June 30, 2014

Summer Quarterly Commentary

"This is a Federal Reserve that helped save the world...Were there risks to doing so? Absolutely. But sometimes you have to take a tough stance, not knowing exactly what the right thing to do is."

Frederic Mishkin, PhD (born 1951)
Federal Reserve Board of Governors (2006-2008)
Academic Expert in Monetary Policy
Professor of Banking and Financial Institutions at Columbia Business School

Though largely unknown to the general public, Dr. Mishkin is part of a cadre of new "unconventional" central bankers and monetary policy figures whose actions and ideas continue to reshape our financial world. A close associate of former Fed Chairman Ben Bernanke (they have authored a number of papers together) and an advocate of current Fed Chairwoman Janet Yellen, Dr. Mishkin is known for authoring a popular textbook on money and banking. His emphasis on the importance of expectations is part of the reason why the Fed currently has a stated inflation target (2%) and why the new, more open Fed takes great pains to issue lengthy communications and explicit guidance, whereas previous central bank regimes were secretive by design.

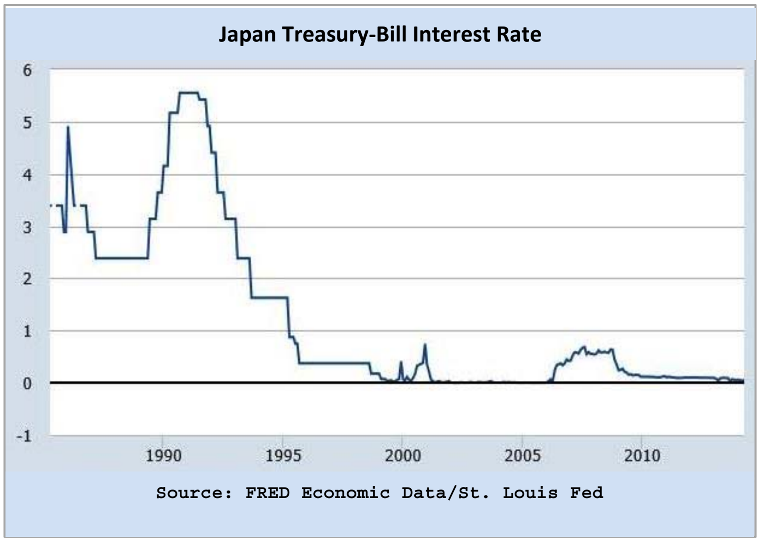
At a time when many are questioning whether the future of the U.S. will look like Japan's lost decade(s), filled with prolonged deflation and economic stagnation, the ideas of Frederic Mishkin and his intellectual brethren provide a ray of hope, of sorts. While these ideas were not embraced by the stodgy central bankers of Japan over the last two decades, they do, however, hold sway with U.S. policymakers today. Indeed, these new "unconventional" ideas have crossed the oceans and seem to be conquering the world.

In Japan, new leaders have taken the reins and "cleaned house" at the Bank of Japan, getting rid of the old intervention-resistant guard and installing the "try anything" Governor Kuroda who has explicitly vowed to end prolonged deflation by purposefully *creating* inflation with a target of 2%. These are powerful words that so far have been backed up by powerful actions, as the central bank has bought massive amounts of government bonds (their own version of QE), which has the effect of putting trillions of new yen into circulation. More recently, even the conservative European Central Bank (ECB), long dominated by the curmudgeonly inflation-fearing Germans, has taken a different and unprecedented step towards expansionary monetary policy. Unlike the U.S. and Japan which have been buying bonds with money that didn't previously exist, the ECB has instead instituted a *negative* interest rate on the deposits of European banks at ECB headquarters. The idea is that banks will stop parking their Euros at the ECB (likely) and instead start circulating them into the real economy via loans (less certain).

