Investing In Bonds Using A "Bond Ladder"

Posted on March 1, 2016

Does buying bonds make sense when record-low interest rates start going up?

By Nick Stonnington

The long-protracted wait for the Federal Reserve to raise interest rates for the first time in nearly a decade is over. In December, the Fed did just that, and in doing so created, for those in the bond market, a proverbial double-edged sword: On the one hand, bonds acquired today may provide a higher rate of return than those purchased pre-December 2015. However, when interest rates go up, those bonds you already own will likely drop in value.

Given this Catch-22, you may question whether you should even stay in bonds. But there is a way to solve this conundrum: Create a "bond ladder."

To build a bond ladder portfolio, rather than purchase one large-sum bond with a single maturity date, buy multiple smaller-sum bonds, making certain each one has a different maturity date. Then space out those maturity dates, for example, over several years. As a result, you will minimize the risk posed by rising interest rates while at the same time taking advantage of them. Each bond in the ladder will mature at a different date, with the proceeds being reinvested at periodic intervals instead of all at once, as is the case with one large bond with a single maturity date. This makes a bond ladder particularly effective in today's low/rising interest rate environment.

Think of each bond with its maturity date as a "rung" on the ladder. When each bond becomes the "top" rung, by maturing, the investor can reinvest the proceeds from the sale of that bond and buy the bond again at a new higher interest rate. Meaning that investors will not only get their money back from the matured bond, but can position the new bond at the "bottom" of the ladder and lock in the new higher-interest rate.

Let's say an investor purchases a single, large-sum $1,000,000 bond set to mature in five years, with 2.5 percent per-year interest. For five years, this person will be unable to access any of the $1,000,000 and, should interest rates increase, will get stuck earning the lower rate until the bond matures. Now, let's say this investor instead takes the same $1,000,000 and creates a bond ladder by buying 10 bonds at $100,000 apiece, with one bond maturing each year and a maximum maturity of 10 years.

Just 12 months into this strategy, the top one-year "rung" on the bond ladder will mature. The investor can then take the proceeds and buy a new rung (a 10-year bond) on the ladder. Meanwhile, the ladder's original 10-year bond, purchased a year prior, will now be nine years away from maturity; the original nine-year bond will be eight years from maturity, etc. One can basically continue this strategy indefinitely.

Another reason bond ladders make sense is that the yield curve of bonds tends to be positively sloped, meaning that shorter-term bonds generally pay lower interest rates than longer-term bonds. As the ladder cycles through its rungs over time, the

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ladder's yield tends to go up as it becomes populated with bonds paying the higher interest rates of the longest-term bonds in the ladder.

A mature bond ladder is made up entirely of the longest-term bonds in its ladder, so the yield of a mature bond ladder tends to be significantly higher than the yield of a new bond ladder, because it is populated with bonds paying the higher interest rates at the longer end of the yield curve.

In short, for the patient, long-term investor, buying bonds nearly always makes sense. The trick is to take advantage of interest rates, using the bond ladder strategy.

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The Impact of "Sequence of Returns"

Posted on December 11, 2015

How does the sequence of returns impact the sustainability of my retirement portfolio over time?

By Nick Stonnington

The entire time you work and save for your retirement, say, 30 years, there will be multiple bull markets, multiple recessions and perhaps a dramatic bubble or two. If your retirement lasts a couple of decades, there will be both bull and bear markets, which will create ups and downs in your investment portfolio.

While saving for your retirement, if you stay the course on a growth portfolio and contribute consistently, you'll end up buying more in an asset when it is cheaper, and less when it is more expensive, which is exactly what you should be doing.

Most retirees, after leaving the workforce, basically contribute little to their investments. Instead, they rely on an existing portfolio to deliver the income they need to live a lifestyle they expect to enjoy. Meaning, they plan for a consistent rate of withdrawals. But, once withdrawals begin and steady contributions end, the portfolio is more vulnerable to market fluctuations, possibly depleting it earlier than intended.

