TS·Capital Economic Outlook

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It is human nature to focus on what everyone else is focusing on. It is difficult for many to avoid joining the herd. If herd mentality were not enough, there are many other forces at play distracting us from independent, objective, and steady thought.

It seems every year Hollywood makes a new "best movie ever", as people's focus is so easily distracted from potentially better movies of the past (yet the opposite is true for some people). One of the key human biases posited by behavioral finance is the recency effect; this is where a person disproportionately relies on or weights new information much more greatly than they do all other information, past and present.

More often than not, the majority of people in the investment community are talking about the same thing. Yet, in the grand scheme of total relevance, how likely is it today's news truly justifies 98% of our attention (as opposed to news from several months ago that has faded from the spotlight). Relative to all of the news that has been reported over the last ten years, the importance of today's news resembles a drop in a big bucket of water, yet it occupies an overwhelming amount of our attention.

Missing the forest through the trees is perhaps the easiest lure a forecaster or commentator can get caught in. Lest we be caught in snare of details, it is best to occasionally hit the pause button and zoom out.

The Big Picture

The U.S. economy is a very complex system integrating:

- Consumers, savers, lenders, borrowers, investors, and entrepreneurs,
- Wall Street, Main Street, Highways, and Byways,
- Skyscrapers, farms, railroads, airports, and seaports,
- Public elections for federal, state, and local governments,
- Courts, political parties and sub-parties, lobbyists, and fiscal and monetary policymakers.
- Public and private sector employees across a multitude of industries,
- Income, Taxes, and Entitlements,
- An intricate network of international trade participants,
- A military protecting domestic and international land, air, and seas, and
- A vast history of good, mediocre, and bad decisions resulting from truths, mistruths, and the fallibility of human decision making.

All of these factors bring us to the present, where we live in one of history's most prosperous nations fighting numerous forces which threaten the nation's well-being. Various cross-sections of the populous continue to engage in a "blame game" to determine who is at fault for the nation's problems.

Easy targets in this debate are the current and former U.S. Presidents and members of the Federal Reserve. The irrefutable reality we re-awaken to daily is that people (Presidents, the Federal Reserve, and the rest of the populous), being merely human, suffer from information overload, believe mistruths, and consequently make at least a few poor decisions.

One common mistruth is a President or Federal Reserve official is ultimately to blame for the problems we face. The truth is, the majority of the economic participants listed above somehow contributed in small or large portions to the current state of affairs. The financial crisis and subsequent aftermath was due to an accumulation of false beliefs and faulty decisions over many years across a plethora of participants.

Fast forward to today, the United States' influential leaders (public and private) are attempting to optimize decisions based upon the context of today's opportunities and constraints (which are oftentimes unappealing relative to the past). Therefore, many of the decisions made today may be relatively unappealing if compared to past environments.

It stands to reason, if someone is criticizing a decision because it is unappealing in the eyes of yesteryear, then criticism is based upon a false supposition (that the decision maker is operating on in a different environment than reality dictates). To be clear, this does not mean all unappealing decisions are good and excusable, it simply means decisions have to be evaluated based upon today's constraints, not the constraints of 1997 or some other more ideal era.

An example of this is someone criticizing Janet Yellen on whether or not she elects to tighten policy simply because the over-leveraged nature of the Federal Reserve is grossly unappealing and threatens the well-being of the economy (even though both of which are true). It is often ignored that the Federal Reserve is deliberately trying to overcompensate for events beyond their control (such as inadequate and inappropriate fiscal policy). In similar fashion, forecasters oftentimes confuse what the Federal Reserve will do with what they should do (based upon the forecaster's perspective).

Most investors live by the rule "don't bet against the Fed". Yet an investor who executes trades based upon a faulty assessment of the FOMC's stance is in fact positioned against the Fed.

Another false truth in regards to the Federal Reserve is, because the unemployment rate is low and core inflation is not too low, that the Federal Reserve will unavoidably begin a campaign of raising interest rates. Underlying this estimation is the assumption that the purpose of the Federal Reserve is to maintain stable inflation and attain full employment. It definitely seems like it is their purpose, yet it is merely their stated objectives with the underlying purpose being simpler yet broader.

An evaluation of the Federal Reserve's history would reveal their purposely is merely to assure the U.S. has a well-functioning economy. How that purpose is accomplished has changed over time. Employees of the Federal Reserve are bound as servants of the U.S. economy, not of inflation or employment. Potentially to a fault, the Federal Reserve operates well beyond its formal "job description".

That said, one must avoid the circular logic suggesting: because the Federal Reserve's objective is to assure a well-functioning economy and the economy is not well-functioning means they are at fault for all its maladies. Again, this is not to condemn or defend the Federal Reserve, it is an attempt to look at it through its eyes with the objective being to better estimate its future decisions.