A lot of mockery has been made recently over anyone asserting that, "this time is different", but truly, many of these strategies have not been tried before or at least not on the present scale. With this advancement in "monetary technology", as some call it, comes the promise of increased aggregate economic efficiency, less unemployment, and a taming of the business cycle. But, as Mishkin acknowledges above, it carries risks as well, and the most-cited risk is inflation.

Indeed, many old-school economic prognosticators have been screaming about inflation ever since QE was first adopted in late 2008. Remember those days? The economy was imploding, and yet, commodity prices were skyrocketing (Goldman Sachs famously warned oil was headed to $200 a barrel). Surely this inflation of commodity prices was evidence of recklessly easy money policies at the Fed! Well, some six years later the academics and bureaucrats, or "Mandarins" as they are sometimes derisively called, have been decisively right...*so far.* The inflation never showed up (in fact, it's been too low for the Fed's liking)...*so far*. Those last two words are important, but still, the

fact that the Bernanke crowd has been correct so far made us sit up when we heard the 60-year-old bearded former central banker is rumored to have recently said that he doesn't think he'll see short-term interest rates, today around 0%, back to their historical long-term average of around 4% during his lifetime.



Source: FRED Economic Data/St. Louis Fed

This possibility of very low rates for a very long time is in direct conflict with the consensus view that rates will soon rise back into normalcy. While there are tendencies in the economic system that often cause rates to rise after they've been depressed, there is no law of nature that says rates must rebound in any human timeframe. Rates can stay very low for a very long time, and the Japanese experience is the quintessential example. The chart above shows that interest rates on short-term Japanese government bonds have remained below one percent since the mid-90s. Don't count on the conventional wisdom that rates are at rock bottom and about to skyrocket up!

A short digression here about consensus views: when it comes to events (not prices[1]), the consensus view may very well be right the majority of the time...however, you are unlikely to make any good money betting

[1] This is a digression on a digression, but when it comes to consensus on future price movements, the consensus is most likely to be *wrong*. A note of caution, the following explanation is only for the bold or the bored: this is because prices are *reflexive,* meaning that opinions on prices actually affect the prices themselves, quite different from the way that opinions about an event usually doesn't affect the event's outcome. Any consensus on price movements creates a force that moves prices in the direction of consensus until one of two things happen. The first possibility is the price moves along with the consensus until enough people are satisfied, change their views, there is no longer a consensus, and the force dissipates. The second scenario is that before the price moves enough for the consensus to dissipate, another force arises in the contrary direction which arrests the price movement. This force probably stems from fundamentals (not speculation). In this situation, the consensus view doesn't self-destruct because the price movement is stopped. When one observes a consensus in the market, it is often trapped in this second scenario and usually turns out to be wrong because fundamental forces are more durable and powerful in the long run.

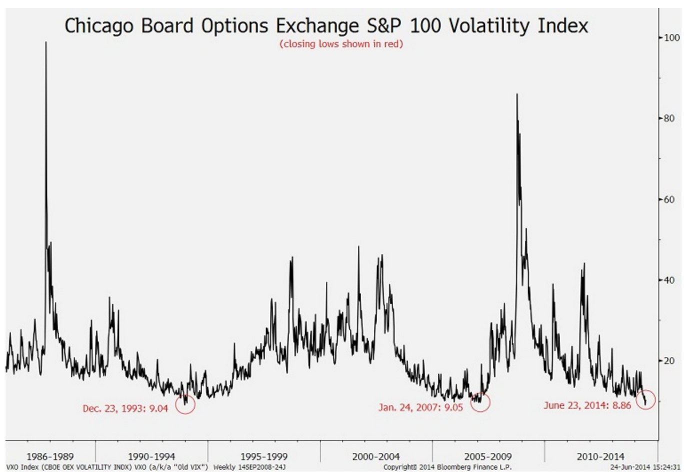
with the consensus, even if the event is a sure thing. For example, Brazil is heavily favored to win the World Cup (we hope they don't...go U.S.A.!), but while they may be the most likely to go on and do so, people's opinions, the consensus, have no effect on this outcome. What the consensus *does* affect are prices, which in this case would be the Vegas betting odds. If you bet on Brazil and they win, the payoff won't be very great because so many people have already placed the same bet, which has moved the odds your bookie will offer. The way betting odds move in accordance with what people expect comes very close to mirroring the way market prices move. In this way, we caution clients from embarking on strategies that bet on interest rates rising. This is a consensus bet. Even if you're right, the payoff won't be great and may not be worth the risk that you're wrong.

