July 2013

Market Commentary

The Great Migration

In East Africa each spring, millions of zebras, wildebeests and antelopes gather their young and set out from their home on Tanzania's Serengeti Plains. Seeking food and water, they head west and then north to the Masai Mara National Reserve in Kenya. The 1,800-mile journey is fraught with danger, especially where they must cross the Grumeti River in Tanzania and the Mara River in Kenya. The young, sick and feeble are easy prey for crocodiles. Along the way, lions, leopards, hyenas and wild dogs also stalk the migrating herds. More than 250,000 animals won't reach their destination.

There are some parallels between what goes on in East Africa every spring and what went on in the markets during the last quarter. Another kind of great migration is now underway: the retreat from bonds and into both risk assets (such as equities) and riskless assets (such as cash). For investors, this is a new environment that offers ripe opportunities along with a need to be mindful of the perils.

The U.S. Federal Reserve was the primary cause of the June stampede. The central bank suggested it might consider scaling back its bond-buying program because the recovery has been gaining traction. Back in 2008, the Fed introduced quantitative easing to prop up the U.S. economy in the wake of the financial crisis. Under the third round of quantitative easing, or QE3, the Fed has been scooping up $85 billion (U.S.) of bonds and mortgage debt each month. This keeps their long-term yields low. The increased money supply provides banks with capital and encourages them to lend money. Fed chairman Ben Bernanke believes these steps will boost hiring and growth.

The transition out of this bond-buying strategy was never going to be easy, even though QE3 was always intended as a stop-gap to allow the economy to recover on its own. Speculators involved in the "carry trade" are also complicating the situation. These investors borrow mainly short-term money at low interest rates in order to buy bonds with longer maturities and higher coupons. The tapering signal from the Fed sent many investors scurrying to the sidelines and caused a sell-off in the capital markets. Borrowers scrambled to sell and cover their loans. Ten-year U.S. Treasury bonds started the quarter yielding 1.84% (U.S.) and finished 63 basis points higher at 2.47% (U.S.) – a substantial surge.

Chart 1: US 10 Year Treasury Yield

Source: Thomson Reuters Datastream

Markets were rattled and overreacted to the mere suggestion from the Fed that it would begin weaning the economy off easy money. The anxiety and the increased volatility don't fully line up with what's actually going on in the broader economy.

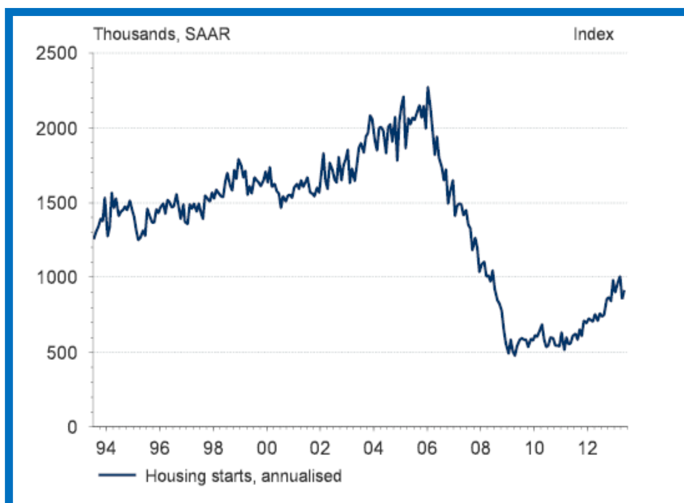
Signs in the U.S. Point to Good News

The Fed's announcement that it might taper off (not exit) its bond-buying program was based on good-news signs: the U.S. economy appears to be growing healthier, although it's slow-motion progress.

Let's study the data a little more closely. Job numbers are improving, but they are nowhere near the Fed's unemployment target of 6.5%. Inflation is running at 1.1%, well below the range of 2.0% to 2.5% that the Fed would need to see before it raises interest rates. Although the beginning of the end of monetary easing may be in sight, the economy is still too wobbly to stand on its own two feet. That also means interest rates will likely remain at rock-bottom lows for the time being.

