Argent Wealth Management

QUARTERLY
Investment Outlook

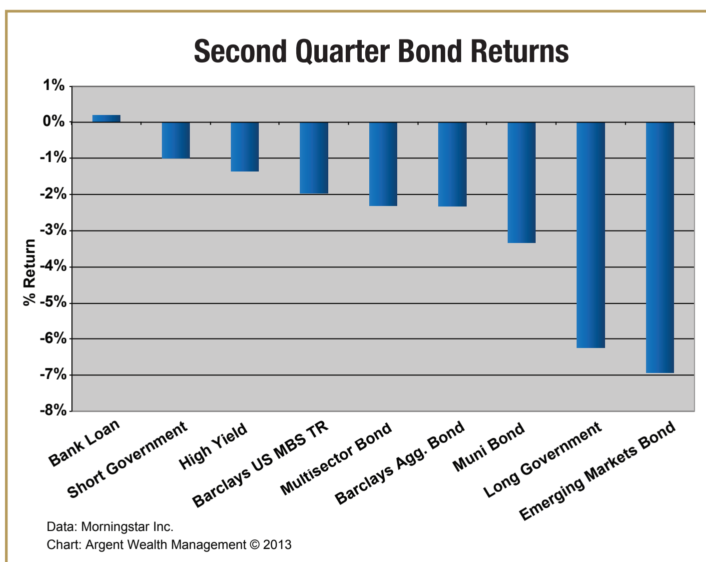
Summer 2013

THIRD QUARTER 2013 INVESTMENT OUTLOOK

Mid-Year Review: Fixed-Income Meltdown

Yields rose sharply over the quarter, resulting in large losses for income-oriented investments. As we noted in our last quarterly outlook, "We believe that it is likely that the Fed will, at some point, begin to reduce asset-purchasing programs that have propped fixed-income prices (and depressed yields). That point may well be sooner than many expect, but most assuredly will be unexpected and unanticipated by the bond markets."

That tipping point arrived in a big way. On May 22, Fed Chairman Bernanke revealed a plan to scale back and ultimately eliminate asset-purchasing programs. He noted that the plan is dependent upon the economy growing rapidly enough to meet economic "markers" the Fed has established for employment conditions (the unemployment rate) and inflation. Perhaps more shocking to market participants was the release of the Fed's significantly upgraded economic forecast. It is no surprise that the market abruptly priced in a reduction in asset purchasing as soon as the Fed's September meeting.

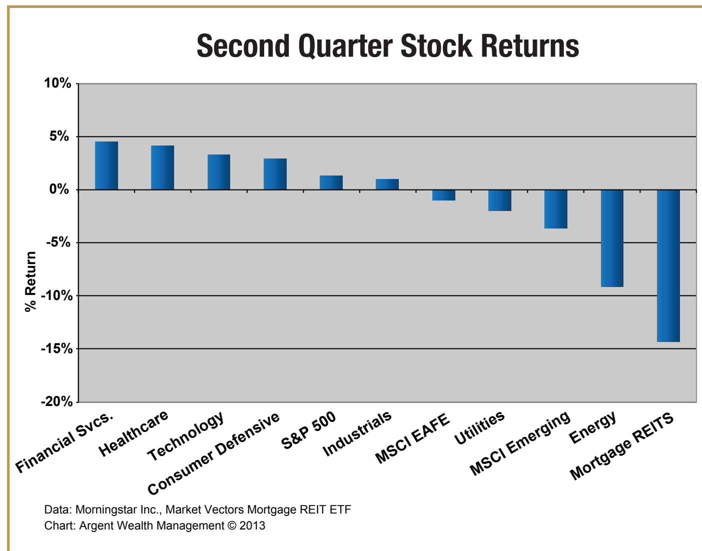


It is not an overstatement to call the resulting bond market sell-off a meltdown. Price losses were staggering and widespread. According to Ned Davis Research, investors dumped a record $67 billion of fixed-income assets over the last five weeks. Bond managers scrambled to sell securities to meet redemption activity. That process was not pretty. Bid/offer spreads exploded and a number of fixed-income markets were disorderly, as billions of dollars of liquidations struggled to be placed elsewhere.