Back to the idea that we might have very low interest rates for a very long time. If we are in a new era of extended low interest rates, then comparisons of today's valuation multiples to those of previous eras start to lose their relevancy. It's an apples and oranges comparison because all financial assets *are intrinsically* more valuable and therefore *should* have higher prices when low interest rates prevail. However, if the old-school hawks are right and inflation rears its head, high interest rates will follow and the old valuation models will become *very* relevant and all financial assets will adjust downward, perhaps abruptly. Again, the point here is to not hold too tightly to comparisons with the past because perhaps this time ***is*** different.

Though inflation is the key risk cited in regards to central banks' new-fangled monetary actions, it isn't the only one. In the U.S., some worry that the Fed could lose control of the monetary process in various ways. Without listing all the scenarios, most are low probability, but quite extreme situations that involve a loss of faith in the U.S. Dollar or U.S. debt. A panic or run on either of these closely linked financial assets would be a complete game-changer for everything from politics, to military power, to the economy. Another perhaps unintended effect of current low-rate policies is that by making the government's borrowing very cheap, a natural incentive for Congress to plug the deficit and reduce federal debt is removed.

A related possibility is that the Fed's unprecedented actions also might throw off traditional market signals. For example, first quarter real GDP was just revised to have *fallen* at a 2.9% annualized rate, the lowest reading outside of a recession since World War II. So far we don't hear any voices calling that a recession has begun.

Perhaps the lack of this view being voiced is partially due to the absence of two reliable signals that a recession is coming: a widening of corporate credit spreads[2] and an inverted Treasury yield curve[3]. However...might the Fed's effect on interest rates through its bond buying and all the associated excess cash flooding bank balance sheets prevent the yield curve from inverting before a recession when it otherwise would have...so no one will see the recession coming? We remain wary of the possibility that traditional market signals may be distorted by the unprecedented monetary actions.



