CITRINCOOPERMAN
WEALTH MANAGEMENT, LP
Registered Investment Advisors

2nd Quarter 2014:

The second quarter of the year produced few surprises for investors, as nearly all major asset classes gained ground. Many equity markets around the world reached highs in the quarter thanks to an improving global economic outlook and very accommodative monetary policy, leaving investors little reason to shift allocations. The low levels of market volatility in the spring led to worries about complacency as investors shrugged off increased geopolitical risks. For the quarter, the S&P 500 was up 5.23% and the Barclays Aggregate Bond gained 2.04%.

In the United States, the Federal Reserve (the "Fed") continues to buy bonds, though at a slower pace, to help keep long-term interest rates artificially lower. In addition, the Fed promised to maintain low short-term interest rates for an extended period of time. One notable surprise this year has been the decline in interest rates on ten-year Treasury bonds, from 3.0% in January to roughly 2.5% currently. There has been a great deal of head-scratching as many try to understand this decline in rates. The answer may be simple: the Fed is manipulating the bond market and bond market participants are playing along. This could end up being a dangerous game, especially if inflation begins to tick up. Any confirmation of inflationary pressure would cause rates to move swiftly higher, in which case bonds would quickly lose value.

Former Fed Chairman Ben Bernanke often described his mission at the Fed as preventing deflation. He did not want Fed policy to contribute to a collapse in the economy like the Great Depression of the 1930s. Easy money policies have apparently been successful thus far. The Fed, however, continues to act as if the US is still mired in a recession. The concern is that the Fed is backward looking and not sufficiently concerned about the future. While investors may be interested in the past, where we are going is more important. The Fed's own work suggests that normal short-term interest rates should be around 4.0%, yet it continues to keep the Fed Fund rate at 0.25%. Does the Fed see something that others don't see? At some point, the Fed will need to raise short-term rates and ultimately get rates closer to the historical norm.

Many of the measures of the economic activity that get the most attention, such as inflation and the rate of unemployment, are either coincident or lagging indicators of growth. In other words, they tell us either where the economy has been or where it is, not where it is going. Many investors fail to understand that stock prices are a leading indicator of economic activity. With prices at all-time highs, the stock market is signaling economic strength, not pending recession. Easy money could pave the way for a market dislocation. The last period of easy money led to the inflating of the housing bubble. That seems unlikely to recur, as housing continues to suffer a muted recovery. Nevertheless, cheap money will find a home, especially with the returns on cash and fixed income being kept at such low levels by the Fed. Artificially low interest rates have the potential to lead to misallocations of capital in the economy, as investors assume greater and greater risk.

Presently, there are few signs of worrisome behavior driven by the Fed's easy money policies. There has been a notable increase in merger and takeover activity, but most deals appear rational and investors have responded favorably to the announced transactions. We have yet to see large, highly leveraged takeovers by private equity firms, perhaps because some of the rich premium high-profile deals of 2006-2007 are still fresh in their minds. CCWM thinks it is too early to worry, but it is prudent to be cautious.

In general, the economy appears to gradually be getting stronger. After shrugging off the effects of severe winter weather in the first quarter, earnings growth could prove surprisingly strong over the balance of the year. The Fed has continued to reduce its bond purchases but interest rates have continued lower. A stronger economy could lead to increased investor confidence and higher price-to-earnings ratios (a valuation ratio of a company's current share price compared to its per-share earnings), with the result being another strong year for stocks – which has been the case through the first six months of this year. However, if signs of inflation begin to appear, rising interest rates could lead to a contraction in valuation multiplies and, as a result, the stock market would decline. In short, the risk/reward ratio for stocks seems more balanced than it has in recent years, but still superior to alternatives like cash and bonds.