Palmetto Wealth Management

"Clowns to the Left – Jokers to the Right"

John M. Gustafson – 6 January 2014

As we reflect on the year in the markets just ended, some may recognize my title from the 1972 Stealers Wheel song "Stuck in the Middle." Once again, a spectacular performance in the US stock market was overshadowed throughout most of the year (and almost blown to bits) by the complete, ridiculous ineptitude and selfishness on both sides of the aisle in our government.

Despite the almost criminal malpractice of the jokers populating Congress, 2013 turned out to be a very good year for equities in the US. As expected, bonds and cash did nothing for you; however bonds were more of a drag on the portfolios than outright damaging, so far. Even the Europeans proved that if you don't completely burn the house to the ground, somehow business will prevail and global economies can recover.

In general, these notes aren't strictly meant to be a review of what went on, especially in a year where the narrative remained very similar to what we've experienced the last few years. (i.e. Politicians in Washington and across the globe continue to prove that they care much more about their own reelection than the countries they serve and well-run businesses will figure out how to overcome artificial obstacles and make money.) We shall try to make this as forward-looking as possible overall – but as with life, one must always remember the path to the present to avoid mindless and dangerous repetition.

One bit of news that could have derailed everything late in the year was the end of Ben Bernanke's term as Fed Chair, smack-dab in the middle of historic liquidity being unleashed by his group. As most readers know, I've been a pretty big supporter of "Helicopter Ben" and give him credit for preventing complete disaster while Congress pointed fingers, complained, threw accusations, but really did nothing except bring us to the brink of default twice in the past couple of year. Primarily because they are all seemingly as stubborn and uncaring as to outside consequences as a 3 year old throwing a tantrum at the mall. (And the 24-hr news channels are their mommy, who continues to spoil them wondering why behavior doesn't improve.)

Yes, it will be difficult to unwind the Fed policy but I believe people need to stop thinking as if they will have to do it immediately. All of this excess liquidity didn't wash up on shore over a couple of weeks, so reining it all back in shouldn't be expected to happen right this minute either. Also, the base driver of inflation is demand outstripping supply and there appears to be plenty of capacity across all channels in the current world economy. Some folks (and many commodities) still seem to be looking more at disinflation, which is much more difficult to correct – just ask the Japanese.

An old market saw quoted here regularly, is that the markets "climb the wall of worry" and that has been happening in spades over the past couple of years. One of the reasons why I'm not imminently fearful of a horrific change in direction in equities is that general market sentiment is "worry" lately. There do appear to be more bullish voices on TV and in print than there were six months ago, but the worriers and the professional skeptics continue to be featured just as prominently. Also, I don't recall having a conversation with anyone inside or outside of the investment business who seemed to temper almost all comments and questions with concern about the nominal level of the market averages. Throwing around terms like "bubble" and "black swan" has become de rigueur.

To revisit a theme we've touched on in these notes the past few quarters, the "Bizarro 90s" where asset prices continue to recover and rise, but everyone remains scared and doubtful seems to be intact. This environment couldn't be more different in tone from the "irrational exuberance" that marked the end of that period. To reset, back in the 90's and early 00's, every skeptical note in the media or by an advisor speaking with clients was shouted down as heresy and viewed in utter disbelief. We are now in a period, that anyone who can see any ray of sunshine is unrigorous in their opinion and foolish in general. (regularly followed by a laundry list of things that are wrong with politics, taxes, the country, etc.) As with most extreme positions in life, these have both proven to be incorrect. It is "the malaise" of public opinion outlined here in a note way back in 2011.

That said, at the end of 2013 there was clearly evidence of performance anxiety, but that appeared to mostly infect hedge funds and other asset managers who charge outsized fees and whose continued caution served them up significant underperformance for the year. The fact that the first few days of 2014 have not seen an incredible blow off shows me that at least some of the late purchases were not simply window dressing.

Another statistic that stands out a bit in terms of the ability of this market to continue on an upward trend is something previously discussed in these notes: mutual fund flows. They show that although some professionals may be changing their tune slightly from caution to enthusiasm but the public has clearly not jumped on board that train en masse yet.

As the learned skeptic Samuel Clemens wrote, there are "lies, damned lies & statistics" and I shall now make the numbers dance just a little to substantiate my argument. Keep in mind, as is always pointed out here – everyone has a bias and mental conflicts – mine is clearly that I believe things tend to work themselves out over time, however you need to be positioned to expect and survive the storms along the journey.