The conventional wisdom is that increased risk during the accumulation phase can help your returns, while decreased risk during the distribution phase can preserve your capital. These investment strategies can impact how much your portfolio

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Consider those retirees who targeted 2008 as their retirement start date. Let's say those 2008 retirees were figuring on a standard 6 percent withdrawal on a $1 million portfolio, for an annual income of $60,000. Practically overnight, the value of their portfolios likely dropped dramatically due to the great recession. By the beginning of 2009, with a diminished portfolio value of say, $750,000, their 6 percent annual income will have dwindled to $45,000. And if they held to their $60,000 withdrawal, they could have further diminished their portfolio to a point where it might never return to its original value.

But what about people who retired with that same $1 million portfolio in 2010 when the market was already vigorously rebounding? Their portfolio will have likely experienced five consecutive years of positive returns. Those portfolios are probably better positioned to withstand both the inevitable bear markets of the future and the systematic withdrawals taken to sustain a retiree's lifestyle over a longer period of time.

Of course, the retirees of 2008, just like most people, never saw the great recession coming. And those who retired in 2010, if they were honest, never figured that a market so beaten down would eventually reach new record highs. So, with such unpredictability, is there a way to avoid the pitfalls of an ill-timed retirement?

While no one can predict the future, there are a few things you can do to shield your retirement portfolio, at least somewhat, from those down times. For example, taking on extra risk, or volatility, during the accumulation phase can improve returns. As you approach the distribution phase, reduce volatility by diversifying your retirement portfolio within multiple assets classes such as cash, fixed income and stocks. To avoid selling stocks when they are down, structure your cash flow to come from the cash allocation while harvesting additional cash from stock dividends, bond interest, maturing bonds and rebalancing.

Finally, make sure your financial advisor has the depth of knowledge and experience to manage your retirement plan. This means an advisor who understands that to some extent, timing is everything when it comes to your retirement portfolio's sequence of returns.

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To Time or Not to Time…The Market – That is The Question

Posted on October 20, 2015

The old saying, "Timing is everything," certainly has applicability to market investing. For equities, "perfect timing" means going to cash right before a market downturn, holding the cash until the downturn hits bottom, then buying up all those cheap stocks right before the market heads back up. As the stocks regain their value, they might eventually double, triple, even quadruple the worth of the original portfolio. **But here is the caveat:**

Anyone who tells you that they can actually "time the market" this way may also want to give you "the inside scoop" on a bridge for sale in Brooklyn.

That is not to say one should ignore timing investments altogether. There are algorithms and other "mechanical" means to create a "timed" investment method. However, this method relies on data trends that indicate pending market drops or upticks that are apparently triggered when you take money out or put it in. Rigid discipline is required not to let your "gut instincts" override the system. In my experience this form of "timing" works maybe half the time, or less.

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Of course, being human, many investors cannot help being drawn to the seeming prescience of those famous advisors who magically seem to "know" when to buy and when to sell and, as a result, make millions. Less famous advisors will point to a time when they pulled out or jumped into the market at exactly the right moment and saved or made clients fortunes. If they offer this boast, you might ask if they ever repeated their good fortune. **Without disparaging those with good gut instincts, we feel there are two investment considerations at least as important as timing:**

1. What you buy
2. Strategies that rely less on timing the market than successfully weathering market volatility

In a recent TED talk, early-stage venture capital investor Bill Gross presented research he had done on start-up companies, something he knows more than a little bit about. He found there were five factors that determined a new company's survival: the idea, the founders/management team, the business plan, funding and timing. Now, Gross did find that timing was the number-one factor in start-up survival and success by far, even though the other factors were important, too.

Here is the point: When you invest in a stock, you invest in a company. Using these five criteria to evaluate a company can help you determine if it is a good investment. That includes timing. An idea ahead of its time, or behind it, is not a good choice. But a solid idea, well-timed and appropriately funded, with a realistic business plan and strong management should be a good investment. The key: Do the homework before you make the buy. but also have a strategy to handle the risk of timing.

