Macro Strategy & Research

February 22, 2013

Odds & Ends

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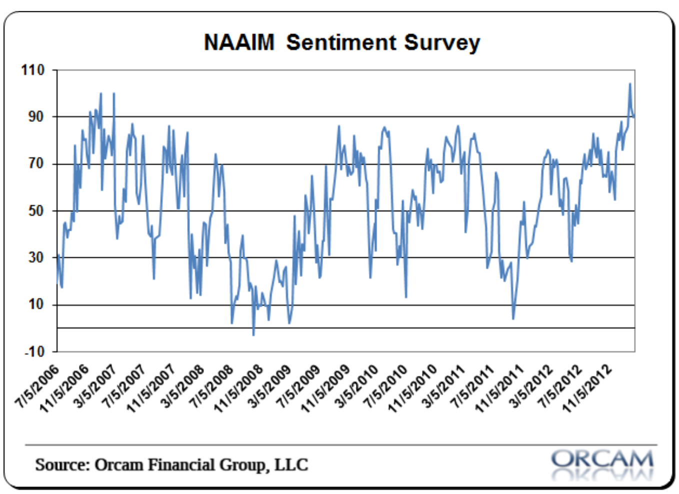
Cracks in the Market Foundation?

An unusual thing happened to the stock market this week. Mr. Market actually showed signs of vulnerability. This week's decline in the S&P 500 was marginal as we're only 1% off the high hit early in the week. But that didn't stop some investors from overreacting to the sharp 2% decline from 1530 to just under 1500. But it's important to keep things in perspective.

The consensus view is still **very** bullish. The NAAIM survey is still showing that money managers are through the roof bullish. The latest reading of 91 is shy of the recent highs, but remains higher than any level since the summer of 2007 when stocks were near all-time highs.



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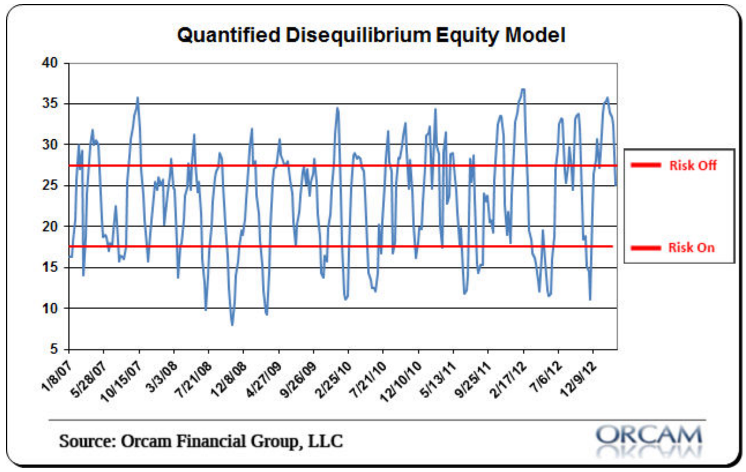
"Risk comes from not knowing what you're doing. "
-Warren Buffett

My quantitative risk models remain high by historical standards though they've come down some in recent weeks. The current reading is still consistent with a market that remains risky to contribute to on the long side. I would let the recent turbulence play out before deciding to make any further tactical moves. This remains the type of environment where sentiment can shift very quickly and with the bulls fully in charge of the situation we're ripe for an environment where manic Mr. Market begins to believe that the world is coming to an end again. Of course, this is all in the name of risk management and understanding when the market is potentially most risky. The minor two day slide in the S&P 500 showed just how quickly a month's worth of optimism can be unwound in a matter of hours. I can't be certain that this is the start of a larger contraction, but the prudent approach leaves me feeling uncomfortable chasing the market at present.



Thoughts on the "Great Rotation"

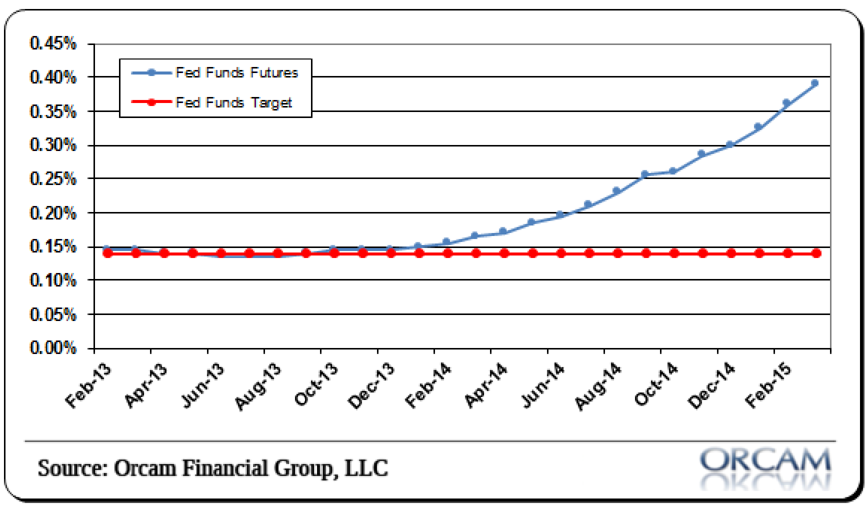
It's been difficult to escape discussion about the "great rotation" in recent weeks. In case you've been hiding underneath a rock, the idea of the "great rotation" is that investors will rotate out of bonds and into stocks. There are three big misunderstandings being made behind this thesis:

- First, investors don't "rotate" out of stocks and into bonds.
- Second, the end of the bond bull implies an end to easy Fed policy.
- Third, the bond bull has been weaker than most presume.