All of the above false presumptions of the Federal Reserve serve to veil a forecaster's view of how the Federal Reserve is likely to respond in the current environment. The reason this is a meaningful mention in today's world is if the Federal Reserve were to make a traditional policy response according to their stated mandates (as most people expect) it may likely compromise the broader objective of assuring a well-functioning economy.

Neon Swans and the Flux of the Fed

Our 1st Quarter 2012 Economic Outlook discussed neon swans. In July 2011, the Wall Street Journal coined the phrased pertaining to unthinkably rare, immensely important, and blindingly obvious events or influences.

> *This observation was made in reference to our unsustainable debt, Social Security, and Health Care burdens. Have you ever heard a person with the "muddle through" stance speak about the potential consequences of these juggernauts?*
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> **TS Bank 1st Quarter 2012 Economic Outlook**

Since 2010, it has been widely known the U.S. fiscal position would begin facing enormous difficulties in 2016 that would intensify each year into the 2020's due to social security, Medicare, and Medicaid. In 2010, it is somewhat understandable that pundits would make an economic forecast that ignores constraints 6-10 years in the future. Yet, it is alarming how rarely we hear of these factors being mentioned in economic outlooks today, as if they do not exist. Remember the concept of people's complete fixation on today's news above all other information; it is remarkable how such an influential issue can be veiled from our attention simply because it is not currently being popularized in the media.

A big question is whether the Federal Reserve is factoring these juggernauts into their economic models and forecasts. It is possible they are not, as several credible sources have said their economic models are far outdated. To the extent they are properly calibrated, monetary policy will likely need to be increasingly accommodative in the next several years. To the extent they are ignoring these forces, the Federal Reserve would likely find itself tightening monetary policy amidst the biggest fiscal distress of a lifetime (which means tightening would not be long lived).

It must also be considered that the Federal Reserve has a massively leveraged balance sheet holding securities that will lose value as interest rates rise. This was not a condition that existed in past rate cycles and tightening efforts.

Finally, the interest expense of the U.S. Treasury would increase exponentially as existing debt reprices upward as it matures while new debt is issued at higher rates and at an increasing pace.

This is not an attempt to cast fear; there is always opportunity for investors regardless of what direction the markets turn, but only to the extent an investor has foresight of what will come.

Sometime in the next few years, the Federal Reserve will likely find its mandate in a state of flux as they recognize stable prices may be of secondary importance and employment conditions are out of their control. It may be the flux has already begun and the Federal Reserve is currently pursuing alternative de facto mandates (such as financial market stability).

The majority of the content mentioned so far largely supports the notion the Federal Reserve will not likely have the ability to raise rates meaningfully over a sustained period of time. They may be able to influence short term rates up one percent for a year or two, but anything more aggressive or prolonged may have the effect of necessitating additional accommodation.

Most of the attention is on Federal Reserve's decision on interest rates, which primarily influences shorter term interest rates. Longer term interest rates are more likely to be influenced by the size of the Federal Reserve's balance sheet (in turn, Quantitative Easing). It remains, Quantitative Easing is likely to have parallels with Hotel California, you can check in any time you like, but you can never leave. *(Thanks to Philadelphia Fed President Plosser's inspiration for the analogy).* This Economic Outlook continues to foresee the Federal Reserve may never actually sell assets, but will instead let its balance sheet amortize over time.

Transparency, No More?

Bernanke believed transparency was an excellent tool for the Federal Reserve to use in coaxing the financial markets into being more comfortable with risk taking. This is something administered not simply because the Federal Reserve thought transparency is something that was generally needed, it was administered for an effect (to reassure the markets).

The Federal Reserve is now in what many call a Transparency Trap. When they offer hints that tightening is near, the markets react quite negatively. When they assert they will be very patient, complacency and excessive risk taking resumes. The markets have become overly dependent on communication from the Federal Reserve, and this may need to be weaned. In all reality, one of the best solutions for the Federal Reserve to use in coaxing investors out of complacency is to become more opaque about future policy actions.

If the Federal Reserve were to cease communications about the timing and direction of future policy, speculators would suddenly be less sure of their trading strategies. Perhaps the removal of the word "patience" from their communication was not a step towards tightening, but a step towards offering a less certain future.

Long / Short Investing

One concept that has been briefly mentioned over the last several Economic Outlooks (and one that has garnered a lot of attention) is the idea of alternatively managed funds, particularly long / short investing. In the above commentary, it was stated there is investment opportunity, regardless of what direction the markets turn.

The returns on an overwhelming majority of investment funds are solely dependent on the direction of the markets. This is due to the popularization of passively managed investment funds. The attraction of a passively managed fund is that you "buy the market". This is a great tool for investors as long as owning the market is an attractive proposition, but what happens when it is no longer attractive? Who is as excited about owning the market today as they were in the 1990's when index funds became popular?

Index funds are a tremendous tool to use as long as the markets are going upwards. What happens when the markets act as they did during the "Taper Tantrum" and both bonds and stocks lose value?

