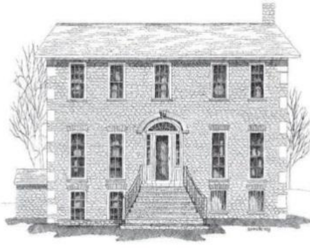

ON THE HORIZON...
NEWS, NOTES, AND COMMENTARY
FOR CLIENTS AND FRIENDS OF THE HORIZON GROUP

BY MARK CONGDON, SENIOR PARTNER

INTEREST RATE JITTERS

JUNE 13, 2013

In case you haven't noticed, since the beginning of May we've experienced some significant volatility in the financial markets. Bond funds experienced declines as interest rates spiked unexpectedly on talk of the Federal Reserve tapering its purchases of treasury bonds. Foreign bonds – particularly those in emerging markets – suffered losses due to currency fluctuations. Japan's stock market has swung up and down as much as 5% daily and caused a couple of big selloffs in our markets this week. I've received a number of calls and e-mails from clients truly rattled by recent developments – especially after seeing supposedly "safer" investments fare poorly (bucket #1). Several have mentioned that their stock funds seem safer and more stable than their bond funds.

At first blush, I was taken aback at the depth of concern over drops in bond funds that were typically about 2%, especially since the 10 year treasury had spiked from 1.66% to about 2.25% in a matter of weeks. But after talking with so many people convinced and *certain* this was just the beginning of skyrocketing rates about to cause a disaster for anyone who owned bonds, I realized there was a serious issue with misinformation being dispensed by much of the media. After a weekend of poring over the financial press, I felt it was time to set the record straight – especially in regard to the reporting and interpretation of recent Federal Reserve comments.

The average person has seen countless articles about "bond bubbles" and is reading that "bond investors are certain to face further losses" in papers and on the internet. I actually saw a commentator on CNBC say "only stupid people own bonds," and yet another predicted the "total collapse" of the stock market when the Fed stops this round of quantitative easing, which will "surely start soon". With all of this wisdom being dispensed by cocksure experts, how could the average client be anything but nervous?

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Before I set the record straight, I have to throw in my two cents about the financial coverage I've witnessed the past few weeks. Commentators are just what the title implies. Not one of the so-called *experts* actually takes the responsibility for managing your money or helping with important financial decisions. And they're free to make outrageous claims and irresponsible statements. Those of us who actually take responsibility for money management are bound by standards of conduct, regulators, and sometimes fiduciary duty to a higher level of care when communicating with the public. For example, this newsletter had to be reviewed by Cadaret Grant's compliance department before being sent – unlike the outrageous generalizations made on TV. The arrogance, incompetence, and self-dealing of the financial press, not to mention the ability to cause you financial harm, can only be matched by the politicians in Washington. In many regards CNBC has turned into the Weather Channel, turning flurries into blizzards for ratings and revenue.

I'd like to take this opportunity to explain in-depth what has been happening, the possible impact on your investments, and my view of the current investment landscape. We were brought to our current situation by the collapse of the housing market in 2007 and the near collapse of our financial system in 2008. The bankruptcy of Lehman Brothers was the watershed moment of the financial crisis. At that point the Federal Reserve embarked on its prolonged program of "quantitative easing" - which means nothing more than flooding the financial system with excess money. At first the Fed lowered interest rates to almost 0%, repurchased toxic mortgages and loans from struggling banks, and even printed money. Most recently, the Fed has committed to purchase $85 billion of treasury bonds each month to keep interest rates artificially low for the foreseeable future. I talked about this "financial repression" at length during the last two financial fairs. The hope is this flood of cash would stimulate a recovery in the housing market, trigger a rally in financial markets worldwide, and ignite growth in our general economy.

This is because when the stock and real estate markets collapsed in the financial crisis, people had far less money to spend. Sales and profits fell at most companies. Spending cuts and layoffs drove the unemployment rate higher, foreclosures boomed as home prices fell, and scared people simply stopped spending. The shrinking economy was caught in a vicious cycle. If Ben Bernanke and the Fed could halt the slide and start to restore the wealth that had been decimated, people would feel better and spend freely once again. After the economy was growing steadily and creating jobs on its own, the Fed could step back from quantitative easing and remove the cash it's been injecting into the system daily for the past five years. In effect, the Fed would declare the patient healed and release the economy to act on its own without Fed intervention.

So where are we today? We find ourselves with an economy that still needs to be medicated with low rates and an IV of $85 billion monthly to help maintain confidence and sustain even a moderate level of growth. The patient certainly isn't ready to be released into his own care – recent tests show activity slowing and unemployment rising. My interpretation is that the volatility we've seen in both the stock and bond markets the past few weeks are symptoms of two distinct worries from each side of the equation. On one side, bond investors are worried the

Fed will stop the medication before the patient is fully healed. This would happen by tapering or stopping the monthly bond purchases, not to mention the rise in rates such an action may bring. The stock market is acting up because by all measures the economy is not ready to stand on its own two feet. This is evidenced by anemic first quarter GDP growth – even with QE3 - and an unemployment rate of 7.6%. My belief is this debate will rage over the coming months, with interest rates and the stock market waxing and waning for the summer. That's my guess, as well as my hope. A correction could certainly make the market much healthier in the long run.