The first point is a very fundamental fact about secondary markets. We must understand that all securities issued are always held by someone. There is no such thing as "getting out of" stocks or bonds. You can sell to someone else who exchanges you their cash position, but in the aggregate there is no such thing as "getting out of" stocks and moving into bonds. All securities issued are always held by someone. It's better to think of money as moving through securities and not into them.

Ultimately, what determines the price of these securities is the desire of the buyers and sellers to acquire or dispose of those securities. But the idea of a "great rotation" is a great misnomer. It implies something similar to switching from Makers Mark to Jim Beam as your preferred form of whiskey.* But stocks and bonds are not consumer products that we can switch in and out of. They are savings vehicles issued as liabilities of the entities who issue them and they are always held until retired.

The second point revolves around the idea that government bonds are no longer an attractive asset class. This might make sense were it not for such an accommodative Fed policy. Ultimately, Treasury Bond prices are pegged to economic conditions and the Fed's perception of economic conditions. Bond traders will adjust their holdings of Treasury bonds based on their perception of future Fed policy. But future Fed policy is contingent upon future economic conditions.

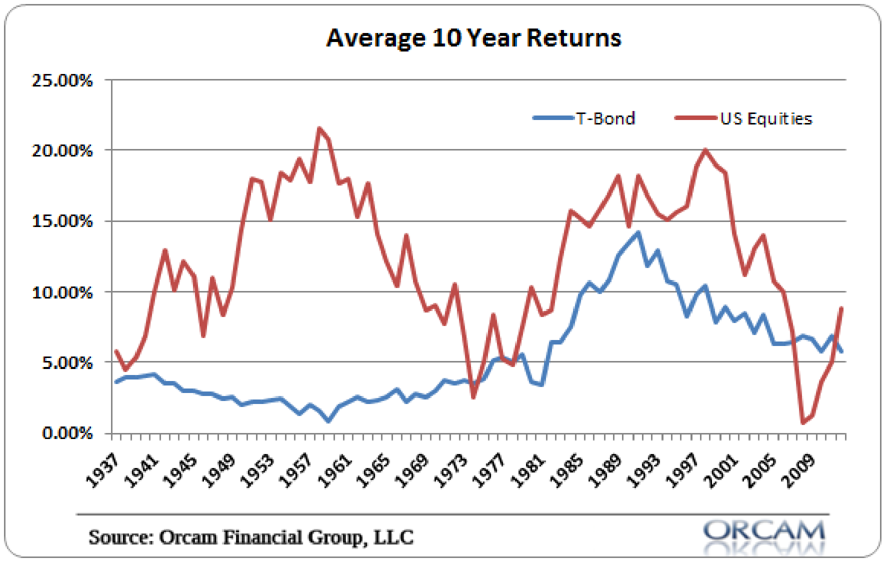


Thus far, the Fed has been very clear about future policy. They will not ease off the accommodative pedal until they see 6% unemployment. That means we're staring at a 0% Fed Funds Rate for the foreseeable future. Since long rates are an extension of short rates I wouldn't expect huge deviations in t-bond prices unless we see a roaring economy in the coming years. And while I've long been optimistic about the economy I would not peg high odds on the sort of growth that would lead to 6% unemployment in the coming 12-18 months.

** While we are not in the business of providing specific investment advice to clients, we would highly recommend against every making this "rotation".*

It's also helpful to put this into perspective by looking at the current guesses of those traders. At present the Fed Funds Futures curve is much steeper than it was just a few weeks ago (see chart on previous page). Traders are now pricing in a rate hike as early as early 2015. I think this is probably optimistic.

The risks to the US economy will remain many in the coming years as the Balance Sheet Recession lingers and government spending slows. It's also highly unlikely that the unemployment rate will drop below 6% before 2015. That likely means the bond market is overly optimistic about future rate hikes and we're likely to see that curve shift to a flatter position.



Lastly, I think it's important to keep the bond bull market in perspective. Since 1928 the average annual return on Treasury Bonds was 5.4%. Meanwhile, the trailing 10 year returns on Treasury Bonds has been 5.76%. In other words, the recent returns have been far lower than most presume and much more in-line with the average annual return. While it wouldn't be surprising to see this rate of return revert further to the mean I think it's a stretch to imply that the bond market is as deeply into "bubble" territory as we constantly hear about.

In sum, I think it's important not to get too caught up in these dramatic sort of concepts that imply we are presently in the middle of some sort of paradigm shift. Bonds aren't going away. They're not going to become a less important part of people's portfolios. Investors aren't "getting out" of bonds. And while the next 10 years are not likely to be as favorable to bonds as the last 10 years I wouldn't fall victim to the idea that you need to dramatically shift your portfolio to account for what sounds more like a marketing ploy than sound advice.

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