In terms of an investment "method," again, I think it is less about timing the market and more about strategies that are timeless. **Here are three:**

1. Diversification of your portfolio—investing in lots of "ideas" and asset classes—increases your odds of having the right investment at the right time.
2. Dollar-cost averaging—meaning you consistently and frequently make same-size multiple investments, the way your 401K does. You do have losses, but usually profit during bull markets.
3. Buy and hold—which still works, as any investor who did not panic and sell off in 2008 can attest. Most of their stocks are worth more than ever.

In sum, the allure of market gurus, famous and not so, who claim the power to time the markets will continue to draw investors to the flame of "hitting it big." The problem is that for investors, like the moth, things can often turn out badly.

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Watching the "Fed" – What's Next?

Posted on August 7, 2015

During the tech bubble recession, the Federal Reserve ("the Fed") reacted by lowering the Fed funds rate13 times in a row from January 2001 to June 2003. The Fed then raised the rate 17 times in a row from June 2004 to June 2006.

Then, 2007 brought the collapse of the housing market boom, setting off a drop in mortgages which contributed to the worldwide credit crisis and the Great Recession. This time, the Fed reacted by lowering rates 10 times from August 2007 to December 2008.

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For the last seven years, while interest rates have stayed near zero, an entire ecosystem has been built around low-cost credit, which could be disrupted should the Fed start raising rates again.

The Fed has been saying for some time now that it expects it will need to raise interest rates to maintain a stable equilibrium funds rate level. The equilibrium level is achieved by the Fed manipulating interest rates to reach its goal of full employment and stable inflation. Thus far, the Fed has held its equilibrium funds rate to what some believe to be a depressed level in order to jump-start the economy.

Now, with unemployment levels in the 5 percent range, the Fed is concerned that if unemployment continues to drop there could be a labor shortage, which could in turn push up wages—this is what some contend to be the biggest driver of inflation. But at this point, it is questionable whether wage growth is really a problem.

According to the Bureau of Labor Statistics, inflation-adjusted average hourly wages for non-management private-sector workers have been stuck in a range of around $20 an hour since 1964, whether the economy was expanding or not. The actual peak was in 1973, at $4.03 an hour, which equates to $22.41 today. Wage growth has been so constrained for so long that there is now a nationwide movement to raise minimum wages to a "living wage." But even if this movement is successful, whether or not it will drive inflation is questionable.

The Fed has been patient, as it likes to say, but may lose its patience if it becomes clear that we are not simply stuck in what economists are calling "secular stagnation." This would mean that instead of just going through a cyclical period of slow growth and low inflation, we could be in a longer-term transformation into a slow-growth or a steady-state economy.

On the other hand, some economists theorize that the economy is strong, that it is simply being buffeted by temporary headwinds such as the protracted deleveraging of banks and consumer debt. Meaning it is possible that the weak gross domestic product figures could belie an underlying growth that we are experiencing anecdotally.

Finally, reacting to radical shifts in the economy, between January 2001 and December 2008, the Fed raised or lowered the Fed Funds rate 40 times. **Since 2008, it seems to have adopted its usual wait-and-see attitude, poised to act should wages or inflation go up.** And, again, history seems to prove it will, in fact, act.

But wages and inflation are lagging indicators. That is, they reflect not what will or can happen but what has already happened to the economy. So, by once again reacting to lagging indicators more than leading indicators, the Fed continues to maintain its role as a force to get us out of trouble, not to avoid it.

Posted in Economic Policy, Monetary Policy | Tagged Bureau of Labor Statistics, Federal Reserve, minimum wage, Worth | Leave a comment

Is "Buy and Hold" still an effective investment strategy?

Posted on June 4, 2015

Not to oversimplify, but today's investors seem to break into two camps that bring to mind that age-old tale of the tortoise and the hare. "Buy and hold" is the tortoise and "active investing" is the hare.

