Stembrook Asset Management

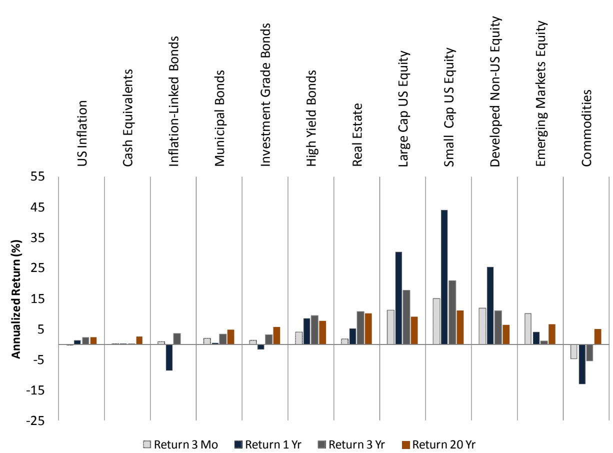
Ever Tried to Push a Car? How About a String?
Stembrook Investment Commentary – December 2013

> "...rising rates don't dependably predict falling stock prices"

Have you ever tried to push a car? How about a string? I've done both, and since the former is arguably more interesting than the latter, I'll start there.

When I was younger, I had a Volkswagen Scirocco, my first car. While my friends and I were at the beach one summer, a squall blew thought and poured a massive amount of rain on the barrier island, which sits just a few feet above sea level; the result was local flooding. The water overwhelmed the Scirroco's engine and the car stalled. Turning the key wasn't getting it started, so as any good friend would do, I asked my friends to get out and push. We were going to try to jump start the engine. This involves getting the car moving forward with some momentum and then "popping" the clutch. When you do this, you connect the spinning tires to the engine through the drive train and the car's forward movement acts as a starter motor. We pushed the car to slightly higher ground, got it rolling down a small hill, I popped the clutch and the engine sputtered to life. I floored the throttle and three young men drove off, satisfied with their manly ingenuity and physical prowess. We were 18.

Chart 1 – Global Market Returns as of 11/30/2013



Source: see endnotes

Fast forward 24 years. My car still has a standard transmission and it's arguably nicer, but nothing will replace my Scirocco.

Our economy is much like a car that sucked a big gulp of water into its tailpipe and stalled in 2008-2009. The figurative hills of the global economy are higher and longer than those in my story, but imagine that we're in the Scirocco. The smell of old leather seats, the hand cranked windows and sunroof — you get the idea. We've stalled. We, the populous, get out and push by getting up every day to go to work, or look for work, to run a business, or run our lives on the resources we've carefully saved. We're toiling feverishly to get the wheels turning and the momentum building. We're pushing hard.

The Federal Reserve (the Fed) has determined that it can use its road grader to create a slight downward slope in the road ahead in an effort to make our pushing easier and more productive, while Chairman Bernanke stands on the gas pedal, waiting for the right moment to pop the clutch, so our economic engine can sputter to life and move on its own motive power.

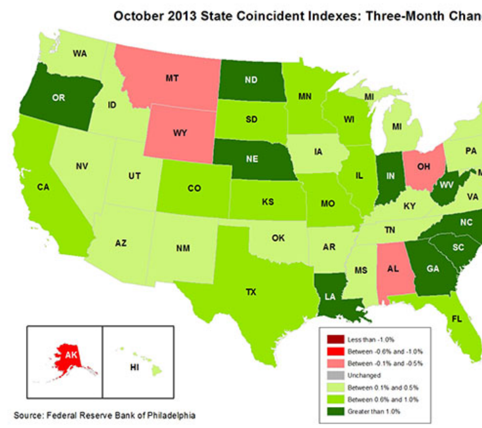
As we've inched the car forward, we've had a number of obstacles fall in the path of our tenuously rolling wheels. The Arab Spring threatened oil supplies and intensified political unrest, two waning U.S. wars taxed our military and our budget, a Tsunami and subsequent nuclear disaster hit the world's third largest economy. The list goes on, but these events are common in that they were all beyond our immediate control.