As for interest rates, it would take a real acceleration of hiring, confidence, spending, and inflation to push rates much higher. Although Uncle Ben and the Fed have deftly orchestrated a recovery and restored much of the lost wealth, the "wealth effect" is not working as hoped. People are feeling better about their investments, 401k's, and real estate, but they're certainly not pumping up the economy with unfettered spending. I help and sit with about three hundred families – many are millionaire households. There are no Gatsby style parties being thrown. Without exception, purchases are still made carefully and are not frivolous. Extra money is often used to help kids and struggling family members with necessities. It doesn't have the feel of an overheating economy or irrational exuberance – not many people are spending like its 1999, or even 2006. Evidence suggests fear of skyrocketing rates is overblown at this level of activity.

I'm not minimizing the pain that bond investors felt in May. There are five distinct risks bond investors face - interest rate risk, currency risk, volatility risk, credit risk, and inflation risk - and all but inflation are hitting bonds hard. Even bond powerhouses like PIMCO and Thornburg can't hide from the storm. A surging dollar is also hurting foreign bonds. But bonds play an important part in a diversified portfolio. Furthermore, it may be a big mistake to project the performance of the past six weeks continuing on the same trajectory into year end.

We're in uncharted waters when it comes to the extent of market manipulation being undertaken by the Federal Reserve. Frankly I'm surprised that the volatility (price swings) caused by the tug-of-war between interest rates and stock prices didn't happen sooner. I'm all but certain it will continue and intensify in the coming months. Your best bet is to turn off the talking heads and focus on the long run with the benefit of common sense and perspective. As for interest rates, Prudential has staked the future of the insurance giant on a 10-year treasury **paying 3.0% in April 2023** - some ten years from now! That's the exact same projection as bond manager PIMCO, who's listed Alan Greenspan as a paid interest rate consultant since May 2007. That's far from an Armageddon scenario for investors holding bonds or bond funds.

As for stocks, everything I laid out in this year's Fair talk, "The Future is Brighter Than You Think," still stands. It was extremely gratifying to pick up the May 20th USA Today and see confirmation of many of the positive points I've made plastered across the front page headlines. But it's always easier to see long-term trends than experience the short-term volatility it takes to get there. With that said, here's hoping the roughest ride we all take this summer is in a boat!

Mark

ODDS & ENDS

Sincere Thanks ….. To everyone who took the time to complete and return our fairly extensive client survey we sent in April. The information you provided was invaluable and will certainly help The Horizon Group become even better at meeting your needs and expectations. Our consultant was "blown away" by the 71% response rate (virtually unheard of) and the quality of - and thought put into - the various comments made. Since so many of you requested to see the results, I've enclosed a summary of the responses received.

As a family, for your family….. One regret I have in regard to the success of my practice is the lack of time to spend when a child, grandchild, or friend of a client needs my advice or counsel. Often it's a question about benefit enrollment, 401k choices, or an important financial decision. The heart of the matter is that working with a sharp planner early and often can be the difference between surviving or thriving later in life – but it's an experience that's out of reach for most younger people, who often lack the resources to engage a top notch professional. That's no longer the case at The Horizon Group. As an added benefit to my clients, I've hired Ken Blazick as a full-time salaried advisor within my office to help deliver quality advice to those you love.

Since joining me in 2011, I've seen Ken handle and excel in a number of challenging situations. Giving financial advice to adult children just got much easier for all my clients – simply refer them to Ken! He'll be hosting a number of family friendly events (kids & grandparents welcome, too) to facilitate a fun and stress free introduction. If someone important to you may be interested in receiving an invitation to these events, receiving newsletters, or scheduling a free appointment directly with Ken, please have them email kblazick@horizonadvisors.net or call 334-3600 and leave their contact information.

Congratulations Mike & Mike…. It's hard to believe it's been almost six months since Mike Silverstein opened the Silverstein Teams new office across the street from the cobblestone. In a relatively short time he and Judy Plain have built a thriving practice specializing in helping people with TIAA-CREF retirements. In fact, he's now on the honor roll as one of Cadaret Grant's top advisors…. After attending McQuaid Jesuit and earning a pair of Finance degrees from Lemoyne, my oldest son Mike worked at Cadaret Grant for three years. He left last year to pursue his MBA full time, and graduated 3 weeks ago with a 4.0 for the spring semester. Since he is now interviewing for positions - and many clients work for firms that pay employees for hiring referrals - his resume and LinkedIn address can be found at www.michaelcongdon.us.

Bonds Post Script …. Since completing the newsletter I've had several discussions with firms relative to their outlook for bonds. PIMCO has stated although they sold Treasuries in May, Bill Gross has been actively buying them back ever since rates surged above 2% on the ten-year. The firm believes that there could still be further declines in bond prices, but they offer value at these levels. Gross thinks the majority of the damage has been done and rates are stuck in a trading range of between 1.6% and about 2.5%. Eaton Vance reiterated that same view on a visit this afternoon. They believe the range is between 1.75% and 2.5% this year, and could creep up by another half a percent mid to late next year. Dan Fuss of bond giant Loomis Sayles sees rates ending this year at 2.6% to 2.8% and added, "if you're reinvesting, it's a wonderful thing". If the worst of those predictions comes to pass, we should weather the storm just fine.