While active investing has gained in popularity, it is important to remember who won that famous race. Buy and hold investing has made and continues to make a lot of people a lot of money, entire fortunes in fact. But to a certain degree

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Successful active investing, as its name implies, requires a lot of "activity" from you and/or your manager(s). Holdings and potential buys receive constant attention and portfolios can get fine-tuned and rebalanced, literally on a daily basis. The idea is to keep a radar-like focus on the market so you take advantage of every opportunity for value increases, particularly when they are short term.

Active portfolios have the benefit of scale whereas buy and hold is typically customized for each investor's portfolio. Done right, active investing can make investors a lot of money, but it has disadvantages, the most obvious being the need to be smarter than the market by knowing when to buy and when to sell, not to mention potential costs of doing the trades and their tax consequences.

In contrast, buy and hold bets not on the short-term success of a stock, but its ability to grow steadily while weathering inevitable market downturns, and in the long-term, to deliver exceptional performance. It is a company with a seemingly bright and long sales future and a management team with the skills and intent to take advantage of innovations that will grow the company.

Too often buy and hold is portrayed as the opposite of active investing; a static, even stodgy low-growth way to invest. But that simply is not the case for a carefully constructed buy and hold portfolio, where it is not uncommon for some stocks to increase as much as 1,000 percent over the long term.

One misstep buy and hold investors sometimes make is to ignore whole new categories of investment that come along. If you review mature buy and hold portfolios, you can spot different "vintages" among them. 1970s portfolios may be full of natural resources stocks, while 1980s portfolios focused on consumer staples stocks. 1990s and 2000s portfolios may be loaded with healthcare and tech stocks.

The best way to avoid having a "vintage" portfolio is to continually add buy and hold stocks over time in burgeoning industries poised to flourish. However, a buy and hold portfolio is still organic. Which is a polite way of saying, stuff happens. Companies can be acquired, or go out of business. In addition, you and your managers need to monitor your investments to cull out underperformers to make sure your patience pays off in the end.

Finally, if a less frenetic investing approach suits your style, a key advantage of buy and hold is tax efficiency. This is so because generally capital gains in a taxable account can be deferred–or avoided entirely by gifting of securities with long term capital gains to a charity, subject to certain limitations, or by a cost basis step up upon the death of the owner.

But, stuff does happen, so perhaps a better way to describe the "tortoise" style of investing is buying *with an intention* to hold—but also a determination to win.

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"Bazooka Style" Economic Interventions – How Should I invest in the U.S. and Abroad ?

Posted on April 15, 2015

First, some background:

Toward the end of 2008, to further stimulate the U.S. economy after the discount rate was lowered to near 0 percent, the

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Chairman Ben Bernanke referred to this massive intervention as an economic "bazooka." By the time the program ended in October 2014, the Fed had bought $4.5 trillion in bonds and a bull market in stocks ensued.

And not just the U.S., but major economies around the world are also in the midst of their own dramatic central bank policy shifts.

For example, as China braces for a slowdown after decades of heady growth, the People's Bank of China is weighing its options. The yuan has been the strongest major currency in the world since 2000. If China is unable to soften its transition to lower growth by measures such as managing its banks' lending, a devaluation of the yuan could be the way China stimulates its export economy.

The European Central Bank (ECB) president, Mario Draghi, promised to "do what it takes" to stimulate growth in Europe. So, beginning in March 2015, the ECB began its own massive trillion euro QE, continuing until at least September 2016.

And in Japan, "Abenomics," a reference to Prime Minister Shinzō Abe's extraordinary intervention policies, is still attempting to invigorate the economy.

While bazooka-style monetary policy interventions are all the rage to get economies on track, fiscal and structural reforms that could help reignite an economy have proven more vexing to implement. Why? **Because while monetary policy is typically run by somewhat independent central banks, fiscal and structural management is run by governments whose political sensitivity can stymie progress.**

For example, the U.S. needs infrastructure rebuilding, immigration reform, management of its national debt, election reform, tax reform and fiscal discipline on Medicare, Social Security and defense spending, but a politically contentious government seems incapable of progressing on any of those fronts.