All the while, members of the U.S. Congress, who seem to have checked their economic knowledge on the steps of the Capital Building, have been pulling on the handbrake from time to time with a budget crisis here, a sequester there, and a government shut down for good measure. If you have ever been the one leaning into the rear bumper, you know how counterproductive pulling on the hand break can be. This may have been a cute practical joke if our situation was that of three teenagers in a summer squall, but that is not the case. Unlike the sand bar which is the beach town of my youth, there are big, long hills in the real world, and if we start coasting down one of those hills (think the next recession) before we can get the motor running smoothly, we'll be in a tough spot. As the Fed begins to ease back to more normal policies, we need the engine running smoothly enough to run the pumps that give us power steering and brakes and the power to drive our wheels down the road and up the next hill.

By the measures of U.S. GDP and our stock market, we've climbed out. Now we need to keep moving down the road without extra help. The Fed has shown its confidence in the healing economy by beginning to reduce its monthly bond buying by $10 Billion. Geopolitical risk remains an unknown. The U.S. Congress now must do its part to keep us moving forward. There is a time and place for everything; now is not the time to be pulling on the handbrake.

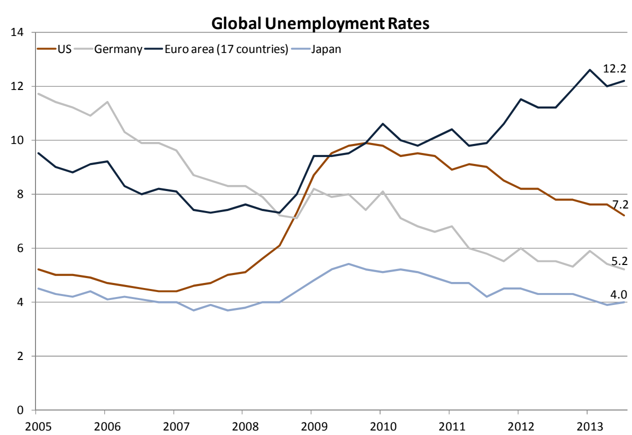
The good news is that a budget is on the President's desk, and there seems to be a new level of sensitivity to the political damage that continued ineffective legislation can inflict. We can only hope that cooler heads prevail when it is time to increase the debt ceiling in the first quarter of 2014.

Chart 2 – State Coincident indicators



Source: see endnotes

Chart 3 – Global Unemployment



Source: see endnotes

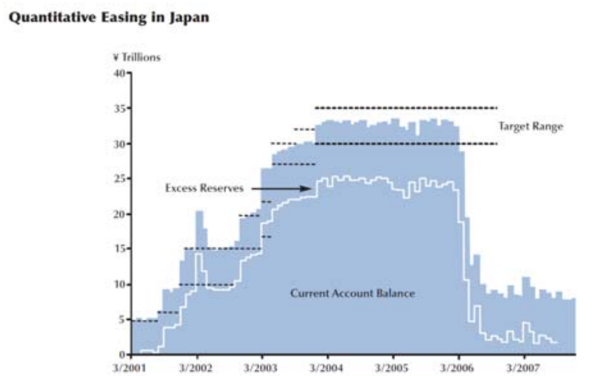
Outside of Washington, the U.S. economic news is, by and large, positive. Since this time last year, unemployment is down 0.8%, GDP is up 2% after inflation, with the most recent quarter showing 4.1% annualized growth. Housing prices are up 13% based on the Case-Shiller 10 City Index, household debt service payments as a percentage of disposable income are down 2.5%, household net worth is up 11% and state coincident indicators are up 2.9%, on average (see Chart 2). Even unemployment in Europe (see Chart 3) seems to be moderating. All the while, inflation is almost too low at 1.2% for the past 12 months. Interestingly and somewhat counterintuitively, consumer sentiment is down 12.9% based on the University of Michigan Consumer Sentiment Survey. This is likely a reflection of still-too-high unemployment and a lingering fear that we won't get our engine running smoothly as the Fed continues to ease off the throttle.

