Palmetto Wealth Management

"Summertime and the livin' is easy…"

John M. Gustafson – 6 July 2014

That famous line from the Gershwin opera *Porgy & Bess* sums up my feelings as to our current environment, but also caused me to recall some sage advice from Bernard Baruch that I always attempt to keep in mind, "Become more humble as the market goes your way."

Global stock and bond markets all seem to currently be in the position of acting in a manner almost directly opposite as to what you would think, if you were paying attention to the media. Every article, talking head, investor letter has been preaching caution for the past 6 to 12+ months. However, the flow of money continues to be toward investing, not "saving." It isn't the same as 2006 or 1999, where all you heard was cheerleading and exuberance toward anything and everything rising. Currently, we all recall the burn marks from 2008 which seems to be keeping a lid on the enthusiasm. And for all those who think the Fed policy of almost 0% interest rates over several years hasn't really made a difference, it might not be pushing blazing inflation in the broader economy, but it certainly has taken away every opportunity for investment dollars other than equities. (not necessarily good, but it is reality)

Investor behavior looks to be mimicking that of general society – "I know what's best for you, so you need to be cautious and do what I say… I'm smart enough to get out of the way when things go awry - I'll just stay over here." There are no big, flashy warning signs that we saw prior to the last big falls – probably because there are still so many things wrong economically and politically around the globe to forestall such overconfidence – but I still have this nagging concern in the back of my head. Although, much more concerning to me than the current level of the equity markets is the continued chasing of the bond market as investors desperately reach for yield "safely."

Looking at one of my favorite indicators, mutual fund flows, they show that after a brief and minimal outflow in 2013 (after massive inflows the previous four years) taxable bond funds have once again collected more net money year-to-date than domestic equities. Unbelievable at these levels…

As with everybody else who works in the financial markets I don't know when the Fed will once again raise interest rates, but I do know that the next move will be up. The other thing I know for sure is that bond mutual funds, unlike actual bonds, never mature – making them much more dangerous to your financial wellbeing than most folks appear to realize. And as we all know, the managers running those funds can only buy what is available in the current market, there is no "special window" were professional managers can buy bonds at rates above the market - especially when cash is being shoveled in the door like coal into a furnace. And worse yet, most of these funds are actually run for "current income" not capital appreciation. (read your prospectus) Which means, they care about paying as much of an income stream (current yield) as is legitimately possible, which likely involves paying out a sliver of principal to enhance that stream, thereby adding to the downside when interest rates eventually go against them. (see any Government bond fund in 1994 to view what downside volatility really looks like in a "high quality" – and long duration – fund)

What does this all mean? Viewed in the context of "What is the public doing?" it tells me that the general investor on the retail side is not even close to acting "bubbly" in terms of the equity markets. Looking at the mutual fund flow data going back 15 years, bond funds have never really seen massive outflows, which I believe is likely related to the general aging demographics of American investors. However before each great fall, equity funds have shown massive inflows for multiple years. We've barely cracked positive over the past 18 months – wild, speculative enthusiasm isn't even on the radar.

So why is everything grinding onward and upward, while still making everyone feel as if things are overdone and sliding imminently toward the abyss? My belief is that it is a continuation of the politically driven emotions I dubbed "The Malaise" in one of these notes penned back in August of 2010. Politics and the divisive emotions surrounding politics have continued to grow more volatile, further away from consensus and with the death of truly "fair and balanced" media outlets (at least any that are widely read or heard) public opinion continues toward the negative on both sides.

We used to only see political mudslinging in the run up to elections (because as much as people hate them – negative ads work) but now our only sound-bites are attacks from both sides of the aisle. Neither political party stands "for" anything other than, "We're not them!"

It's as if the entire country has been split into two equally insulated groups that could each possibly be heard to utter the famous quote attributed to Pauline Kael, "I can't believe *{insert right wing or left-wing politician's name here}* won! I don't know anyone who voted for him!" All "news" media have become profit centers for their respective owners out of economic necessity, therefore they work very hard to cultivate their audience – and nowadays their audience isn't seemingly interested in hearing, as Paul Harvey would say, "The rest of the story…"

In my work I have a lot of conversations and email exchanges all across the country with people both in and outside of my business and invariably, if the conversation turns to economics and politics, many times I can tell which side of the aisle someone sits simply by listening to whom they quote or send to me via email. I understand, everyone is busy and in my mind it's not truly the fault of the viewer/reader to pick one outlet and stick with it. Rather, it's the fault of the outlet for choosing to be the house organ for one party or the other rather than telling Mark Twain's three sided story, "Your side, my side and the truth."