As to the future, questions loom worldwide that could affect investor strategies. For example, in the U.S., will the Fed raise its discount rate or start reducing its balance sheet, and if so, will that result in U.S. stocks and bonds dropping due to higher interest rates? Will the Eurozone be the next place for a bull market in stocks as its economy responds to its interventions? Will China devalue the yuan to stimulate its economy? Can Japan get it right?

In light of all of these interventions and potential interventions, the real question is: **What should investors do now?**

They might be wise to reduce investment exposure to economies where central banks are slowing down, while at the same time putting some of their money in weakened economies as central banks launch bazooka-style interventions. But before they do, investors must also question to what extent those interventions have already been priced into the markets and, for that matter, whether they will be successful. And returning to policy versus politics, perhaps the ultimate question is:

Can economies such as that in the U.S. which have achieved liftoff continue to reward investors without fixing the problems that got them into trouble in the first place? As the saying goes, only time will tell.

Posted in Monetary Policy | Tagged China, deflation, Economic growth, Economic Interventions, European Central Bank, eurozone, Global Economy, inflation, investments, Japan, Shinzo Abe | Leave a comment

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Posted on February 3, 2015

“American exceptionalism” is the idea that the U.S. is qualitatively different than other nations. Scottish historian Richard Rose put it this way: “America marches to a different drummer. Its uniqueness is explained by any or all of a variety of reasons: history, size, geography, political institutions, and culture.” [1]

The person most often credited with the concept is no less a historical figure than the French writer Alexis de Tocqueville. In *Democracy in America* (1835-1840), de Tocqueville described this new nation called the “United States of America” and concluded: “The position of the Americans is quite exceptional.”

Over the years, the phrase fell in and out of favor, being revived during the 1980s in tandem with Ronald Reagan’s campaign to restore America’s reputation as a nation dedicated to doing good domestically and globally. For some, including contemporary politicians, the phrase may connote a more right leaning political view, but in truth “American exceptionalism” describes our nation and its citizens, not any faction within it.

As the writer Peggy Noonan put it: “America is not exceptional because it has attempted to be a force for good in the world, it attempts to be a force for good because it is exceptional.”[2]

In the 20th century, American exceptionalism was exemplified by America leading the world militarily, imparting its democratic ideals, and by its leadership in the world economically. This century, the economic dominance of America was no longer a foregone conclusion with the rise of the emerging markets, in particular China, and with the formation of the European Union. The rate of growth of global economies looked to be putting the American economy into a significantly less dominant role.

However, with global aggregate supply exceeding global aggregate demand, the theme of global economic growth has now shifted to deflation. Many of the first-world’s economies are mature and not expanding on pace. Europe has been skirting recession for six years. Japan has been mired in deflation for 20 years. Developing markets’ rate of growth is dropping across the board.

The good news is that the United States seems to have a global lead in adjusting to the current environment, despite its own issues. **With less than 15 percent of its GDP dependent on exports[3], the American economy can grow even if global economies don’t.** At the macro level, deflation leads to lower prices and the risk of economic contraction. At the micro level, companies that are not in commoditized markets can benefit from cheap materials, cheap labor, cheap money and improved productivity as a result of technological advancements. Add to that the insatiable American consumer, a self-sustaining American marketplace, and American exceptionalism, the result has been an American stock bull run for six years, which is about as long as it has ever had one, outperforming most world markets.

So, while much has changed over the nearly two centuries since de Tocqueville visited the United States, his description of Americans as “quite exceptional” has not. **Meaning that, yes, “American exceptionalism” and the economic resilience that it fosters is good for American investors and their businesses.**

[1] Political Science Quarterly, (Spring, 1989) Richard Rose, “How Exceptional is the American Political Economy?”