How about the string?

It is often said that the Fed can only loosen monetary policy so much, after that, it's like pushing on a string. I'll spare you my story about pushing on a string, but will share a few thoughts about how monetary policy is evolving and how it may impact the financial markets.

In a normal recession, the Fed attempts to spur the economy using a number of tools at its disposal. One such strategy is reducing short-term interest rates by engaging in open market operations. This involves going into the open market and buying short-term Treasury Bills. This tends to push prices higher and reduces yields on shorter-term Treasuries. Reduced yields translate to lower short-term interest rates, which is stimulative. In the economic crisis starting in 2008-2009, after easing short-term rates to near zero, the Fed believed they needed to do

Chart 4 – Scale and Speed of Central Bank Intervention in Japan

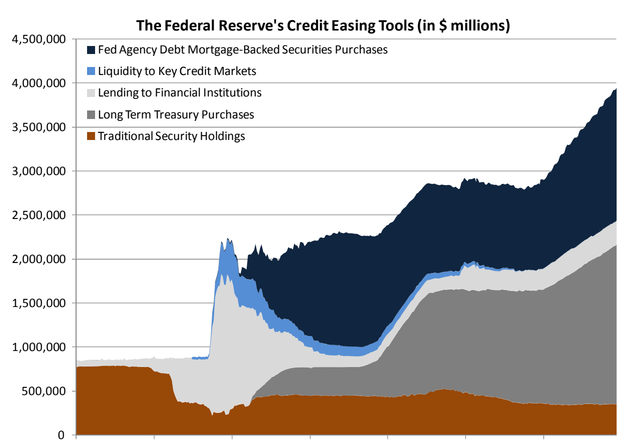


Source: see endnotes

more. So, they started to buy ***long-term*** bonds, which pushed long-term rates down. This, too, is stimulative. This second activity is a gross oversimplification of what has been dubbed, Quantitative Easing or QE. Being discussed today, is how quickly to reduce and eventually end this massively stimulative bond purchase program. Note that cutting back on purchasing bonds is different from stopping purchasing, or selling bonds the Fed currently holds.

This is not the fist time Quantitative Easing is being used. In fact, the term was adopted from Japan's attempts to stimulate their economy between 2001 and 2006. If Chair-

Chart 5 – Scale and Speed of Central Bank Intervention in the U.S.



Source: see endnotes

man Bernanke had it his way, his program would have been dubbed Credit Easing to avoid any association with the Bank of Japan's earlier attempts.

Japan's outcome is not one we want to emulate, but it does give us some sense of what could happen, and perhaps more importantly, what won't necessarily happen when quantitative easing slows and ultimately ends. Japan started its QE more than ten years after the bursting of their asset bubble. Their exit was also ill timed, as it coincided with the beginning of the global credit crisis. As chart 4 shows, Japan was slow to ramp up their QE program and quick to end it. The U.S. Federal Reserve is following the opposite path, with a very aggressive entry and what is being planned as a slow exit. The Fed's approach is also more nuanced in that they are targeting specific types of bonds, mostly mortgages, as depicted in Chart 5.

We know that when Japan abruptly ended their Quantitative Easing policy over the course of only 4 months in 2006, their long period of economic stagnancy continued. This is surely something to be avoided. What did not happen was an immediate collapse in the economy or a stock market crash caused by the withdrawal of QE. Given a more aggressive entry, a more gradual exit and an improving economy, combined with a Fed that is keenly aware of the perils of pulling back stimulus too quickly and the ability to restart its bond buying at a moment's notice, a reasonable person could argue that we are not destined to imitate the economic stagnancy that followed Japan's withdrawal of QE.

One thing we know for certain, is that as the Fed tapers back its bond purchases, bond prices will tend to fall and yields will tend to rise. We can do a lot of theorizing about what this will mean for the economy and financial markets, and we've done that, but we

Fundamentals—Tax Efficiency

It should come as no surprise that taxes play a large part in the returns that many investors experience. It is for this reason that taxes are considered as a key factor in the investment decisions made on behalf of our clients.

