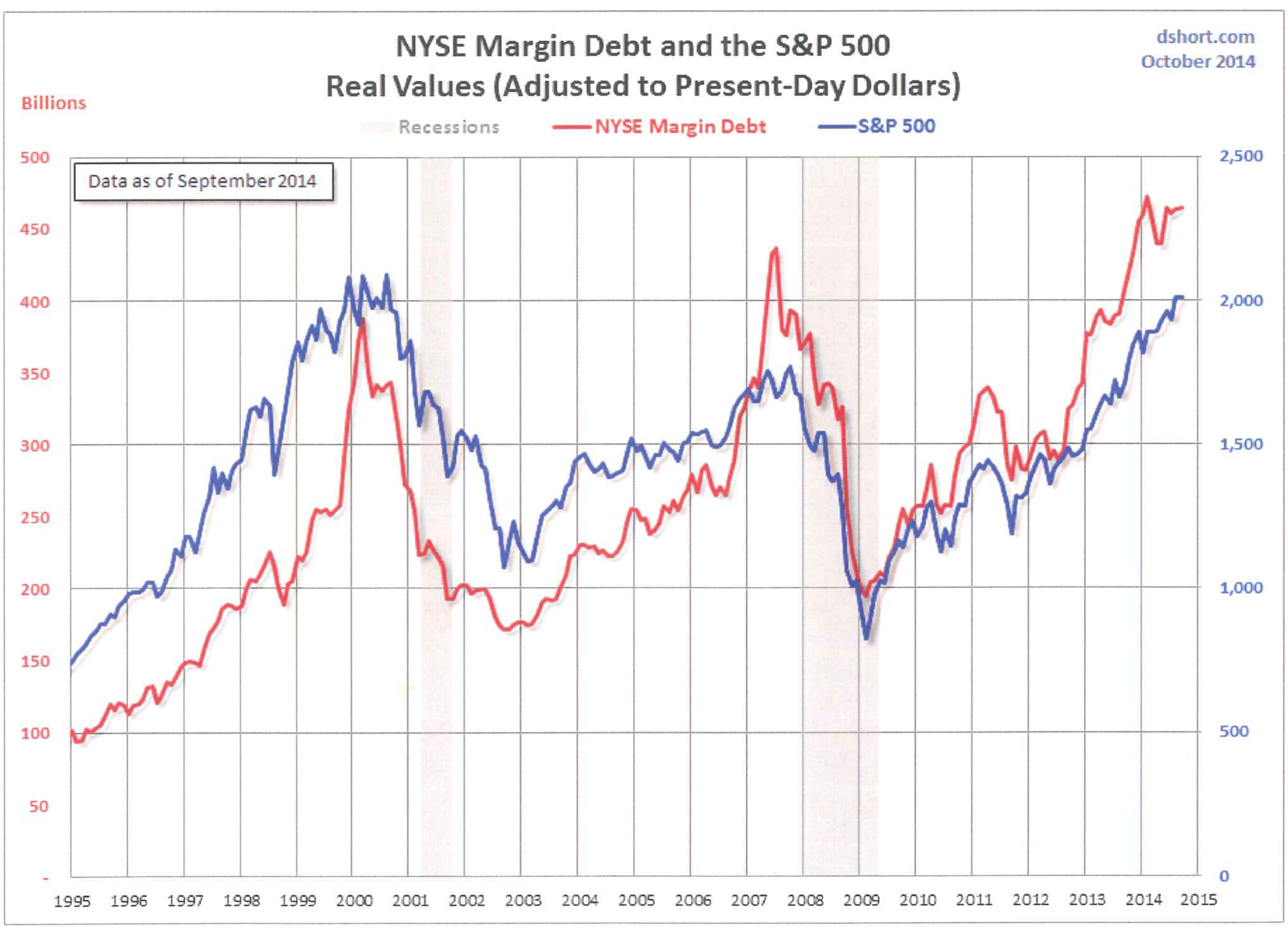
Louis Vuitton and Moet have gone up about 400% in the last 6 years, whereas the stocks of J.C. Penney, Macy's and Kohl's have increased only about 70% in the same period of time.[7]

Many companies have found that they can use accounting tricks and hardball tactics to create short term profits and an illusion of more growth than they actually have. As one commentator noted: "In order for profitability to surge, despite rather weak revenue growth, corporations have resorted to four primary weapons: wage reduction, productivity increases, labor suppression and stock buybacks."[8] None of these "weapons", by the way, help the working man or working woman.

