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LINNARD FINANCIAL MANAGEMENT & PLANNING, INC.

Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

With the advent of summer vacations upon us, it appears that the economic crises earlier in the year have also taken a much-needed rest. Other than Turkey, Europe has calmed down, although social unrest has surfaced in Brazil and Egypt. Washington is focused on other issues, like immigration and the scandal-du-jour. This relative quiet allows us to review the implication of "Quantitative Easing" and basic risk reduction theory in this issue.

The Economy

Outlook & Trends readers have been aware of the gradual improvement in real estate for some time. Improvement was reported in *O&T* while foreclosure signs were still prominent in the nightly television newscasts. That trend has accelerated with "Sale Pending" signs sprouting out of lawns, at least here in the North East. We have heard of several homes being sold, even before they were officially listed, as buyers scrambled to close the deal before mortgage interest rates rose. The median price of an existing home is up 16.8% from last year, according to the National Association of Realtors.

It appears that the Federal Reserve's "Quantitative Easing" (or money-printing) policy has had some success in inflating the domestic stock market and real estate prices. However, success in the overall objective is questionable. The Fed expected that higher home and stock market prices would make people feel wealthier, spend more, and thus create economic growth. That connection is less than clear. Unemployment ticked up to 7.6% last month. GDP growth was revised down to 1.8%. Annual corporate profit growth is down to 4.5%. The economy continues to bump along the flat line, unable to reach its "escape velocity" where growth would become self-sustaining.

Part of the rationale for the Fed's policy is to support the economy as the Government budget is cut back and payroll and other taxes have been increased, substituting artificial monetary support (QE) for a reduction in artificial fiscal support (deficit). Both monetary and fiscal supports have their limits, however. The Congress is caught in the tension between those concerned about the immediate welfare (and votes) of the nation, and those concerned about its future welfare. Voices warning about the dangers of continuing the Fed policy are becoming louder, now even including some Fed policy makers. The problem is, just like a drug addiction, the longer the dependence lasts, the higher dosage is needed to maintain the effect. The greater the dose, the more severe the eventual letdown will be.

The Markets

The markets, especially bonds, got a taste of that letdown recently, a potentially ominous sign of the inherent risk that has been created by the easy money. Fed Chairman Bernanke dared to mention the possibility that the Fed might reduce ("taper") the monthly dose of $87 billion added to the money supply later this year or next, if economic progress warranted. What seems like an entirely benign and reasonable approach sparked an across-the-board bond market sell-off like the one that occurred in the height of the 2008 financial crisis. Since bond prices move inversely to interest rates, this could either turn out to mark a permanent upward turn in rates, or simply a panic reaction. Apparently many bond traders whose holdings were enabled by the excess Fed cash decided not to wait around to find out. This fierceness of the reaction could presage things to come when the policy really changes. The stock market also reacted, but volatility is more in the character of stocks than bonds, so it did not draw much attention. The potentially important occurrence here is that stocks and bonds both dropped sharply at the same time. Typically when stocks rise, Treasury bonds fall and vice versa. This "inverse correlation" is the basis of risk reduction through portfolio diversification. Unfortunately in times of market panic, traders may begin to sell all their assets, stocks and bonds alike, and the correlation can become positive, with both stocks and bonds dropping simultaneously, and nullify the risk reduction property of diversification just at the time when it is most needed.

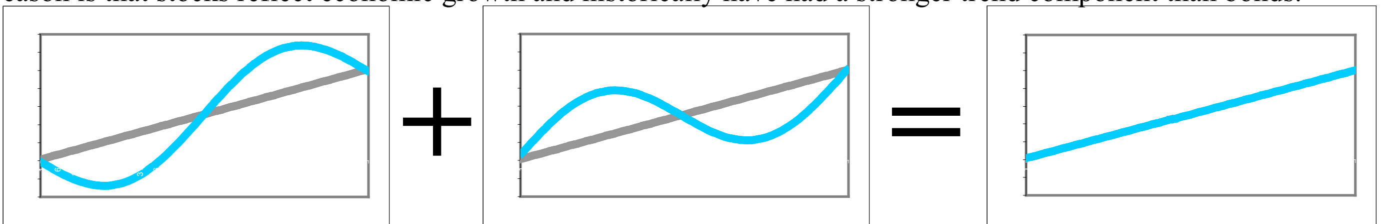
Cycles, Trends. Diversification and Correlation

If you just listened to the evening news reporting large cap domestic stock results, all would seem well. The S&P 500 was up 2.3% during the quarter. You would have missed that 10-year Treasury bonds were down 4.1%; foreign stocks, down 5.0%; emerging markets, down 8.8%; gold down 22.9%. Investors who followed good investment practice by broadly diversifying did not do well last quarter, but there will be other times when the results will be reversed. Prices of investment assets, whether stocks, bonds, homes, gold, or stamps all respond to multiple economic forces in different ways and at different times.

Some of these forces are cyclical, following several-year business cycles, cycles as short as several minutes in length, or decades-long periods reflecting the pace of technology. Long cycles can move so slowly that they seem like slow growth trends or flat periods. Wiggles in investment prices are the shorter cycles (plus the effects of random events) superimposed upon the longer trend-like movements. Recent results not withstanding, investment risk reduction can occur through portfolio diversification when one investment's cycle is not correlated with another's, because the wiggles tend to cancel each other out. One may ask, "How can I earn a return if my gains are cancelled out?" Why should I invest in losers like emerging markets or gold? There are two points to consider here.

First, if your gains are cyclical in nature, by definition they will not remain gains indefinitely. Purely cyclical gains will eventually become cyclical losses. This is true whether the cycle lasts a week or for years. The cyclical portion of a gain will be given up in time, unless you are an adept trader and can avoid the downside of the cycle. When the cycle completes, it is the trend that remains, that slow moving change that resides underneath the cyclical wiggles.

Second, if you can construct your portfolio out of uncorrelated assets, the volatility risk of the wiggles will be cancelled out (to a greater or lesser degree), exposing the underlying trend. The gain from this trend is all that you would likely retain over the long-term anyway. Diversification does not cancel out the trend gains. It reduces the cyclical risk. This is not to say that a diversified portfolio of stocks and bonds will return the same as an aggressive portfolio of stocks. It won't in the long run (although it may take 20-30 years in some cases, perhaps like now). The reason is that stocks reflect economic growth and historically have had a stronger trend component than bonds.



Another other take-away from this discussion is that it is both difficult and important to distinguish between the real long-term trend and what may seem to be a trend, but is really a longer cycle. At cyclical tops, investors often mistakenly believe they are observing the trend, which will continue up forever, even as the cycle begins to turn down. Right now, stocks could be near the top of an artificially supported cycle that has been created by government policy, superimposed upon a flat trend that has existed for about fifteen years since the late 1990s. Until the economy turns around sufficiently to generate unsupported organic growth, the underlying trend is like to remain reasonably flat, and the gains that are witnessed, even if they occur over a multi-year period, are likely to be cyclical in nature, followed by the typical negative outcome when the cycle reverses.

In these unpredictable times, the key is to adapt, plan and manage risk. A good, well-executed plan is likely to be an investment worth far more than the cost. To learn more about our client goal-centered financial planning and investment management services, please call or e-mail. We invite you to visit www.linnardfinancial.com.

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