A way to quantify the impact of taxes on an investment is estimate its tax efficiency. We use this measure both in selecting investments and in strategic planning.

What is Tax Efficiency

Tax efficiency measures the percentage of the total return that an investor keeps after paying taxes. For example, a taxable investor should expect to keep almost 100 percent of the return they receive from a Municipal Bond. This is due to the fact that the income received from a Municipal Bond is free from federal taxes (and state taxes if the bond is issued in the client's home state) (1). At the other end of the spectrum is a Corporate Bond, who's coupon payments are taxed at the income tax rate. This translates to a tax efficiency ratio of roughly 0.57 or less for a person in the highest income bracket. For example, if we received a 10% return on an investment with a 0.57 tax-efficiency ratio, the investor would take home only 5.7%. Given the massive impact that taxes can have on returns, we need to consider taxes earlier in the process than one might think, looking not at the expected return of an investment, but the expected AFTER-TAX return of an investment.

As we move to the equity space, the estimates of tax efficiency get a bit more complex, as there are more potential sources of return, but the concept remains the same. Factors to consider include income and capital gains tax rates, expected principal appreciation, dividend income, turnover and holding period. Our models incorporate these inputs into every investment under consideration. This leads us to maintain two expected returns for each asset class. One before tax and one after tax. Our taxable portfolios are built using the after-tax expectations.

As I mentioned, this logic is also used as we craft strategic investment plans, since the amount of money you keep after taxes (and inflation—the topic of a future discussion) is what matters.

How Can Tax Efficiency Influence Your Bottom Line?

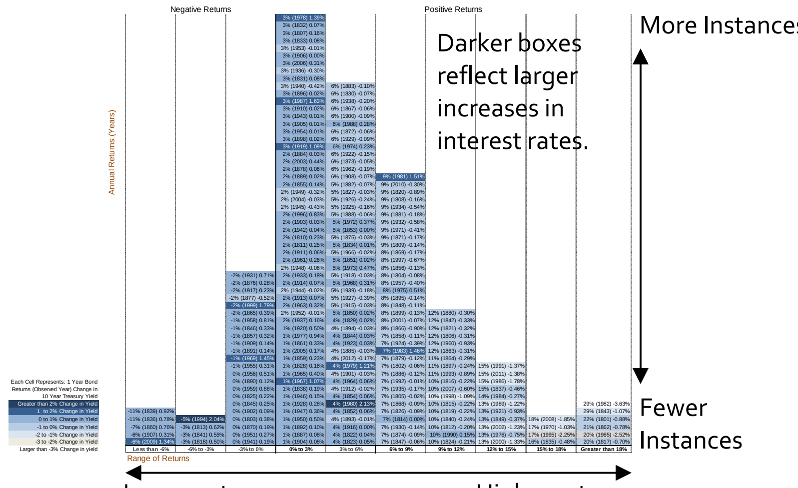
By considering the impact of taxes before we invest, we improve our clients' odds of obtaining the highest return possible, after taxes and this is the return that ultimately matters.

also wanted to look at the historical evidence.

Do rising rates necessarily lead to poor equity performance? Charts 6 and 7 show the historical record for bonds and stocks over the past 213 years. We've attempted to display a large amount of information in both graphics, so please bear with me as I describe the components. Focusing on Chart 6, we show U.S. bond market returns displayed in a histogram. Across the bottom of the chart, we have grouped annual returns into columns. The left most column shows annual returns of less than -6%, the second from the left shows returns from -6% to -3%, etcetera. Each colored box represents one year and is stacked in the column corresponding with its annual return. The largest stack of boxes falls in the 0% to 3% column. Meaning that the most typical annual return for bonds falls between 0% and 3%. The shading represents changes in interest rates in a given year. The darker the box, the larger the positive change in interest rates. So, if there was a perfect relationship between rising rates and falling returns, we would see the darkest boxes on the far left, the lightest boxes on the far right and a gradation across the middle. When we look at Chart 6, we observe this general pattern. This should be expected, as bond prices are highly sensitive to changes in interest rates. However, the relationship is much less clear when we look at stock market returns in Chart 7. Here, the darker boxes (years with larger upward changes in rates) are fairly well distributed across the histogram. Said another way, rising rates don't dependably predict falling stock prices. Why?

