The Margin Games

Although you may have not seen ‘The Hunger Games’, you have probably heard of the movie and soon HG 2 will be showing at a theatre near you. For the uninitiated, the premise is one of survival amongst your peers. Basically, kill or be killed. Barbaric indeed, but true. I bring this up in the context of changing the Gazbit title, slightly, to describe what little effect all the continuous QE (Quantitative Easing) is having on the global economy. Indeed, the tsunami of cheap money has saved the financial sector (read: banks) from Armageddon (we can debate that later); this artificial, yet purposeful manipulation of the money supply goes on and will continue to do so, according to ‘Helicopter Ben’. (Bernanke) My question is why? Oh, you will hear the conventional pabulum, “The economy is still fragile, in recovery mode’ or ‘You can’t slow or stop this policy or else the economy will go back into recession’.

Hogwash. The real reason the Federal Reserve and other central banks are keeping interest rates on the floor is it is easier to spend cheap money, then spend expensive money, ergo financing government spending, domestically and worldwide. If interest rates were to “normalize”, the “kick the can” budget deficit would explode, due to the interest the US would have to pay to finance the irresponsible spending in DC. Thus the title, ‘The Margin Games’, is highly appropriate since everything today is “done on the margins” and in my opinion, we have reached the ‘point of diminishing returns’. The rubber band is stretched so taut that even the lapdog media is now starting to fret about central banks’ ability to withdraw money from the economic system, without causing a calamity.

When do we put on our ‘Big Boy Pants’, take our fiscal medicine for decades of profligate spending and learn the first rule of finance, ‘Don’t Spend More Than You Take In?’ For all the US braggadocio and lecturing of other countries on their fiscal problems, we can’t even enact sequestration, which was a bi-partisan piece of legislation and would be a good starting point in getting spending under control. Ah, but that doesn’t get you re-elected because that means actually living within (Gasp) a budget !!! I have said to many clients that we are headed for a lower standard of living in the USA.

Problem is, everybody wants theirs, but don’t cut me in the process. I thought the term ‘Shared Sacrifice’ meant just that – we all must have some skin in the game. Not just the “rich”. Everybody. Problem is, the fake fiscal cliff deal, nails some taxpayers, but not all. My problem is, that is you. You get to pay extra and not just the increase in payroll tax (2%). Oh no, throw in the 3.8% tax on investment sales (Affordable Health Care Act) and a tax on ‘millionaires’, you know, those married couples that earn $ 450,000 or more. Wait, there’s more on the same tax road that the ‘kicked can’ resides, namely limiting or eliminating deductions, of several varieties, let alone other things that ‘You must pass the bill first, to see what’s in it” waiting for us in one form or another. Truth is, I am tired of bending over and ‘taking one for the team’. I, and you, I dare say, (not a stretch) have been ‘taking and giving’, a double negative with regards to money, with no end in sight.

Herein lies my problem in advising you. The Ponzi scheme or game of musical chairs, being orchestrated by the Federal Reserve (easy money, above) will end. When, not if, that happens, my responsibility to you is to ensure your financial survival . (Just like 2008-2009) Yet, Uncle

Ben is shoving us to invest in riskier assets and bring about an economic recovery to the land. Thus the conundrum of trying to balance Risk and Return. I can and will invest your money, but it is a brave new world, one of momentum, absent most financial fundamentals. Be aware of this paradox going forward. Thankfully, many of your investment portfolios have higher yielding, fixed income securities, but those are fast becoming extinct.

Reinvestment risk is one of the 'unintended consequences' of the Federal Reserve's actions. The movement to dividend-producing equities, thereby replicating those "lost" higher fixed interest coupons, is amping up the level of risk and I can certainly accomplish this, but want assurance from you that we agree and proceed with 'Eyes Wide Open'. Will this investment climate continue in 2013? Yes. Bumps in the road will happen, but with inflation still tame and the unemployment rate nowhere near 6.5%, the money spigots will stay open.

Factoring it all in, what does it mean? First, all that you need to know post-election is taxes are the solution to every fiscal problem, Federal and State. That's all folks. (Courtesy Warner Bros.) Prepare for more tax-advantaged investments (Especially in Minnesota) to become a larger part of your portfolios, if not already. Second, a laser focus on large cap, multi-national companies with "battleship balance sheets", equating to continued earnings power and dividend growth with a nod to "fairly valued" organizations. Examples include 3M, Johnson & Johnson, McDonald's and ConocoPhillips. Third, a dedication to my favored industry groups, specifically Energy, Pharmaceuticals and Manufacturing, in that order. Finally, very select Preferred Stock and Real Estate Investment Trusts with the same characteristics as the "battleships" noted above.

Can equities continue to "climb the wall of worry"? Yes, but let's note what I think is a distinct narrowing of the "investment pyramid" and more importantly, heightened risk profile. More dollars are chasing fewer "quality" assets, in my opinion and although the tepid economic recovery goes on, any hiccup including a lack of sustained employment growth, Europe flaring up, another US can" kicked down the road", the continued flood of central bank dollars, etc., and my sleeper factor, the bond vigilantes, eventually forcing the Federal Reserve's hand in raising interest rates before it wants, thus resulting in a larger US budget deficit, will end the equity party in a hurry.

Japan has tried multiple monetary stimuli for 25 years to little or no avail; Europe's societal-centered spending has caught up and is reshaping future generations; The US is following the same blueprint, yet expects different results. Hmmm, I think that is the definition of insanity. Nonetheless, leaders are trying to apply yesterday's solutions for today's global problems. Trouble is, there is no blueprint or textbook that addresses the "new normal". That is why risk is growing daily and exponentially.

I firmly believe our investment processes and discipline will continue to work to your benefit going into the middle of the decade. Having the knowledge of your complete financial situation and advising accordingly, provides the bulwark to your financial fortress. I just hope the moat is large enough to repel all medieval gargoyles (risk).

On the bright side, Punxatawney Phil did not see his shadow so Winter should fade to black soon. His prognostication cannot be any worse than what we are witnessing now from worldwide “experts”. Thing is, Phil can crawl back into his hole and ignore the world. Unfortunately, we cannot.

All The Best…

February 17, 2013