[2] Wall Street Journal Opinion Online, Sept. 20, 2013, Peggy Noonan, “Noonan: Vladimir Putin Takes Exception”

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Are We There Yet?

Posted on September 17, 2013

The Great Rotation

Investors have been liquidating bonds and rotating into stocks as they anticipate an improving economy and higher interest rates. The secular bond rally which began over 30 years ago has likely ended. The money flow into bonds has reversed this year for the first time since the credit crisis began. 10-year Treasury rates have gone up from a May 2 low of 1.6% to a current yield of 2.9%.[i] The NASDAQ return for this century with dividends reinvested is almost zero, specifically, -0.37%, but it is up over 25% year-to-date. [ii] Despite an annual return with dividends reinvested of only 2.7 % this century, the S&P 500 with dividends reinvested is up over 21% year-to-date and now is up 20% with dividends reinvested since its pre-credit crisis high in 2007.[iii]

As the World Turns

Other recent directional changes suggest a nascent yet vulnerable global recovery is underway. The JPMorgan Global Manufacturing & Services Purchasing Manager's Index showed a slowdown in global markets beginning in 2010 before a convincing uptick last month.[iv] Overall the Eurozone experienced a tiny 0.3% growth in the 2nd quarter; which technically is enough to qualify as the end of its painfully persistent recession. The German stock market, the DAX, yesterday reached an all-time high.[v] The expected result of the upcoming German federal election on September 22 is that Angela Merkel will be re-elected for a third term. If re-elected, it's likely her coalition, keeping in place the critical German financial backing of the Eurozone, will continue. Emerging stock markets and commodities had been essentially flat since 2010 as global demand slowed and supplies increased. EEM, an exchange traded fund ("ETF") which represents an index of emerging stock markets, is down 5% year-to-date but that includes a 9% rally so far this month.[vi]

Driving Forward but Looking Backward

An example of a leading indicator is the stock market, which tends to go up as improved earnings growth is anticipated. Another leading indicator, the Institute of Supply Management Manufacturers Purchasing Managers Index, has finally shown an impressive uptick of purchasing managers placing new orders, which anticipates increased manufacturing to fill the orders. Rather than focusing on indicators that are suggesting the economy will continue to grow, the Fed is focusing its attention on two indicators that report what the economy has already done: the unemployment rate and the rate of inflation. A stubbornly low inflation rate has made the Fed fretful that the economy remains vulnerable to deflation. When and if the Fed decides to "taper"– which in this case means to gradually reduce programs that lower interest rates and inject capital into the economy– may have more to do with the Fed looking backward than looking forward.

Removing the Training Wheels

In May, the Fed Chair, Ben Bernanke, indicated that as the rate of unemployment approaches the Fed target of 6.5% — now only 0.8% away — he would begin to taper. Stock markets reacted negatively to his comments — which became known as

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Federal Open Market Committee meeting. The Fed is expected to reduce its Quantitative Easing program of buying $85 billion a month in treasuries and mortgages by only $10 billion, all in treasuries. Anything more will be showing greater confidence in the economy than the markets expect and might cause a negative reaction. The question is will the Fed be swayed more by the low inflation rate than the declining unemployment.

The Markets are Yellin'

Bernanke is retiring when his second term ends on January 31, 2014. JPMorgan reports that former Treasury Secretary, Timothy Geithner, is leading the search for a replacement; the nomination might happen as early as the days following Bernanke's scheduled speech this Wednesday. Despite Geithner's public comment to the contrary, speculation persists from industry watchers that he could also be a potential replacement upon Bernanke's retirement. On Sunday, September 15, Larry Summers withdrew his name from consideration for this position. That announcement coupled with industry speculation that Fed Vice Chair Janet Yellin may be the appointee prompted a worldwide market rally on Monday; the industry thinking being that Yellin would likely follow Bernanke's current strategy and be extremely cautious about the rate of tapering.

