ORCAM | ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

January 8, 2014

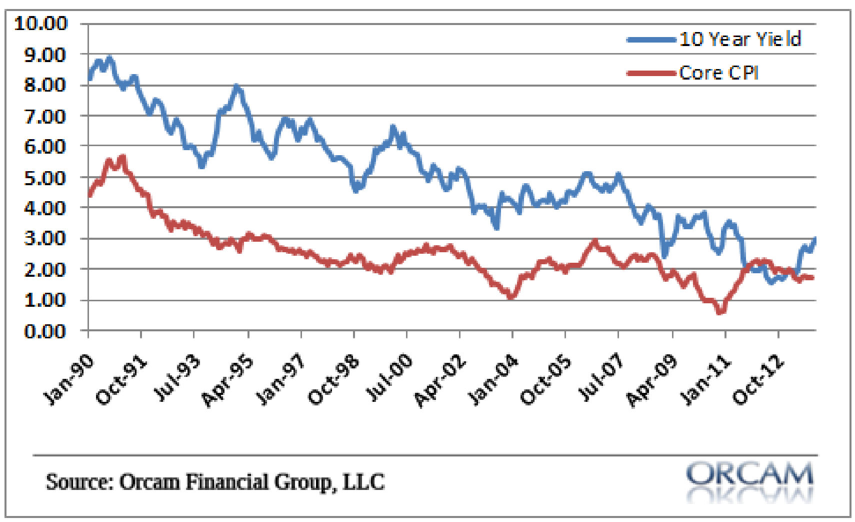
Q1 2014 Quarterly Outlook—A Clarification

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

"Failure to prepare is preparing to fail."
-Coach John Wooden

In the quarterly outlook issued last week I made some comments that may have come off as being much more bearish than I intended. I said:

"In order to gauge the potential risk in fixed income markets let's consider a return to what market participants consider "normal". Over the last 10 years the 10 year note yield has commanded a 1.7% premium over core inflation. At present, that sits at about 1%. If bond investors command the average 1.7% historical premium then we could be in for at least a 3%+ loss in US government bonds. That certainly isn't good, but we've seen a substantial change in the risks of owning US government bonds after the price reset from 2013. That said, I would be hesitant about owning 20 year+ US government bonds in this environment as there remains the potential for economic upside surprises and continual "tapering" talk. If you're going to own fixed income instruments I would much prefer to own shorter duration instruments and a bond market aggregate like the Ishares aggregate (ticker: AGG)."



Source: Orcam Financial Group, LLC

I should have clarified this statement a bit further. I view the 1.7% threshold as being a worst case scenario. And frankly, I view it as being a low probability scenario. Instead, I think we're likely to see something much closer to the 1%-1.25% levels. That said, long bonds will expose you to greater risk than some are comfortable with so a portfolio of 20 year+ durations could be a bit aggressive given the potential downside and the meager yield of 3.25%. So this is a risk/reward perspective. The long bond has the potential to expose us to greater negative returns in a worst case scenario than short duration maturities will. But I do not see high probability of this worst case scenario occurring, and frankly, I do not think that a ~3% loss in the fixed income portion of the portfolio is something that we should get too worked up about.

Therefore, I do not think it's prudent to be overly bearish on fixed income as a whole. A moderately long duration is likely to perform well in 2014 given that inflation is likely to remain low and the economy won't be excessively strong. Most importantly, I think that the Fed has eased investors into digesting the taper and the majority of the price adjustment off the May 2013 lows has probably been accounted for. So while there is some potential for downside risk in fixed income in Q1 or the first half of 2014 I do not think the risks to the downside are as great as they were in 2013. Therefore, I would actually be more bullish about fixed income as a whole.

Additionally, I think it's important to keep things in the proper context. If you are overweight equities as our strategic positioning states, then a rising interest rate environment should not be one you fear. Why? Let's do a bit of scenario analysis considering why rates might rise.

Scenario 1—Rates Rise Because the Economy Improves During Inflation

In this case you will want to be overweight equities relative to fixed income. Because the economy is improving we would expect corporate profits to be growing and demand for stocks should be on the rise as profits rise. This doesn't mean fixed income has to perform poorly, but a portfolio that is overweight equities will perform well in such an environment. 2013 is a great example where a simple 60/40 balanced portfolio generated a 17% overall return.

Scenario 2—Rates Rise Because the Economy Deteriorates During Inflation

This is the 1970's environment that many fixed income investors most fear. I don't see the corollary between the 70's and today. In the 70's the labor class had wage negotiating power, oil prices increased at a rate of over 170% year over year in the mid-70's and credit growth was extremely strong. The current environment is almost precisely the opposite. Oil prices are stagnant/declining, the labor class has no negotiating power and credit growth is weak. This means the risk of a 1970's style inflation during a weak economic environment is unlikely.

Scenario 3—A Weak Economy During a Deflation.

In this scenario corporate profits will fall, equities will likely fall, interest rates will fall and high quality fixed income assets will perform extremely well.

In sum, I presume that 2013 was an anomaly of sorts and that fixed income will perform much better in the coming years than it has in the recent past. I would be extremely aware of the tendency to view the recent performance with excessive emphasis. Therefore, I would emphasize that there is some risk in fixed income given the potential for a strong economic environment in 2014, but I think that 2014 will be much more friendly to fixed income portfolios than 2013 was.

I hope that helps clarify.

Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.

Important Disclaimer

ORCAM