We believe Congress' actions to remediate Wall Street's sins following the 2008 market collapse exacerbated the pain. Broker dealers and banks were slapped with stringent additional capital requirements and prevented from performing "proprietary trading" operations. Those changes greatly reduced liquidity in the bond markets and increased transaction costs. Perhaps this is not what Congress had in mind when it "reformed" Wall Street.

Pain was not at all restricted to fixed-income assets. As we also highlighted in our last quarterly report, assets across a wide spectrum of "yield-oriented" sectors were all highly correlated in the sell-off. These affected assets included Utility Stocks, REITs, MLPs and High Yield. An extreme example of this was the Mortgage REIT sector, which fell a staggering 14% over the quarter. OUCH.

Equity markets finished the quarter with moderately positive returns. However, dispersions across sectors were huge. At the bottom were the interest rate-sensitive Utilities and Telecom sectors — the very same supposedly defensive areas that had led the market earlier in the year. These sectors experienced a double whammy of being quite expensively priced and highly correlated with interest



rates. That combination resulted in a lot more downside than many investors might have anticipated. For example, Utility Stocks fell 9% in May alone — hardly "defensive." This correlation problem is the most vexing of all for conservatively oriented investors. Unfortunately, correlations are not stable over time. Assets such as a Utility Stock and a High-Grade Bond, for example, may appear to be nicely independent and diversified. However, during sharp rises in interest rates (as happened this past quarter), these sectors are highly correlated at exactly the wrong time — as prices are falling rapidly.

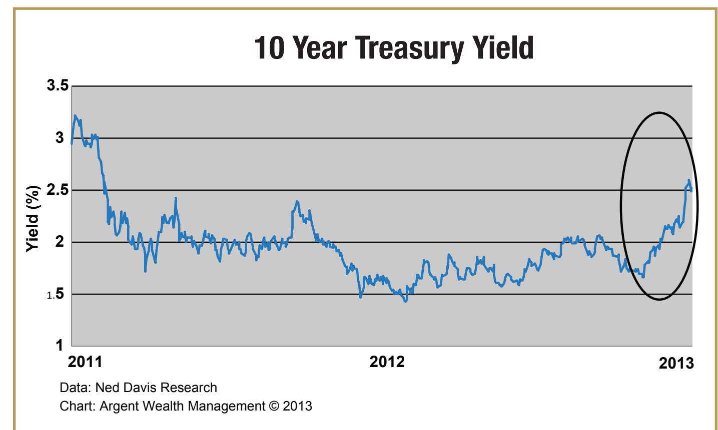
Conservative investors were stunned by the amplitude of losses and the large number of highly correlated sectors. Having large allocations, high correlations and larger-than-anticipated price declines is a toxic combination. The result is a much larger loss on a portfolio than anticipated.

While our clients most certainly did not avoid all of the damage, we were able to minimize the pain. We work extremely diligently to construct truly diversified portfolios. That means not just understanding the past correlation among securities but also anticipating how those correlations might change under different scenarios. We entered the period with virtually zero exposure to the higher-grade fixed-income sectors and greatly reduced exposures to other assets that performed poorly over the period.

Is the Fixed-Income Sell-Off Over?

In the near-term, we think the answer is "yes." Yields have risen very sharply over a short period of time, and redemption activity appears to have peaked. Importantly, any material additional increases in yield levels from current levels would depress lending activity across a variety of sectors, such as Real Estate. The economy would slow as a result and push back the timing of the Fed reaching markers to begin reducing asset-purchasing programs. In effect, the market has significantly tightened monetary policy.

With economic activity still fragile, the Fed does not want any additional tightening of monetary policy at this time. However, containing market interest rates is tricky. The Fed must also be mindful of maintaining credibility, and



contradicting prior statements could backfire. We expect them to walk a fine line, calming market fears by suggesting uncertainty and moderation about the markers being

achieved and the timing of asset purchasing. They will be careful to avoid contradictions about prior messages. Importantly, interest rates are global in nature. At virtually the same moment that the Fed introduced the concept of scaling back asset purchasing, the European Central Bank (ECB) revealed, in a stunning change of policy, that their interest rates would stay at very low levels or even possibly go lower. The ECB strongly suggested this policy of super-low interest rates would be in place for a long time. The clear intent of this policy was to prevent European bond rates from rising in sync with the rise in Treasury yields.

