BEACON POINTE

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Beacon's Point: Prescription Refill

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Prescription Refill

The outcome of the much-anticipated September meeting of the Federal Open Market Committee (FOMC) caught market participants by surprise. Instead of beginning to gradually taper the program of quantitative easing, as many had expected, Fed officials voted to maintain the status quo. The immediate reaction of financial markets was overwhelmingly positive, with the S&P 500 Index rising to a new record high (1,725 at the close on September 18, 2013) and the 10-year Treasury yield falling by 15 bps on the day to 2.71%. However, in the words of one astute market observer (Brad Alford of Alpha Capital Management), this latest market advance may prove to be a "short-term gain for long-term pain". In fact, the Fed downgraded its outlook on the U.S. economy, projecting real GDP growth of 2.0%-2.3% in 2013 and 2.9%-3.1% in 2014. It is quite ironic, then, that markets rallied following Chairman Bernanke's press conference.

Fed officials stated that they want to see more evidence of sustained improvement in the economy before scaling back their purchases from the current $85 billion-per-month level. This bond-buying program was launched about a year ago in an effort to push down interest rates at the long end of the yield curve. According to the Fed, the program is "not on a preset course" and the decision to end it is "data-dependent". Presently, the central bank's lingering concerns include the underlying strength of the job market (with a focus on the labor participation rate), tighter financial conditions that may hold back the housing market recovery, and reported inflation running below its 2% target.

Analyzing the latest Fed statement, some market historians argue that the Fed wants to avoid its past mistake of triple tightening. In 1937, taxes were going up and spending was being cut at the same time as the Fed began tightening monetary policy. The still fragile U.S. economy, not fully recovered from the Great Depression, was pushed back into a deep recession that saw a 9% output contraction and 11% deflation. Fast forward to today, Ben Bernanke and his colleagues may have chosen the wait and see approach, given the tax increases already in effect, the ongoing sequester, and the upcoming budget and debt ceiling debates. While this caution may well be warranted, keeping rates too low for too long comes with a price. Some of the consequences are known and expected, but others are unintended and cannot be foreseen. Quantitative easing has undoubtedly overshadowed market fundamentals as the primary driver of returns over the last few years. This creates a very challenging environment for active managers that focus on fundamental bottom-up research and intrinsic valuation.

Beacon Pointe reached out to a few of the investment managers we respect and recommend to clients and asked them to share their thoughts on the Fed's decision and its potential impact on financial markets. We provide highlights of their views below (the managers' original comments were, in some instances, shortened or paraphrased in order to fit the format of this letter):

Kevin Tanner, Saratoga Research and Investment Management

> *Today the Fed delayed an important decision: when to begin weaning the market off the trillion-dollar-per year dosage of artificial demand Ben Bernanke and his colleagues have been injecting since 2009. Investors have grown so addicted to Quantitative Easing (QE) that when Bernanke merely hinted last May that the supply of monetary elixir might someday be crimped, markets convulsed for weeks.*

We think the Fed's QE policies do very little to stimulate the real economy. They do, however, drive asset prices higher while adding little to underlying intrinsic value. For the last several years the Fed has forced asset prices to rise at a pace much faster than underlying values have grown. By doing so, they have systematically increased risk and reduced future returns for all investors.

Eventually – maybe in the next year or so – circumstances could force the Fed to actually halt QE. That could happen because the economy continues to muddle forward to an extent that Fed employment targets are met, or the Fed could find itself tapering for other reasons. Regardless of the reason, when Quantitative Easing ends, we think the market is likely to experience a sustained period of painful withdrawal. As this happens, the market will begin to discover the real levels of supply and demand. Before the fact, we don't believe current market prices can tell us much about what underlying businesses are truly worth.

Robert Mark, St. James Investment Company

The Federal Reserve announced that they will not taper their current efforts at quantitative easing. Equity valuations will continue to delink from reality while idle money will feel compelled to leave the sidelines and chase performance. We are now in the final act but we have no idea when the show ends. All we know is that a massive amount of capital is misallocated, and then justifiably purged. What should allocators of capital do? Should they capitulate and play the game of relative valuations and relative performance? Of course not, but now they assume the increasing pressures of business risk and professional risk that Jeremy Grantham at GMO describes so eloquently.

The market had already priced in the beginning of the end of the central bank's extraordinary monetary stimulus, but now the market and its prognosticators will continue playing the game of parsing each economic data point to determine the future intentions of the central bank. "Machines" are programmed to trade each economic data point and technical level in the market to a degree that far exceeds the market of 2007. Just as quickly as the market marches higher on monetary stimulus and manufactured news headlines, the reverse will likely prove true when the final act ends.

The current environment is similar to 2007 in that valuations are stretched but today is definitely different than 2007. There are few, if any, remaining conventional fiscal or monetary instruments to fight any shock to the economic system. In 2008, the "bad" debt shifted to the government's balance sheet while corporations and individuals repaired their balance sheets. Today, the government's balance sheet appears increasingly hobbled and yet the current environment is fostering malinvestments that will once again damage corporate and individual balance sheets. In 2007, after-tax corporate profit margins averaged 7% and top line revenue growth averaged around 7%, but today profit margins are closer to 10% and revenue growth is stalling at 1.5%–2.0%. How do you justify higher equity valuations if profit margins are more likely to contract than expand and revenue growth is stalling?

Nick Tomprass, Alpine Capital Research

The Fed's decision to continue its current level of stimulus does not, in our opinion, have a meaningful impact on the stock market's intrinsic value. We believe the argument that low

> *interest rates should produce higher stock prices is flawed, and believe any strategy designed to predict the end of tapering speculative.*
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> *First, the Fed policy of temporarily holding down nominal yields does not mean that real stock discount rates will be permanently lower and thus stock values permanently higher. Second, predicting when the Fed will end its low rate policy and selling stocks and bonds at just the right time is as problematic as predicting the demise of the Internet Bubble and selling at just the right time.*
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> *We believe there are both differences and similarities in the economic environment today compared to 2007. The U.S. economy is fundamentally healthier today. Financial institutions are stronger, and housing prices are at reasonable levels. However, stock prices are, in our opinion, at similar levels of over-valuation, and bond prices are more precariously high due to lower interest rates. In short, we believe caution is warranted today as it was in 2007, although the U.S. economy would be comparatively better able to withstand a severe contraction.*

Beacon Pointe shares many of these concerns. We think it is imprudent and very risky to chase asset prices (and market indices) that are disconnected from the true intrinsic value of companies as dictated by their fundamentals. (We remember only too well the euphoria of the late 1990s when TMT stocks kept going up despite being grossly overvalued. Participating fully in the market's movement was enjoyable on the upside but very painful on the subsequent downside.)

In our view, the continuation of the Fed's bond-buying program is similar to a prescription refill for a patient whose symptoms have stubbornly refused to subside. Perhaps another round of the treatment will be sufficient to cure the patient, or so the thinking goes. However, if the medicine does not seem to be working, will more of it solve the problem or, instead, make it worse? As caretakers of our clients' portfolios, we focus first and foremost on avoiding destructive capital loss in the event of an overdose. Our approach may prevent us from fully capturing the benefits of the dosage, but we are able to protect and grow portfolios that effectively meet their goals whether there is a remedy or not.

Policymakers may be better served by reducing the medicine dosage and evaluating the patient in a more natural state. Only then will economic signs become reliable indicators, allowing financial markets to serve as the true arbiter of fundamental health at the micro (company) and aggregate (economy) level. We would expect a rise in volatility during that adjustment period, but have built our clients' portfolios to withstand and benefit from such an environment.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.