We often hear, and have recently been bombarded with the notion that the tapering of QE will lead to higher rates and a collapse in stock prices. There are many arguments to support this, but the bottom line is that rising rates happen for various reason and the reasons tend to determine how equities react. In our current case, our view is that rising

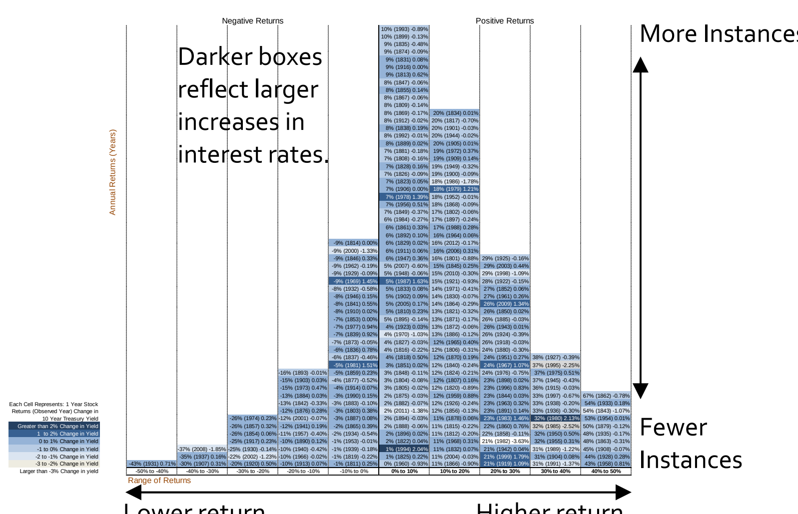
Chart 6 – Bonds In Rising and Falling Rate Environments



Source: see endnotes

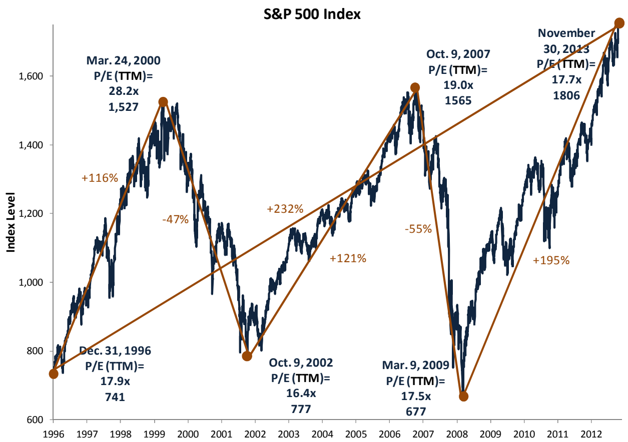
rates will most likely be due to an improving economy. An improving economy is good for corporate profits and stronger corporate profits drive higher share prices. There is another very positive thing about rising rates driven by the tapering of QE. Tapering will put us on a path to more normal monetary conditions and that is good for business confidence, which in turn leads to increased capital spending, more jobs, higher income, etcetera. We've made this argument for some time, and we don't see a reason to change

Chart 7 – Stocks In Rising and Falling Rate Environments



Source: see endnotes

Chart 8 – Total Returns and Valuations Since 1996



Source: see endnotes

our position at this point in time. It is still early days, but the market seems to have taken the first leg of tapering in stride.

Are We In A Bubble?

A number of clients have asked me if I think the stock market is in a bubble. While there seem to be pockets of bubbles forming, overall, I think the equity market is far from bubble territory. No market goes up forever, and we can be certain that this year's returns will not continue to repeat themselves ad infinitum. We can also be certain of a "technical" pullback at some point, but this does not indicate a bubble either.

Our various stock market models project a range of long-term expected equity returns. Currently, our point estimates for U.S. Equity returns using various models range between 6% and 9.7%. This is a fairly wide range, and the expected returns have come down from a few years ago, but there is no other asset class that we know of with better long-term prospects than equities, at this time.