Source: Bloomberg

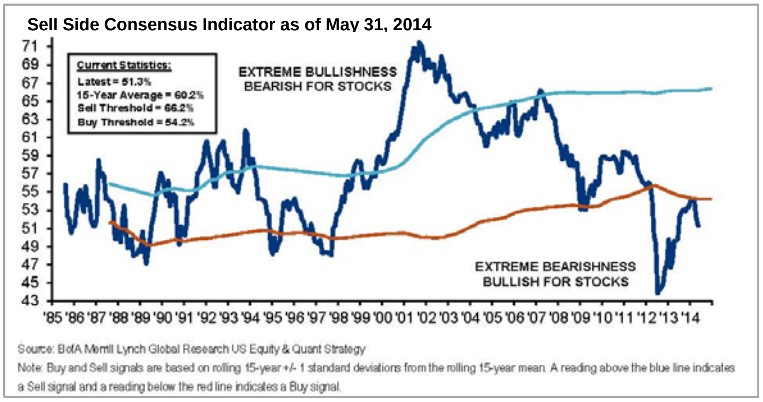
Source: Strategas Research Partners

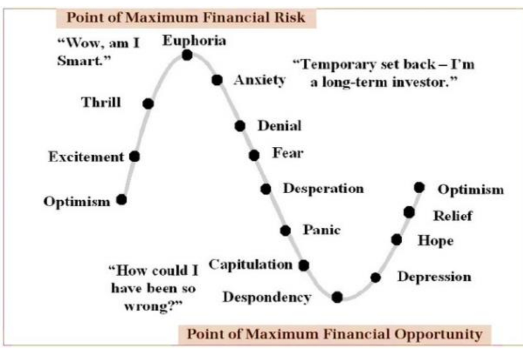
Moving on to stock market activity, U.S. equities trudged through a series of rolling corrections this year: first the S&P 500 Index dropped 6% by early February and then it was NASDAQ's turn, off 9% from its high by mid-April. More recently, small cap stocks dropped 11% between March and mid-May. However, since then things have settled down, with the S&P 500 Index creeping to new all-time highs without moving one percent in either direction on any of the past 50 trading days (the latter a feat not seen in 20 years). In fact, volatility, as measured by prices paid for options on the S&P 100 Index, popularly known as the "VIX" (the most common barometer of volatility in stocks), just hit the lowest level since the measure was created in 1986. Meanwhile NYSE trading volume has been running at decade lows.

Many worry recently diminished volatility and trading volumes signal investors are overly complacent. Maybe...although we would point out

[2] Risky companies always have to pay higher rates to borrow than their more creditworthy peers do. A widening of spreads means that they have to pay even *more* above their peers than they previously did.
[3] Means short term borrowing rates are higher than long term borrowing rates.

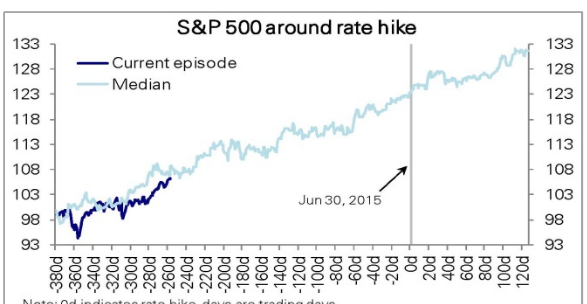
that just like there is precedent for interest rates to remain low for a long time, volatility can and has in the past remained low for a long time too. Our experience indicates that high volatility provides a "buy" signal but low volatility does not provide the converse "sell" signal. While the overall U.S. equity market is no longer screaming cheap, we continue to find individually attractive stocks and there are signs the market wants to go higher. Investors seem more focused on what can go wrong than what can go right...a healthy backdrop. The Wall Street analyst community (the "sell side" - see the above chart) is nowhere near bullish...which is also healthy.





Source: Think Big Blog

We believe in stock market cycles. While difficult to know how stretched these cycles might become horizontally[4] or vertically, we do find the stock market oscillates largely according to investor attitude. Looking at the chart to the left, we would pin current conditions at most in the "optimism" phase, with the "thrill" of investing still to come. While it may be late in the game and require vigilance, we expect there remains money to be made in the market, even if we are climbing in "above average" territory.



Source: Deutsche Bank

What might be the engine for a final equity ascent? Perhaps, as we wrote earlier, the surprise is that interest rates remain low for some time, with funds continuing to slush into equities in search of a higher return. Better yet, investors may win either way, as stocks have tended to rise strongly in the year

[4] Horizontal stretching (especially on an economic-cycle time-frame) can make it feel like the cycle has disappeared altogether, when it really has just slowed down.

prior to the Fed's initial rate hike, currently expected by many to occur during the second half of 2015.

As things change in the markets, so they do at Knightsbridge as well. This summer we welcome Miles Yourman back into his full-time role as a member of our investment team. For the past eighteen months, Miles has been pursuing his MBA at Columbia Business School, the former home of Benjamin Graham and Warren Buffet, where he had the opportunity to learn from noted figures such as former Fed official and Columbia professor Dr. Mishkin. We look forward to benefitting from his new skills and perspectives.

As always, all of us at Knightsbridge Asset Management appreciate your continued support.

Very Truly Yours,

John

John G. Prichard, CFA

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