To Be Continued

Although both the House and the Senate passed a budget, they have not passed appropriations bills for the 2014 fiscal year. Congress has until this September 30 to pass a short term spending bill known as a "continuing resolution." Mandatory cutbacks, referred to as sequestration, would be implemented when the government runs out of money, presumably by November… unless, after a Republican led attempt to extract concession such as a change in the Affordable Care Act, Congress kicks the debt ceiling down the road for the 11th time since 2001.

[i] Source:Marketwatch.com – 10 year Treasury monthly performance YTD

[ii] Source:Bloomgberg.com – Snapshot Data – Nasdaq Composite Index

[iii] Source: Bloomberg.com – Snapshot Data S&P 500 Performance

[iv] Source: Institute for Supply Management – 09/03/13 ISM Report on Business August 2013

[v] Source; Bloomgberg.com YTD Snapshot Data – reaching 8,613 as of 09/16/13

[vi] Source: Bloomgberg.com YTD Snapshot Data –for EEM

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Bye-Bye Miss American Pie

Posted on November 5, 2012

Middle Class are the New Poor

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addressing how to bring the 50 million Americans living below the poverty line into the middle class, tomorrow's election is more focused on how to save the middle class from falling into poverty. The subtext is that the American dream is at risk.

What's Your Number?

The Fed's recently completed Survey of Consumer Finances reported that the median net worth of households fell 39% from $126,400 in 2007 to $77,300 in 2010. The mean fell only 14.7%. The middle class had taken the hit. After steadily rising since measurements began in 1967, real household median income peaked in 1999. Meanwhile, the average share of the federal deficit by household will be $140,000 in 2012 compared to $80,000 in 2007 and $50,000 in 1999. Remarkably, GDP has gone up every year since 1949, except for 2009. In 1999, GDP averaged $93,000 per household, in 2007 it was $130,000 and in 2012 it will be $138,000. The business of America seems to be in better shape than the middle class.

Shop 'Til You Drop

As the credit crisis began to unfold, both the Treasury Secretary and the Federal Reserve Chairman preached that the economy would fail without widespread intervention. Only then did the American consumer lack the confidence to spend. The Great Recession ensued. In order to stimulate growth, the Fed lowered interest rates dramatically, eventually getting close to a rate of zero, and pledged to keep rates that low through mid-2015. Yet GDP growth remains sluggish. The Fed has aggressively added to the money supply. Yet the M2 velocity of money, the frequency of the flow of funds spent on new goods and services, is now at its low since 1962, well down from its high in 1997. Despite the questionable benefits of the Fed's policies, the American consumer's ability to keep the economy strong is unassailable – as long as the middle class has the resources and the confidence to spend.

There You Go Again

The US is now guaranteeing or funding essentially all new conforming mortgages since taking over Fannie Mae and Freddie Mac. The Fed buys a lot of those same mortgages. Homes are especially affordable as prices hit bottom five months ago and mortgage rates are at record lows. The largest institutional investors in the country are buying up many of the homes for sale, outbidding owner-occupant buyers. Many homes are being deliberately held off the market by banks and government agencies. From a glut of houses in 2007 that set off the credit crisis, the inventory of homes for sale is back at low levels. These efforts to increase home prices may end up benefiting bank balance sheets more than those of the average household, whose home equity represents only 12% of net worth.

Get a Job

The Fed has announced a policy objective to reduce unemployment, even though it is a lagging indicator. Meanwhile, the employment numbers in the private sector have gone up for the last 32 months in a row. At the current unemployment rate of 7.9%, the Fed has only a 2% to 3% reduction in unemployment left to reach its goal, which some economists are predicting can happen by 2014, potentially causing a conflict with the Fed's promise to keep interest rates low. Employment is improving despite the headwinds of job automation, recession-tested businesses using fewer employees, government jobs shrinking, and expanded relief programs targeting the poor and unemployed.

