

INSIGHTS ON FRONT STREET



BY JASON P. TANK, CFA
FRONT STREET INVESTMENT MANAGEMENT LLC

EYES WIDE SHUT

JANUARY 2012

Over the last decade we have witnessed the bursting of two colossal market bubbles. Each produced increasingly large consequences for both capital markets and the broader economy. It is possible we are witnessing an attempt to blow yet another and an even more consequential bubble. We would call it the *final* Fed-induced asset bubble.

Since early 2009, we've argued the Federal Reserve was embarking on a massive economic experiment. The Fed lowered short-term interest rates to zero and then unleashed multiple financial "liquidity baths" by injecting two trillion new Federal Reserve Notes (that is, US dollars) into the economy.

Now three years in, despite the mixed results, the Fed remains totally committed to its policies. Interest rates are still nailed to the floor and with each whiff of a slowdown they automatically hint at more money-printing. The only part of the economy that seems to respond is the financial markets. The real economy barely twitches.

Housing has been grinding along the bottom and now without its usual impact on consumption through increased credit, it is no longer an industry that punches above its economic weight class. Auto sales have seen a substantial recovery following the sudden collapse. However, like residential housing, auto and auto-related activity make up less than 3% of the US economy. These two industries were relied on in the past to boost economic recoveries. This recovery is different.

Consumer confidence has improved only marginally with current readings more indicative of past recessions, not a healthy recovery. Household debt has declined some, but statistics clearly show we are only in the early days of the long process of deleveraging. This process feels a lot like watching the first quarter of a January regular-season NBA game. You get the sense that many are just going through the motions.

Job growth has picked up over the past three months to a pace of 140,000 per month. This is better than the average of 130,000 per month recorded for all of 2011. This was also a touch better than the 120,000 monthly average we've experienced since the employment recovery began in early 2010. It would be hard to argue that we are showing much momentum.

Since the economy's official bottom was reached in mid-2009, GDP has grown at an annualized clip of 2.4%, before inflation. This is not a strong recovery, especially after the horrendous decline we experienced during the recession. For 2011, real GDP growth should come in slower still at close to 1.5%. The current forecasts for 2012 are not much

more optimistic. It appears the momentum has also slowed in most regions of the world. This is not only the case in developed markets such as Europe and Japan, but also in higher-growth developing markets like Brazil, India and Asia.

Rendering an early verdict on the Fed's experimental policies involves trying to prove a negative. Ask President Obama about how hard that is to do convincingly! Without the Fed's zero interest rate policy and massive money-printing campaign, could things have been worse? Without the Fed's actions, we deeply believe things would likely have turned out far worse for the economy in the near and intermediate term. Yet, the longer-term impact is still an open question.

However, from an investor's standpoint, there is a more relevant question to ask. Can the continuation of the Fed's policies help drive stock prices higher and bond yields lower, despite the economy's weak underpinning?

While nobody knows, an affirmative answer would certainly give us pause regarding the timing aspect of our current conservative investment strategy. It is plausible that we'll see a strong push by the Fed to force investors into another level of bubble-based thinking.

By forcibly driving down all forms of investment yield to the point of income starvation, the theory is the Fed can create an environment where investors have little choice other than to run up the price of risky assets - like stocks and junk bonds - to the point where those assets' expected future returns are nearly as low as the expected future returns for far less risky assets.

If you could listen to the thoughts of many money managers their self talk might go something like this:

"My clients need income to live", "It is hard to find it safely anymore", "the Fed's policies are holding up stock prices", "that's exactly what they mean by, Don't fight the Fed", "see, stocks won't stay down even on bad news", "I mean, look, stocks just keep moving up", "it's as if bad news is good news",

"money-printing obviously works", "maybe I can just own some stocks with good dividends and solid balance sheets that allow my clients to sleep at night", "after all, a 4% dividend, even for a very slow grower is better than the paltry 2% I'll get on a 10-year Treasury", "even a boring stock with a 3% dividend is better than 2%", "okay, honestly, a stock with even a 2% dividend and some modest growth prospects is better than that measly 2% government bond!".

And, naturally, their stream of thoughts ends with, "What else am I supposed to own besides stocks and longer-term junk bonds? I mean, it simply isn't okay to earn next to nothing in boring bonds!"

Once the final thought is internalized by enough investors, the Fed's bubble blowing game would of course reach its natural conclusion. The key for investors involved in this type of game - one based on pragmatism at first and then unadulterated momentum at the end - is to dance some, but to do it as close to the exit doors as possible. When the music stops, to paraphrase the now-infamous Chuck Prince of Citigroup, investors better not get caught dancing with their eyes wide shut!

If this admittedly low probability scenario came to pass, we believe we know the location of the exits in the dance hall. Our strategy of actively hedging risk while consciously attempting to adjust our exposure to a scenario like this is definitely a challenge. It is, however, a challenge worth the effort. We obviously still remain very skeptical of the longer-term risks of the Fed's ongoing experiment and we vow to always dance (as awkwardly as it sometimes looks) with our eyes wide open!



FRONT STREET
INVESTMENT MANAGEMENT