Multinationals such as Microsoft, Apple and IBM benefit from a skewed tax system that allows them to avoid paying taxes on profits that they manage to store abroad. Bloomberg estimates that "multinational companies have accumulated $1.95 Trillion(!) outside the U.S., up 11.8 percent from a year earlier, according to securities filings from 307 corporations."[9] Not only do they avoid paying taxes, but they also postpone putting most of that money to productive use in the U.S. economy.

Finally, there is always the danger that low interest rates will distort the prices of capital assets, including stocks, by encouraging the use of margin (i.e. borrowing money to buy stocks). As the chart below shows, margin is at an all time high on the New York Stock Exchange.



With the wisdom of hindsight, we can see that almost every time central banks have kept interest rates extremely low for a long time, financial bubbles ensued. Low interest rates make it tempting to borrow money to buy income producing assets, and, these actions tend to feed on themselves: if many people starting buying a given asset class with borrowed money, the increased buying tends to drive up the price of that asset class. These higher prices make profits, which are amplified by the borrowed money, so people are now even more excited about borrowing money "to invest." In other words, once the cycle starts it tends to be "self-validating" and may proceed in this fashion for such a long time that we become complacent about fundamentals and forget all about the risk… until it comes crashing down.

Difficult Times call for Innovative Solutions

Given this uncertain world, how do we invest safely at this time? Now, more than ever, I recommend having investment strategies that emphasize protecting against loss as a first criterion. Over the years I have offered you a number of ways to achieve this, most recently since 2007 by using investment methodologies that use asset classes with lower volatility and trailing stop losses to protect against severe down markets. At the advice of my advisors, over past two years I developed two new investment programs in partnership with Trust Company of America. One program is for retirement income, and the other for taxable savings, so one is named Retirement Income (RI) and the other Tax-Advantaged High Income (TAHI). Both share the same goals with two main distinctions. RI is designed to achieve a higher total return but should only be used inside of tax shelters like IRAs. TAHI is designed to be more tax-efficient, by using actively managed municipal bond funds, so a large percentage of its total return should be free of Federal tax.

The overall objective of both programs is to produce satisfying long-term total returns while limiting downside risk in a fully liquid program. Below is a list of their goals and methods. Of course, there is no guarantee that we can achieve these goals, and past performance is no guarantee of future results. Feel free to contact me if you would like more information about either program.

<u>Our Goals</u>:

1. Steady Results: RI uses a wide range of potential asset classes and will target a balance between high total return and low volatility. TAHI uses mainly high yield tax-exempt bond funds and will seek to have a high after-tax total return with low volatility.
2. Preservation of capital: We attempt to limit short term losses to less than -4% during any volatile quarter.
3. Liquidity: Your investment account is linked electronically to your bank account. You have 100% access to your money at all times.
4. Simplicity: All costs of management, trading and administration are covered by one quarterly fee. There are never any commissions or surrender penalties.
5. Automatic Discounts: Fees are reduced as accounts get larger.

Our Methods:

1. Active, Discretionary, Daily Management.
2. Transparency and Security: Client Accounts are held at Trust Company of America, and can be viewed online 24/7.
3. Selective Research: Most funds and many asset classes do not meet our criteria.
4. Diversification: Typically RI invests in 4 to 8 high yielding stock or bond mutual funds. TAHI invests in one or more high yield municipal bond funds. We never invest in individual stocks or bonds.
5. Safety: We determine a stop loss system for each fund before we invest. We never invest in highly volatile funds.
6. Opportunity: Before investing we confirm that each selected fund appears to be in an uptrend.
7. Daily Monitoring: We chart each invested fund daily. When a fund drops to our stop-loss point, we sell it and park the money in a money market fund and wait for the down-trend to reverse. Occasionally we invest in other asset classes that are currently counter-cyclic.

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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] Martin Neil Baily and Barry Bosworth, "The United States Economy: Why such a Weak Recovery?" Brookings Institute, September 11, 2013. The Brookings Institution
[2] http://www.ft.com/cms/s/0/2bfa11d6-4a44-11e4-8de3-00144feab7de.html#axzz3I9QtSSLT
[3] http://cnsnews.com/news/article/ali-meyer/record-20-households-food-stamps-2013
[4] Sierra Investment Management, "Outlook for Current Trends, Capital Markets." Frank Barbera, October 2014
[5] http://thefederalist.com/2014/08/01/with-labor-force-dropouts-included-unemployment-is-still-above-10/
[6] http://luxurysociety.com/articles/2014/01/record-sales-for-luxury-car-brands-in-2013
[7] Bloomberg, November 2013.
[8] http://streettalklive.com/index.php/4-tools-of-corporate-profitability-the-economic-consequences.html
[9] http://www.bloomberg.com/news/2014-03-12/cash-abroad-rises-206-billion-as-apple-to-ibm-avoid-tax.html