Let Them Eat Cake

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The biggest drought in recorded history in the Midwest has moved the price of wheat to an all-time high. Since June, international prices for agricultural commodities have risen almost 30%. Growth policies that increase demand and create shortages can impact lower-income households as they need to devote a larger portion of their disposable income to inelastic expenses.

Can the Patient Survive the Medicine?

We can only speculate if a free market would have sorted out how to distribute and protect capital, services, products and wealth without interventions and regulations that benefit the status quo. If the American dream is at risk, hopefully the risk is not from the policies and programs designed to save it.

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Don’t Worry, Be Happy

Posted on October 30, 2012

Wall of Worry

Despite multi-trillion dollar monetary policy programs designed to support financial institutions and stimulate economic growth, economists and investors worry that European recession, GDP deceleration in China and the US fiscal cliff will deflate the global economy.

It Shouldn’t Be Able to Fly but It Does

European Central Bank (“ECB”) president Mario Draghi delivered his “Bumblebee Address” on July 26th in which he said that the euro was like the bumblebee. Rather than relying on the laws of nature to continue to be broken, he committed to do whatever it takes to make sure that the euro survives on its merit. He opined that the eurozone as a whole does a better job balancing budgets and managing debt than either the US or Japan. He foresaw a supranational eurozone founded on four building blocks: a fiscal union, a financial union, an economic union and a political union. The ECB now has the resolve, the tools, the political backing and the plan to have its wealthier members share in the support of its more challenged members. The ECB has gained credibility and market confidence.

When Pigs Fly

Portugal, Ireland, Italy, Greece and Spain were collectively known by their acronym as the “PIIGS” when they were deemed destined to cause a global economic domino effect and market panic. Portugal and Ireland are now able to borrow money at multi-year lows. Two years ago, hardly anyone anticipated that Greece would not default or leave the euro by now, but Greek debt is also trading at improved pricing. The cost of borrowing has dropped dramatically for Spain and Italy because they are expected to take advantage of ECB bailouts. Spain is expected to start negotiations with the ECB in November, committing to improve its fiscal controls in exchange for the bailout, a critical step in ECB fiscal union.

Is China Bust or Robust?

The markets have been worrying whether China will have a “hard landing” from its many years of outsized growth. As global economies are slowing down, China’s rapid growth seems like a bubble ready to burst. China’s economy may have a slightly lower growth rate than in the past but it is on a much bigger base. Unlike in the US, the Chinese economy might be better served by slower growth as it faces a chronic labor shortage and high priced housing. The Chinese government’s

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Cliffhanger

The biggest US market worry has to do with the Bush tax cuts which will expire at year-end unless Congress intervenes. Federal Reserve Chairman Ben Bernanke coined the term "fiscal cliff" to warn policy makers that the US economy would instantly fall into recession as a result of these tax increases. To the chagrin of investors, Congress still seems unable to forge a bipartisan compromise ahead of the elections. If the deadline comes and goes, as seems likely, it doesn't necessarily mean that nothing will get done. The "grand bargain" hoped for this year will probably happen in early March, 2013 instead, after the next Congress convenes and the new presidential term begins, by which time the debt ceiling will have exceeded its legal limit of $16.4 trillion.

Is the Private Sector Doing Fine?

Since bottoming out in 2009, the US has had consistent recovery in private job growth and household net worth, while the stock market has more than doubled. Consumers' ability to handle their monthly nut is, unbelievably, at an all-time record high. This year, the US stock market is beating bonds, commodities, gold, European stocks and Asian stocks. Notwithstanding, the Fed is unsatisfied with the results of the $2.6 trillion it put into the US economy. On September 13th the Fed announced QE III, which is an unlimited and open-ended mandate for it to buy up mortgage-backed securities.

Central Planning

These are unprecedented times. Using monetary policies to intervene in slipping economies while implementing fiscal policies to keep governments solvent defies economic theory. Only time will tell if the right decisions are being made in Europe, China and the United States. For now, the reality seems to be better than the perception.

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