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Investment Thoughts for the New Year

Mark Burkhardt, Portfolio Manager January 10th, 2014

While 2013 was an excellent year to own equities, especially those shares of companies that call the U.S. home, it was a very difficult time for many bond investors. The losses were greater for those investors with exposure to U.S. Treasury Bonds, but many other asset classes that were being used as income generating alternatives underperformed as the year progressed. Those categories would have to include municipal bonds, Real Estate Investment Trusts, utilities and to a lesser degree investment grade corporate bonds. Even the shares of large companies that pay substantial dividends also saw substantial outflows as investors who had purchased those shares for income rather than the long term growth potential of the firm's business came under pressure as long term interest rates began to rise.

It is important that to understand what the future may hold, we need to understand what the past has shown us. Interest rates tend to move in long trends that can easily span decades. The historically low interest rates that we saw last year actually began that decline more than three decades ago when interest rates actually hit a high of 20% in May 1981. Those 32 years saw the greatest decline of interest rates in modern history as the Federal Reserve lowered short term rates to their current level of less than a quarter of 1% (0.25%). That decline did a wonderful favor if you were a borrower or had substantial amounts of debt. But the other side of that coin, there were an equal number of losers. If you were a saver, and not heavily indebted, the Federal Reserve's actions have left you much poorer as the return on your savings have been reduced to less than zero once you account for inflation. If you depended upon that income from your savings, you were actually forced by the Federal Reserve's action to invest in much riskier assets to achieve a comparable rate of return that you had previously earned with much less risk.

These choices that the government made after the financial crisis could be seen as having moral implications, but in reality it just came down to the raw numbers. They chose to bail out the nation's debtors and decided to punish the nation's savers simply because there were more people that were way over their head in debt than those who weren't. And what better way to allow the banks to recapitalize, or heal themselves, than to let them basically borrow money from the government at next to nothing and encourage them to lend out for rates of 4-5%. It doesn't take a genius to make a profit with that type of margin. Better yet, the banks can help return the favor by being voracious buyers of long term U.S. debt that pay interest rates much higher than their cost to borrow, creating essentially the ultimate risk free trade.

That brings us to the reality that lies before us now. While the economy is healing and growth appears to be accelerating, five years into this recovery this is by far the weakest economy we have seen in several decades. Over the last five years the Federal government has spent $9 trillion it didn't have and the Federal Reserve printed another $4 trillion and we still find ourselves with high structural unemployment, stagnant wages and a stubborn reluctance by business to take on any additional risks. It is important to differentiate between what is perceived as a negative on the evening news and what is really relevant to you as a shareholder.

Many events can be seen by the average citizen as a negative whereas when viewed by an investor, the same news is actually a net positive. For example, a high level of unemployment means that businesses will have an easier time filling any open positions. A lack of wage growth, while hard on working families, tells a business that they won't have to deal with an increasing cost for one of their biggest expenses. We can all agree that the current Federal Reserve policy hurts all savers by keeping interest rates artificially low. But for a business, those low rates allow that company to not only borrow cheaply but it also gives them the ability to refinance expensive debt at a new much lower rate, creating substantial savings.

This results in an unusual situation where the national economy continues to slowly plod along while at the same time the nation's corporations possess the strongest balance sheets, the highest amounts of cash, and the leanest operations then at any time in our history. As an owner of many of these companies you should and have been rewarded for that unique and ultimately healthy situation. Looking toward the future, any sustainable and substantial improvement in the economy would quickly translate into dramatic increases in corporate earnings and profitability.

The stock market today is no longer as undervalued as it was just twelve months ago and some sectors are trading at valuations that I consider rich or at the very least more expensive than what I'm willing to pay. That's not to say there aren't bargains to be found. It's just like when we go shopping at the mall. It takes no skill to pay full price for something that may go on sale at a much better price in a couple of weeks, but it does take patience. In the near term, I detect a certain level of complacency with the markets which leads me to take a more cautious stance and wait for a more compelling entry point before I put new money to work in certain sectors.

I am expecting interest rates to continue to slowly rise toward a more normalized range in the 4% area which would accurately reflect the anticipated slow paced recovery now underway. This steepening of the yield curve, that is long term interest rates moving up faster than short term rates, creates a much more profitable operating environment especially for banks and other financial institutions. Not only do they benefit from an improving economy, their net interest margin, the difference between what it costs them to borrow versus what they charge on the money they lend out, increases dramatically. There are several large domestic banks that are still trading at a significant discount not only to their peers but also when compared to their previous historic valuations.

There are other asset classes that I feel were unfairly punished with the selloff in Treasury Bonds that now present compelling value. Real estate trusts and municipal bonds will actually see their revenues and credit quality improve as the economy recovers, thereby offsetting the effects of rising rates. For now, vigilance and a search for value will continue to be our primary focus as I determine how to best navigate an investment environment that is evolving from a post crisis mindset to a slow growth, but sustainable recovery. This is an economy in transition, one that still feels dependent upon an overly accommodative Federal Reserve, but one that will eventually be forced to learn to stand on its own.