Therein lies the importance of actively managed investment funds. Full disclosure: investors cannot lazily invest in any actively managed fund and expect success. Passively managed funds were largely created because picking fund managers is normally more costly, requires skill, and is time consuming. So by no means is "invest in actively managed funds" an end-all-be-all piece of advice being advocated.

First off, there is a multitude of different types of actively managed funds. Many actively managed funds look much like passively managed funds, and the investor is ultimately still "buying the market" yet with a higher expense ratio.

A smaller subsection of the actively managed fund universe is alternatively managed funds. Alternatively managed funds are often confused with alternative investments such as commodities, precious metals, art, etc. Alternatively managed funds are best described as a fund manager taking a differentiated process driven approach to a specific investment strategy. Examples are computer-ran algorithmic trading strategies, managed futures, event driven funds, funds pursuing different kinds of arbitrage strategies, and long / short funds.

Even within long / short funds, there are a number of different strategies. Some carry the same amount of aggregate market risk as index funds whereas others are designed to be free of aggregate market risk. In a world where both bonds and stocks may face a material amount of market risk, a strategy neutral of market risk may have appeal. Depending on each investor's objectives, outlook, and predispositions, a market neutral investment strategy may be a tool to implement.

A market neutral investment strategy often pursues opportunities where there are incongruent prices between similar investments. Another disclosure: according to Efficient Market Hypothesis, this type of scenario and opportunity is not probable and not lasting.

An example of a long / short strategy is if an investor viewed Exxon as being undervalued and BP as being overvalued. These companies are similar enough that, beyond being different companies with different stock prices, they don't have an expansive list of meaningful differences. A potential strategy would be to be "long" (bet on, or buy) Exxon and "short" (bet against, or sell short) BP.

The investor would simply earn the differences in return between Exxon and BP. If BP performed better than Exxon, the investors would lose money and if Exxon did better than BP, the investor would make money. If both companies fell exactly 20% due to the price of oil or macroeconomic risks, the investor would have no gain or loss. If Exxon fell 18% and BP fell 21%, the investor would have a gain of 3% (-18% minus -21% equals +3%).

This also works with a number of other asset classes, such as bonds. If an investor found a safe twenty year taxable municipal bond yielding 4.80% and a risky twenty year corporate bond yielding 4.75%, the investor could go long the 4.80% bond and short the 4.75% bond and earn a spread of 0.05% over twenty years. That may not sound like an attractive return, but if investors became more fearful of the corporate bond and it lost value, the investor would likely have a meaningful gain.

One genuine disclosure is this type of trading strategy is more sophisticated and complex than any generic actively managed equity fund. An investor truly needs to independently investigate the strategy and any potential fund manager and understand how it complements or contradicts their investment objectives before investing. Given the resource intensive nature of the strategy and the need to monitor holdings more closely, the expense ratios on this type of fund would be higher than passively managed investment funds. To the "Bogle-heads" out there (the people who identify with Vanguard's founder), this would be unappealing.

One example of an undesirable long / short strategy is if an investor went long Honda Motors and short gold. Any relationship between Honda Motors and gold is likely to be spurious and unpredictable. Market neutral long / short funds rely primarily on the expertise of the fund manager and not all fund managers will consistently generate desirable returns.

Alternative Strategies

Long / short funds are one of many important tools being used to construct an unconventional asset allocation that is being developed to perform amidst turbulent and potentially negative market environments. Given today's ultra-low yield environment, many of the industry's commonly used conservative- to moderate-risk investment portfolios are finding themselves more reliant upon equities than may be appropriate. The intent is to create a portfolio that mimics the returns of traditional asset allocation models while having much less equity exposure.

We will end by repeating the list of takeways from last quarter:

1. *This is one of the best times to re-evaluate asset management strategies. Both stock prices and bond prices are at cyclical highs.*
2. *This is likely to be one of the best possible opportunities to make a change, if one is needed, to better position for the "go-forward".*
3. *Take a look at your current assets and investment portfolio and decide if your current arrangement provides you the flexibility to actively manage through the volatile environment.*
4. *Look to see if you are over exposed to the USD and Equities.*
5. *Look to see if you are ready to diversify into alternative assets and strategies.*
6. *Determine what your current plan is for your cash to earn income while waiting for future opportunity.*

Reports like this quarterly economic outlook have been created since 2007. Until 2011, they were for internal use only, to assist in establishing the bank's business and investment strategies.

We spend a great deal of time every quarter sifting through and digesting books, magazines, newsletters, and other research resources to prepare this economic outlook. As we have continued to ride the turbulent wave and witnessed the economic crisis firsthand as a company, bank, investment manager, risk manager, and investor, we have found these outlooks to be invaluable to our success.

We plan to provide this report quarterly as a guide for moving through these volatile times. If you are not on the distribution list, please email kevin.forristall@tscapital.com and request to be added by putting "Economic Outlook" in the subject line.

If you would like to discuss things on a more personal level or would like to learn more on how to best position yourself for the outlook, we would invite the opportunity to talk with you.

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