To wit, in every year since 2006, domestic equity mutual funds have had cash outflows. The most significant being in 2008, 2011 and 2012 with approximately $150 billion each of those years heading out the door. That trend did turn positive for 2013, but only to the tune of $15 billion. Contrast that with the years 1998 through 2000 – the "tech bubble" - that were as follows: $149 billion, $176 billion & $261 billion of equity inflows washing over the bow. That, my friends, is irrational chasing of returns… In fact, from 2009 through 2012 "taxable bond" inflows seem to follow that very same pattern. Stay tuned…

Something that may turn the bond tide more quickly is as simple as our country's demographics – we are aging as a nation because of the Boomers, whose lack of ample savings has been regularly outlined. At some point when rates do rise and folks are uncomfortably reminded that bond mutual funds have no final maturity date and can lose money, (quickly) I believe those funds will flow elsewhere accelerating the slide. They don't necessarily have to go into stocks, but short-term / cash rates are a long way from being a viable allocation option for much of a portfolio, especially for those with already limited savings. However, even in the face of 0% interest rates for cash, plenty of folks continue to try and "hide" there – according to a stat I saw from JP Morgan the other day, in the US alone there is still more than $10 trillion sitting in cash and money markets. In this low-inflation environment that still generates a negative real rate of return. Not sustainable…

I don't want to give the opinion that I'm completely undisciplined and rely solely on reading tea leaves or the feelings of my ample gut, however having watched and participated in the investment world for over 20 years now I can look back and see some environmental factors at different inflection points that I just can't seem to find currently. Social / media cues are not always as blatant as the cover of "Newsweek" declaratively stating "The Death of Equities" as we had back in the early 1980s, but there are certainly cumulative behaviors that show up.

In the late 1990s, the canary in the coal mine should have been the tow truck driver who owned his own private island or "Stuart" teaching his wealthy father-in-law how to trade online. (or perma-bear Michael Metz for those who remember that name, finally throwing in the towel after being loud and wrong for years)

The opposite was true around 2002 when everyone had given up investing in the stock market and every CNBC show spoke of real estate, antique cars, coin collections and fine wines as alternatives. (the origins of the housing bubble) The pattern repeated once again around 2007 when I would receive calls continuously, but never to discuss stocks or a traditional portfolio - even though they had done fine - it was almost always regarding flipping condos / houses, leveraging multiple properties, how much someone's home had appreciated, etc.

Currently, I would agree that you can fairly state that equities are fully valued, but they are not wildly overvalued just because the averages recently reached new nominal highs. We are several years' worth of earnings growth and fat-trimming by companies since the last time we were hitting highs in these indicators. Equities also yield considerably more than a comparable bond currently – and remember you can't fake dividends like you can stock repurchases.

Taking a look at newspapers, magazines and television, every show & article discussion still seems to center around risk (fear) and very little plainly discussing potential reward. (greed) None of this means that a correction shouldn't be expected or even seen as healthy sometime in the next few months. We need "the pause that refreshes" in order to keep that rational fear in everyone's mind and feelings of greed and hubris in check.

This is also likely to sound completely non-rigorous, but I've yet to see a magic machine or program that can consistently trade the market and win every time without cheating. (*cough* high-frequency trading *cough*) There are fundamental and technical indicators that always have to be respected as part of the overall picture, but in the end there are generally humans coordinating that dance and that fact needs to be considered as well. (The HFT machines don't set the trend, they simply react more quickly and unfairly front-run the humans - something I still can't believe is legal…)

What could knock me completely out of my skeptical but bullish pose? War and terrorism in this day and age are unfortunately game changing realities that are always around. Another machine driven flash crash that gets much further out of control, even with the circuit breakers and other mechanisms set up to "protect us" from such an occurrence. A drastic change in Fed policy, or some other bond market shock, causing a dramatic spike in both short and long-term rates, similar to the early 1980's. I believe this would not only cause a stock market drop as people try to "get liquid," but it would also be a crushing psychological blow to already unenthusiastic individual investors who've poured so much money into bond mutual funds thinking they are a safe haven.

Keep an eye on unemployment as well… The complaint there continues to be that it isn't getting better fast enough. Sounds more like political doom and gloom sound bites to me. I realize it would be great to really ramp up job creation, but with the dysfunctional Congress and White House constantly in the way, I just don't see that happening.

This uncovers two canards I'd like to point out before I sign off that really seem to get folks agitated. The first is "job creation" (or lack thereof) by the government – from both sides of the aisle. It is all complete hogwash! Let's get something straight; as a business owner, the government can either make it difficult for me to grow my business or impossible, but outside of subsidized "green energy" or military purchasing, they do not directly "create" jobs. This situation will probably not change much this year because of the looming interim elections, which generally mean nothing of significance will pass. And any capacity they do have for a difficult discussion will be monopolized by the train-wreck, Affordable Care Act implementation and the unintended consequences in the details that always come into play with a program that broad.

The second is that the same folks who wring hands, gnash teeth and try to scare everyone about the Fed and their "imminent" taper, (a headline before every Fed meeting since last June) shutting off the liquidity hose and immediately spiking rates thereby bringing economic nuclear winter across the globe – generally wax rhapsodic in their next paragraph or two about how weak job growth has been and how precarious our economy is currently. That's like complaining about a restaurant, "The food's terrible here! And on top of that, the portions are too small!" The Fed has been pretty clear about what it will take for them to look for an exit. We finally arrived on a small scale last month and the market rallied. Go figure…

I get it, today's society is impatient and that's also what makes good TV and keeps reader's attention, but most folks investing don't need to react like an algorithmic hedge fund to every little blip of the flickering ticks. Again, it's not a light switch – it's a rheostat. Stay in the game to make a few shekels and live to fight on.

Thanks for the continued loyalty and trust in 2013 – wishing us all a prosperous and fun 2014.

Cheers!