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Registered Investment Advisor, Wealth Management & Financial Planning

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Outlook & Trends

The folks in Washington are at it again, vigorously arguing about their financial and social priorities and predicting something close to catastrophe if their position does not prevail. Wall Street has not paid much attention this time so far though, since there are no major budget initiatives or new taxes on the table.

The Economy

The continuing story for the economics watchers last quarter was the recent chapter of the Fed's Quantitative Easing plans. The Fed confounded many of the pundits, giving the plot a bit of a twist by continuing to supply $85 billion per month to the economy, rather than reducing the rate of monetary life support as expected. This was despite the fact that the Fed itself said that the economy was growing at a modest to moderate pace, which is consistent with the GDP's 2.5% annual growth rate. The bond market reacted strongly last June, at the mere mention of "tapering" the support level, rapidly dropping bond values and thereby causing prevailing interest rates to rise. It is possible that the Fed was concerned that reducing their support could cause rates to rise further, jeopardizing what economic growth we have seen. If true, that would suggest that the Fed might be in a bit of a policy box, continuing to flood their balance sheet with increasing amounts of debt, but unable to easily stop.

Indications are that the economic growth may be becoming mature, even though employment is still significantly retarded in comparison to past recoveries. New claims for unemployment are reaching the 300,000 mark, near the low points of prior cycles, but peak employment growth is still below prior recoveries, because the percentage of people participating in the labor force is at the lowest point since 1978. Reducing the labor force is not an effective way to promote economic growth.

Whether the Fed policy has helped the economy is a subject of ongoing debate. Although the results have been lackluster, it is entirely possible that the situation would have been worse without their efforts. What is clear is that the policies have reduced interest rates, penalized savers and encouraged investors to take additional risk in a reach for higher returns. The lower rates also had the intended effect of helping banks, borrowers, and businesses improve their financial positions by refinancing debt, finally leading to a turn-around in home sales and home prices. The National Association of Realtors reports a 14.4% increase in home prices over the last year. Stronger family financial health is reflected by a household debt-to-income level that is the lowest since 1983.

The Fed polices have primarily helped those owning real estate and those willing and able to take risk with equity assets. Despite the Washington rhetoric, it is surprising that most people whose wealth depends on receiving a paycheck have not been helped much. According to the Associated Press, the percentage of the national income earned by the top 1% last year was the highest since 1928. In contrast, since the bottom of the recession, median inflation-adjusted household income reported by the Census Bureau has actually decreased by 4.9%. The percentage of people in poverty currently (15%) is greater now than the number at the recession bottom (13.2%) and similar to recession troughs in 1990 and 1983.

The Markets

Domestic stocks made fresh new highs during the quarter. International stocks, from both developed and emerging market countries are still well below their pre-recession levels. Gold and most commodities have been in a two-year bear market, and bonds are trying to regain their footing after the June "taper" talk drop. When one listens to the evening news, there is the clear impression that all is well in investment-land. But the reality is that this is largely a one-dimensional investment landscape, with only domestic stocks doing well. Despite welcome recent gains, real estate is also still well below its previous pre-recession highs. Investors who maintain a disciplined, well-balanced portfolio have not been rewarded as well as might be expected, which unfortunately could prompt many to abandon good diversification practice, concentrate on stocks for gains today, only to lose it all and more later.

Reversion to the Mean

Before interplanetary rocket launches, the basic law of gravity was, "What goes up must come down". A corollary applies to many human events. "What goes up must come down, then go up again." Wikipedia describes *reversion to the mean* in finance as a process where "Periods of lower returns are systematically followed by compensating periods of higher returns" (and vice versa). This leads to the wisdom of the phrase, "It's not how much you gain. It's what you keep that matters."

Reversion to the mean is seen in all parts of human endeavors in economics and politics as variation around a central trend. The winter is cold. The summer is hot, but the annual mean temperature in a given location does not change very much. High inflation followed by periods of low inflation. Conservative politics follows liberal and back again. High taxes are followed by low taxes, reaching some maximum point where the direction can no longer be sustained. Sometimes these cyclical changes can be very long, sometime very short. There has been much discussion about income inequality in the US. The last time that the top 1% of earners controlled 20% of the income was in the 1920's. That fell off to less than 10% in the 1970's, averaging about 15% over the years. Inflation was minus 2% in 1949, 14% in the 1980s and is 1.5% now, averaging about 3 percent. Likewise, 10-year bond interest rates were a little more than 2% in the 1940's and 13% in 1984. Today it is 2.62%.

In order to take a long-term view of financial planning or investing, it is important to forge a strategy based on the understanding of this variability, have a sense for the time frame in which the variation occurs, and also consider the degree of variation. Past issues of *Outlook & Trends* have discussed some of these concepts. Another key concept is that the right strategy is different for every one. A young person who saves regularly for retirement can fairly safely ignore the highs and lows, knowing that over the long-term the returns can be expected to revert to the mean. With diversification, risk can be sufficiently balanced to approximate the mean return over time. What the US economy looks like in 40 years is likely to be affected very little by any given event even though it may seem important today.

On the other hand, the closer one gets to reversing the saving process and planning for a finite but totally unpredictable retirement period of withdrawing funds, the less important the mean becomes, and the impact of the variations increases. Today, Fed policy has discouraged saving and encouraged risk. The stock market has been driven back to valuation levels approaching the outside ranges of high valuation. In our view, attention to risk planning should be elevated, particularly if a retiree's assets are only marginally adequate. A retiree should not be thinking about "How can I cash in?" but rather, "How should I protect what I have". Reversion to the mean suggests that today's valuations will not last; that there will be a lower valuation at some time in the future. This could be a large risk for the unprepared or the impatient, or a future opportunity for those with a longer-term view and a risk-managed strategy to match.

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