

Investing Despite the Taper!

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As investors celebrate the fifth anniversary of the bull market, an epic near tripling of the market averages, they must give thanks to our Federal Reserve. Its unprecedented monetary support, including three installments of Quantitative Easing, has been an important factor in the market recovery.

To fight the most vicious downturn since the 1930s, the Federal Reserve slashed short term interest rates to near zero and forced longer term rates to the lowest since World War II. It gobbled up longer dated Treasuries and mortgage backed bonds, to the point where its balance sheet is burdened by some \$4 trillion in debt.

Investors have shifted billions from bonds to stocks as yields plummeted. Corporations bought back their shares by borrowing at the low rates.

Investors cheered Fed induce improvements in the economy. Lower mortgage rates staunched the slide in home prices, as buying became cheaper than renting. Waves of mortgage refinancing put more money in Main Street pockets, boosting spending.

However, the Federal Reserve has started to take the punch bowl away, reversing its liberal monetary policy. In December, it started reducing (tapering) by \$10 billion per month its bond buying program; short term rates are poised to rise in 2015.

Given the powerful impetus the Fed's expansionary policy provided, just how should investors play the great coming contraction in liquidity, with a corresponding rise in interest rates?

In a Nutshell

There's no way you can spin the tapering as a positive for stocks. Higher interest rates reduce their present value, including their dividends. Higher yielding bonds create greater competition for equities.

The great rationalization is that the Fed wouldn't taper if it didn't feel the economy had improved; better economic conditions lead to superior profits which lead to higher stock prices. That's all true, but a better economy without rising interest rates is better still.

Longer term we're optimistic. The stock market will remain a cornerstone for portfolios. Even if rates rise, they're still at very low levels. A 3.5% ten year Treasury is still not enough for retirees to live on, endowments to distribute, or pensions to rely upon.

Different companies will react differently to a tightening in monetary conditions. More cyclical companies will benefit more from the improving economic conditions giving rise to the tapering.

Valuations still matter. Even non-cyclical stocks can perform well if the tapering proves less damaging than has already been priced in.

There May Not be a Taper

Before getting too alarmed over the taper, realize that the future is never certain. Fed Chair Janet Yellen has repeatedly stated that monetary policy is flexible; if the economy slows or stumbles there's nothing to prevent the Fed from halting or even reversing the taper.

This is the same Fed that missed predicting the subprime crisis, and then when it started downplayed the potential fallout. While it's certainly consensus that the economy is improving and healthy enough for the Fed to mop up the excess liquidity, the consensus could well be wrong.

A steeper slowdown in the enigma called China, the world's second largest economy, could cause the Fed to rethink the taper. War in the Ukraine could also give pause.

A portfolio's first job is to preserve capital. Even if you're committed to restructuring your portfolio to compensate for the taper, stay diversified enough to cope with no taper, or even an expansion in liquidity.

Should the authorities reverse the taper, your best portfolio holdings may well be safe haven holdings like very high quality fixed income, gold, and blue chip non-cyclical stocks.

Stocks That Could Benefit From Tapering

It's true that the present value of all assets declines as interest rates rise. Some companies' business improves as rates rise.

Financial stocks' earnings should rise with higher rates. Their business is lending money, so when rates rise the yields on their loans and investments should improve, padding the bottom line.

Of course, if the rates they pay on deposits and other borrowings rise at the same time, the so called net interest margin, or gap between their cost of funds and their loan rates, may remain constant. However, Chair Yellen has repeatedly stated that the Fed intends to anchor short term rates for a very long period even while they taper.

Banks, saving and loans, and other commercial lenders typically borrow short term and lend long, and thus would seem to be key beneficiaries of the taper. Insurance companies, too,

should benefit; as they invest the premiums received higher rates should boost earnings, while those same higher rates should not diminish the premiums received.

Inflation as Driver of the Taper

If the Fed doesn't taper, and money velocity picks up, all the Fed's monetary creation can trigger inflation. If that velocity picks up faster than the Fed can or wants to taper, inflation may result.

Investments that hedge that risk could be a good bet now. Chair Yellen and many others see inflation as quiet. While that's true, the good news from an investor's point of view is that the cost of inflation insurance is cheap.

So, just like it makes sense to buy your sun block in winter and your snow shovels in summer, you're well advised to buy inflation protection now, when it's on sale.

Commodity producing stocks are desirable inflation hedges. Energy concerns like **Chevron (CVX)** would be major beneficiaries of rising prices. So, too, would be miners like **Freeport McMoran Copper and Gold (FCX)**. Even regions of the world that are blessed with natural resources could benefit, like Canada and Brazil.

Economic Growth as the Driver of the Taper

The Federal Reserve is confident the economy can withstand the taper because it is growing fast enough to tolerate higher interest rates. A great investment strategy, therefore, to offset the taper is to focus on those companies that most benefit from a growing economy.

Cyclical stocks' earnings vary with the economy, like home builders, auto makers, appliance outfits, and other makers of big ticket items. Such companies as **Toyota (TM)** and **Deere (DE)** may be able to ramp up earnings that would more than offset the tapering headwinds.

Stocks Already Tossed Overboard Out of Taper Fears

To shun non-cyclical stocks, such as utilities, consumer staples, and telecoms, merely because their earnings are less sensitive to economic variability, may be an error. Why? Investing isn't just about predicting future earnings, it's also factoring in how other investors have handicapped those earnings, and considering whether the resulting valuations make sense.

Stocks that are basically bond surrogates, meaning their earnings and dividends are very stable despite economic fluctuation, like food, beverage, and tobacco, may be deemed to offer little protection against the taper. There's no reason to suspect their business growth will accelerate to offset the taper.

However, whether or not the taper is halted, if there's so little enthusiasm for these stocks that they're just plain too cheap, they may be good buys. **Philip Morris (PM)** and **Coca Cola (KO)** have lagged dramatically in the last year and now make interesting investments notwithstanding their non-cyclical nature.

Emerging market stocks (EMS) were some of the first jettisoned from portfolios over taper fears; investors believed that with higher rates Stateside investors would repatriate overseas investments. EMS are down 6% over the last year while domestic large cap names are up nearly 20%, with valuations at a substantial premium to EMS. Taper's effects may be priced in to EMS, and they may perform well, particularly if the taper is not accelerated.

Buying Your Fixed Income Directly

The taper may spell big problems for fixed income investors. Rising rates are anathema to bond holders; expect a slide in value approximately equal to the maturity, including interest payments, of the bond in question per 1% increase in rates. That means a ten year US Treasury may slide 8.6% in value if rates rise 1%.

However, those buying their fixed income directly have the comfort of knowing exactly, absent default, how much and when they'll receive their principal back, no matter how high rates rise. Bond fund investors, on the other hand, generally have no such certainty that a decline in value due to higher rates will reverse itself; there's no fixed date for the return of their investment.