There's more good news. At the state, local and federal levels, fiscal drag (excessive taxation or lack of spending) appears to be peaking. Fiscal drag puts a damper on the economy since increased taxation or reduced government spending slows the demand for goods and services. In the private sector, momentum is building. The housing market is steadily improving; that upturn will help consumers continue to pay down their debts and boost their confidence levels, and will ultimately encourage consumption. Business spending is set to accelerate: corporate balance sheets are flush with cash, which will enable them to upgrade aging structures, equipment and software that impede productivity. Light vehicle sales have also been strong. Barring weaker global growth, U.S. equities seem poised to advance.

Chart 2: U.S. Housing Starts: Bottoming and Turning



Source: Thomson Reuters Datastream/Fathom Consulting

China's Debt Problem

China is facing a mounting debt problem whose root is structural. Provincial and local debt is accelerating quickly. Local government debt is used to finance investment, including housing, that accounts for almost half of GDP. Right now, debt growth exceeds revenue growth by a wide margin; eventually that growth in debt must be reined in. Local governments are not permitted to borrow. Instead, they raise debt through corporate entities financed by "shadow banks." That debt is an asset for the wealth-management industry that profits from packaging these debts into investments. Capped deposit rates and capital controls make the purchase of these debts very attractive to investors. The central bank has no direct control over shadow financing; however, if it tightens monetary policy hard enough to slow economic growth, it will eventually cut off liquidity to the shadow banks. Monetary policy was tightened in 2010 for this very reason.

Policy makers in China are not deliberately setting out to slow economic growth, but that may be the unintended outcome. The need to tame credit growth somewhat increases the risk of a policy error. This explains their recent hesitancy to loosen credit. Reason prevailed and the central bank took steps to alleviate the cash crunch and stabilize short-term rates. It's likely, however, that we will see revisions downward to GDP growth estimates.

Europe's Economy Starts to Stabilize

Despite a continued slow recovery, Europe delivered some good news during the second quarter of the year. European Union leaders have agreed to create a much-needed banking union to help restore stability and move beyond the eurozone's three-year debt crisis. The banking union will provide tighter oversight and a mechanism to resolve problems, most notably, how to deal with future bank failures. For taxpayers, the upside is clear: the amount of public funds available to bail out banks will be limited. The European Commission, an EU institution, is in charge of plans for a central resolution body called the Single Resolution Mechanism. Don't expect much to happen, though, until we're past the German election in September.

While austerity programs and persistent high unemployment are still frustrating recovery, policy makers are moving ahead to stabilize the financial system.

C$ Drops with Commodity Prices

Bond interest yields in Canada have increased almost in lock step with those of U.S. bonds. Commodity prices have weakened further over the last few weeks. This hammered the Canadian dollar, which ended the quarter at $0.9508 per U.S. dollar. That's a drop of 1.4% in the month of June alone. Commodities will likely remain soft as long as the Chinese economy shows weakness. Not surprisingly, gold has fallen as well, ending the quarter at $1223.70 (U.S.), off 12.2% over the last month.

Our Strategy

BHIMI has been very deliberate in positioning client assets defensively over the last few quarters. We concluded that the fixed income side of portfolios represented the greater risk. We completely exited the long end of the market a number of months ago, based on our firm belief that this is not a risk habitat suitable for

private clients. We've also shortened the average maturities of our bond portfolios in recent weeks, knowing that eventually the monetary stimulus will stop. Many fixed-income asset classes are somewhat oversold; now BHIMI will selectively seek out those buying opportunities.

The Last Word

When wildebeests want to ford rivers and streams, they adopt a simple strategy: charge ahead as quickly as possible and try to outrun your colleagues – not unlike the approach of some leveraged bond traders. BHIMI's strategy for transition is a bit more sophisticated than that … and a lot less perilous. We've maintained a defensive posture in relation to interest rates, which makes the migration much safer. We've shortened the portfolio's average maturity and ensure that there's good cash flow from higher coupons to reinvest as rates ratchet up. We understand markets need time to adjust to the notion that monetary stimulus will come to an end at some point. Historically, super-low bond and mortgage rates are not the norm. Over the coming quarters, rates will "normalize."

Despite the pause in financial markets, an optimistic view is justified. Capitalism has a wonderful built-in mechanism that enables it to recover and adjust. One such positive outcome that's starting to gel is the partnering of policy makers and business. That's worthy of further discussion in future commentaries.

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