As also discussed in these notes over the past few years, I clearly have biases and blindsides like everyone else, although I do try to be somewhat self reflective as I'm not selling my writing per se, I'm selling my thought process and brains to my advisory clients. Therefore I tend to be an equal opportunity disparager toward both extremes – at least that's my intent. And the toxicity of politics across the globe and especially here at home are what concern me more than any economic or monetary piece of the puzzle at this point.

What do I think is to come in the second half of 2014? As has been the norm the last few years, unfortunately I think much of it will be politically driven. I feel that the reason the market was able to slowly grind higher in the face of massive negative opinions is simply because the government has ceased to do anything crazy or extreme since the last "can-kicking" of the debt ceiling and government spending bills. It's a midterm election year in a second Presidential term after all; therefore investors have been able to focus on the still slowly improving fundamentals after a massive bubble implosion.

Turmoil in the Middle East, which most of us have almost become numb to since it is half a world away always has the potential to wreak havoc. A terrorist attack, a dirty bomb, all-out war in Israel and the West Bank and/or between the Muslim sects in Iraq also has the potential to drag everyone down the rabbit hole of despair. As we march toward Election Day, certainly the rhetoric will ramp up on our own side of the Atlantic, however I continue to believe that truly not much will be accomplished – for good or ill. Everybody in government will remain in fundraising and accusation mode, rather than actual work mode. (And to be honest, I don't really remember what "work mode" looks like for them.)

The recent rebalancing to bring our core portfolios back in line with the target allocations, and also raise a little bit of cash certainly feels like the right move. Again, our opinion is, and always will be, that investing for the long term should be thought of as operating a rheostat and not a light switch. It's not "risk on / risk off" – it's turning up the wick and backing it down at times, but the flame continues to burn.

What would I like to see to feel more positive in the near term? I'd like to witness reasonableness breakout in Washington, but based on the most recent primary battles I think that's a pipe dream. We are living in a political climate in which both sides view a 60% win as a 100% loss and unfortunately all that does is continue to fan the flames and accomplishes nothing for the broad economy or our country. It is the biggest threat to the sustainability of our climb out of the abyss in my opinion. (This fall, I think we will hear the following ad nauseam: Democrats need to make sure the GOP gets no credit for their accurate mantra that the ACA is a complete fiscal &

functional disaster – and the Republicans need to make sure the President and his party receive no credit for the fact that unemployment is down multiple percentage points and the economy and markets have grown for the past several years. It's bound to be noisy, accusatory and very ugly…)

Unfortunately fiscal irresponsibility in Congress is like quitting smoking… Do you know why I believe it's so difficult to quit smoking? Because it doesn't kill you fast enough. Think about it – whenever someone contracts a chronic disease they immediately change their behavior based on the best advice of their doctor. Even though that doctor may have been suggesting these exact changes for years and years already! The same thing occurs in Washington – we all know that many of the current policies are ineffective and dangerous in the long run, but we're not yet to the point to where it's terminal. (Though that too is being debated in the media currently…) Both sides seem to realize that things need to change, but the danger is not felt imminently enough to force those changes right now.

Overall, the market reality is that equities are not in a bubble. Bonds feel as if they are, but based on the economic metrics and the Fed's current position, that isn't a problem – yet. What keeps me comfortable with current positions is actually the negativity I've been outlining – the wall of worry – keeping speculation in check. At some point, we need the public to push liquidity from money market to stocks instead of bonds, but there seems to be plenty of liquidity from other sources to maintain our upward trajectory. For now…

Would I like to see a pause (correction) to settle some of the bubble talk? Absolutely… Perhaps the lazy, easy days of summer will bring a little downside as the Bulls head to the beach. That's the way it works on Wall St. – the (current) winners get a break and the (current) losers have a chance to get back in the game by pressing their bets on low volume. That is one emotionally-driven pattern that has a good chance of continuing. Stay tuned…

Thank you as always for your continued support and please email or call with any questions or concerns. (And thank you for the recent referrals – always welcome!) Enjoy the summer.

Cheers!