

PORTFOLIO WATCH



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Fee **FO** Only

All Good Things Come to an End

Last Monday evening my wife and I prepared for what has become a tradition. We set up a table near the front door, poured a couple glasses of wine (keeping the rest of the bottle close by), brought out the big bowl of candy (minus most of the Snickers), and got ready to contribute to the tooth decay of the kids in the neighborhood. The little Trump and Hillary costumes were cute and everything was going well until it started raining. We then spent the rest of the evening on the couch playing “tag, you’re it” to determine who had to answer the door next. Halloween always ends for us when the first high-schoolers show up with pillowcases and no costume. If you have to wait to go trick-or-treating until you get off of work, or you can dress up as one of the Duck Dynasty dudes without using a fake beard, you’re too old to go around asking for free candy. You have reached the end of that phase of your life.

A Market Phase That Is Now Done

Interest rate cycles can and do last longer than our investing lifetime. When inflation is increasing, interest rates rise. When inflation (and the economy) slows down, interest rates fall. The last time interest rates were really on the rise was back when bell bottoms were cool (maybe they are again; I wouldn’t know). After they peaked in 1981...35 years ago...they began their long downward slide to zero. Lowering interest rates is the primary tool for perking up the economy because it frees up more capital and discourages saving. When interest rates fall, stocks do well because of increasing investment, and bonds do well because their prices rise AND they pay interest. This has been the case for longer than many of us have been investing, but like the bearded kid who is still trick-or-treating, this phase of the market cycle has come to an end.

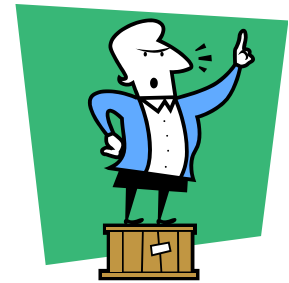


Investing Theories That Are Now Done

Almost all investment philosophies that are based on Modern Portfolio Theory (which is older than I am) use a combination of stocks and bonds to balance growth potential and risk. The more bonds, the less risk. When you’re young you might have an 85/15 portfolio (85% stock; 15% bonds). When you get close to retirement you will want to shift to a 60 /40 or 50/50 portfolio. But what happens when interest rates have hit bottom? Japan recently decided to let the rates on their 10-year bonds drift UP to 0%. Who buys a bond that pays nothing, or at least less than inflation, for 10 years? People are still doing it, so the only rationale would be an expectation that central banks will do even more to drive interest rates negative (and bond prices up), or the Greater Fool Theory which says that no matter how much I pay for something, someone in the future will be willing to overpay even more (e.g. Amazon stock). Bonds work as an investment when they deliver a return above inflation. For Treasuries and many investment-grade bonds and CDs, this is no longer the case, which breaks the traditional stock and bond models.

Now What?

The premise on which most portfolio construction is based (bonds provide low-risk, steady returns) is no longer true, and the most common response I see is...nothing. As an advisor community, we still talk about the long-term track record of stocks and bonds, and ignore the fact that the primary risk-mitigation tool cannot deliver a return when interest rates are less than inflation. It’s time to hang up the costume and think of something else.



Market Comments

I wanted to get this commentary done before the election, because it's a lot more fun to speculate on what might happen than to talk about what did happen. Next month will be a different story. Frankly, I'm not that worried about the election. If Hillary wins the market will breath a brief sigh of relief, and then go back to speculating what the central banks are going to do to keep the world economies propped up. If Trump pulls off an upset and proves that a majority of voters have lost all faith in government, the markets will jump around while the world figures out what just happened (just like Brexit), and then will go back to speculating what the central banks are going to do to keep the world economies propped up.

I expect the Fed to hike interest rates in December. They didn't want to announce a hike in November right before the election, but if they don't do one this year it will send a message that they are not confident in the economy (whether they are or not). The market is already expecting this for the most part, but it will still cause some turmoil. It probably won't mean the end of the world, and I don't expect the stock market to fall apart anytime soon. Companies are still making money, the typical signs that normally precede a recession are not showing up, and interest rates will continue to be too low to create any incentive to get out of stocks.

I said I don't *expect* the market to fall apart, but that doesn't mean it can't. There are too many financial experiments going on right now to be comfortable. The Bank of Japan ran out of bonds to buy and is now buying stocks on the open market. After several months of doing this the Bank of Japan is now one of the top 5 shareholders for 81 Japanese companies. Someday they are going to need to unravel that position. In the U.S., the Fed is out of tools to help boost the economy unless they go the negative interest rate route. The U.S. has been borrowing most of its ideas from Japan, mainly because Japan has been trying to fix their economy for 20 years longer, and negative interest rates didn't seem to work there. Negative interest rates and central bank stock purchases are things that have never been tried before, so no one knows how it ends. The hope seems to be that if there is a price to pay for market manipulation, maybe it can be held off long enough so that our kids or grandkids will be the ones to pay.

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