Another point to consider when asking if we are in a bubble is the path the equity market has followed in recent history. We've shown this chart before, but I think it bears repeating. Chart 8 compares S&P 500 levels with valuations at recent peaks and troughs. We are at a new high, but valuations are lower than they were at the last two peaks. A large component of the multi-year rally is a process of shaking off tremendously bad performance over more than ten years. So being at all time highs might feel toppy, but consider the depths that we've left in our recent past as well as current valuations, as you form your own opinion.

Our Portfolios

At a very high level, we remain overweight equities versus bonds. At a more granular level, we remain overweight U.S. Large Cap Equities, U.S. Small Cap Value, U.S. Technology, Value (versus Growth), Emerging Market Equities, Floating Rate Bonds, Municipal Bonds, Corporate Bonds and Short Duration Bonds. We maintain holdings in, but are underweight Real Estate Investment Trusts, Inflation Linked Bonds, Longer-Term Treasuries and High Yield Bonds. After very strong performance, we are considering when to scale back a number of our overweight positions.

Investment Planning

Your goals have a critical impact on your investment decisions. Whether you are an individual preparing for retirement or a trustee on the board of an endowment, your goals will lead you to invest in a specific way.

The foundation of every one of our client's investment strategy is their Stembrook Strategic Investment Plan. This plan takes into consideration your current portfolio, your expected saving and spending and various scenarios for market returns. Please contact me if something has changed significantly with your unique state of affairs so that we may adjust your plan accordingly.

The economy has been jump started and has the potential to begin firing on all cylinders. We will continue to search for investment opportunities and risks in light of economic and political events, in an effort to keep our clients' portfolios stable and growing. As always, I welcome your comments and questions and appreciate your continued confidence in our investment management and advice.

Sincerely,

Peter D. D'Agati, CFA
President
Stembrook Asset Management, LLC
83 Wayne Street, Suite 208
Jersey City, NJ 07302
Tel: 201-484-0063
Fax: 201-484-0070
peter.dagati@stembrook.com

Endnotes and Sources

Chart 1: Consumer Price Index – US, U.S. 30-Day Treasury Bills, Citigroup Inflation-Linked Index, Barclays Capital Munis 5-Yr Index, Barclays Capital Aggregate Bond Index, Merrill Lynch U.S. High Yield Cash Pay, Dow Jones Wilshire REIT Index, S&P 500 Composite Total Return, S&P SmallCap 600 Total Return, MSCI EAFE Index, MSCI EM (Emerging Markets) Index, Dow Jones UBS Commodity (Total Return) Index.

Chart 2: "October 2013 State Coincident Indexes" Federal Reserve Bank of Philadelphia

Chart 3: Eurostat, BLS, Japanese Statistics Bureau Stembrook Research

Chart 4: Quantitative Easing in Japan - Quantitative Easing: Entrance and Exit Strategies—Alan S. Blinder— Federal Reserve Bank of St. Louis Review, November/December2010,92(6),pp.465-79.

Chart 5: Federal Reserve Bank of Cleveland, Stembrook Research

Chart 6: 10 Year Treasury Returns: Global Financial Data 1800-1925, Ibbotson Associates 1926 - 2006, Thomson Reuters 2007 - 2012, Stembrook Research. Ten Year Treasury Yield: Federal Reserve

Chart 7: S&P 500 Total Returns: Global Financial Data 1800-1925, Ibbotson Associates 1926 - 2006, Thomson Reuters 2007 - 2012, Stembrook Research. Ten Year Treasury Yield: Federal Reserve

Chart 8: Returns shown are cumulative and include both principle and income. JP Morgan Asset Management, S&P 500 Prices and fundamentals — Standard & Poor's, Stembrook Research

Notes:

(1) The taxability of municipal bond interest depends on a number of factors including, but not limited to, the investors state of residence, the state and municipality issue the bond. Please consult with your Stembrook investment manager or your tax advisor for further information regarding specific bond purchases.