While we believe interest rates on U.S. Treasury Bonds will ultimately rise a lot more, that process will take a number of years. It may well evolve in a "stair-stepped" manner, such as the sharp adjustment we just experienced followed by periods of consolidation and even retracement.

Pressing the "Reset" Button for Some Income Sectors (Preferred Equity and High Yield)

The large drop in prices and indiscriminate nature of the sell-off in income-oriented assets has created a number of excellent opportunities. Some sectors that are unusually sensitive to retail redemption activity have dropped disproportionally in value. The challenge is to isolate the highest-quality assets at the widest discounts to fair market value.

At the top of our current list of opportunities are hybrid assets such as Preferred Equity. Several closed-end funds that hold such assets can now be purchased at deep discounts to NAV and with yields in the 8% range. These high-quality assets are senior to debt securities and issued by a wide number of Commercial Banks, Insurance Companies and other sectors. Most of these sectors have improving credit quality and increasing capital ratios. We find the combination of income, credit quality and appreciation potential to be attractive.

We also are finding compelling opportunities and attractive valuations in some of the credit sectors, such as High Yield. In contrast with comparable Treasury or higher-grade bond sectors, prices dropped disproportionally (and yield levels rose substantially more). However, default levels remain at historically low levels, and

High Yield Valuation

High Yield Valuation	Average	Latest
High Yield Spreads	5.90%	5.40%
High Yield Defaults	4.20%	1.10%

Data: J.P. Morgan Asset Management: Guide to the Markets
Chart: Argent Wealth Management © 2013

most issuing companies have done an excellent job of refinancing higher-cost debt, extending bond maturities and building liquidity. That suggests to us that default levels will remain quite low for at least a few more years. However, just because a sector sold off dramatically does not suggest it is a bargain and will rebound in price. Certain sectors were grossly overpriced and potentially flawed in construction, so a cheaper price does not make them appealing. For example, we would not suggest purchasing Mortgage REITs given the substantial leverage and huge volatility.

We are also not attracted to higher-grade fixed-income securities, even following such a sharp rise in yields. While there may well be a period of consolidation and a moderate rally in these sectors, yield levels are still quite low by historical standards. We will continue to sharply underweight these sectors.

Emerging Markets and Commodities

Both of these sectors have been hit with the perfect storm so far this year. Even before the Fed's actions, these markets were weak due to fears of a slowdown in China, among other risks. The U.S. dollar rally had also made investments in these areas less appealing. The Fed's actions exacerbated this "negative feedback loop," as they are quite sensitive to market liquidity.

Unlike with many income sectors, we believe the longer-term trends are positive. China and other Emerging Market economies will continue to place strains upon commodity sectors, and marginal costs of production are increasing. Once the current weaker patch of global economic growth runs its course — which we think it will sometime in the second half of this year — prices should firm.

Emerging Market Valuation

Emerging Market Valuation	Price/ Earnings	Median Price/ Earnings	Standard Deviation from Median
Brazil	9.8	16.8	-1.58
China	14.2	22.4	-1.18

Data: Ned Davis Research, Cyclically Adjusted Price/Earnings
Chart: Argent Wealth Management © 2013

Importantly, the economies of many Emerging Market countries are sound and improving. Countries such as Brazil and Mexico have made large strides in reducing inflation, increasing growth and balancing budgets.

We favor a broad range of Equity and Debt in the Emerging Markets as well as Commodity sectors. We find entry prices compelling, although we realize the negative momentum could last a while longer. In our view, the odds strongly favor currency appreciation over the next few quarters, if not years, as the strong dollar trend abates. Significant redemption activity of retail investors strengthens our conviction, as we believe the weaker hands have exited these categories.

Fortunately, these areas can appreciate very sharply when negative trends abate. They are sensitive to liquidity and cash flows, which obviously works in both directions. Inflexion points are inherently unpredictable, and a significant portion of an entire market's advance can occur over a relatively short period of time. That is why we believe it is prudent to maintain our positions now.

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All of us at Argent thank you for your continued support and confidence.
If you know of anyone that might benefit from Argent's services, we would welcome the opportunity to discuss their particular situation with them.