Argent Wealth Management
QUARTERLY Investment Outlook
Spring 2014

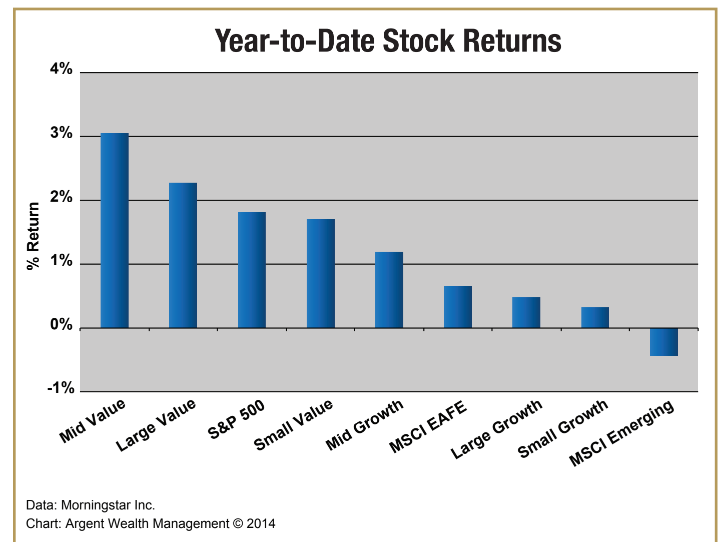
SECOND QUARTER 2014 INVESTMENT OUTLOOK
FIRST QUARTER 2014 REVIEW

Fed to Financial Markets: No More Training Wheels

Ever since the "Great Recession" and global financial meltdown, the Fed has taken extraordinary actions to provide liquidity and support financial markets. At any material sign of weakness in equity or credit markets, the Fed has come to the rescue. That has inflated the value of financial assets and lowered market volatility. It has also reinforced a "buy the dip" mentality among investors. Why would you not buy the dip knowing there was a safety net?

In recent Fed minutes and the ensuing press conference, new Fed Chairman Janet Yellen made it very clear that the training wheels are coming off. The Fed further reduced the asset purchasing program (the so-called QE) to a pace of $55 billion per month and reinforced the plan to wind down this program completely by year's end. She then made a rookie mistake (in the context of an otherwise excellent performance) by defining the term "considerable period" as something like six months before the Fed would start raising shorter-term interest rates after tapering ends. The yield on a five-year Treasury note jumped an astonishing 20 basis points in just minutes.

The Fed abandoned the previous "marker" of a 6.5% unemployment rate for starting the process of raising interest rates in favor of a host of indicators for employment conditions and inflationary expectations. That will make upcoming economic data critical. Any indication of acceleration in economic growth, tightening labor conditions and/or deteriorating inflationary expectations will be a problem for the fixed-income markets and potentially equity markets as well.

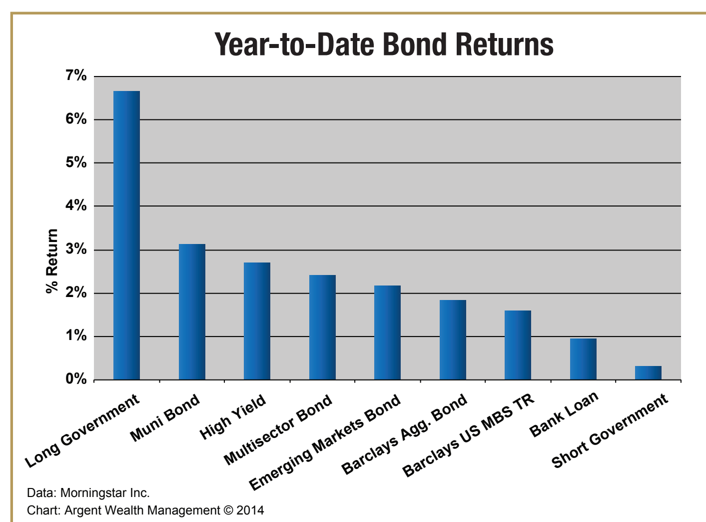


Recent market performance may provide a sneak peek into the potential shifts in market leadership. For example, the smaller-capitalization Russell 2000 Index has corrected very sharply over the past several weeks. The more speculative (i.e. more growth-oriented) biotech sector has corrected much more violently than the index as a whole. The NASDAQ has experienced a similar shift in leadership. These more speculative sectors are highly valued by any measure and have been supported by the Fed's largess.

Meanwhile, non-U.S equity markets have started to improve materially versus U.S. markets. While the Fed has clearly indicated a desire and path to exit quantitative easing and eventually raise interest rates, other central banks are not going in the same direction. The European Central Bank, for example, is positioned for an additional reduction in shorter-term interest rates (along with potentially other extraordinary actions) to deal with a still-falling inflation rate. The Japanese are stimulating their economy at roughly three times the relative magnitude of the Fed.

We believe this stark contrast in the eventual tightening of U.S. monetary policy and further accommodation of many non-U.S. economies are a big deal for equity market leadership. Broadly speaking, we favor non-U.S. assets.

Ironically, U.S. fixed-income markets enjoyed a very nice quarter. That was consistent with our view from our last quarterly that yields were at a reasonable level and certain "credit" markets (e.g. High Yield) were attractive. A key reason for this seemingly inconsistent performance was a U.S. economy that was uneven, at best.



However, with a 10-year Treasury bond now yielding a meager 2.7% and credit spreads in many markets at razor-thin levels, we feel the best fixed-income performance is now behind us. Any hint of economic data pointing to the Fed raising rates should prompt a swift sell-off. This repricing of yields may not be as aggressive as last year's May-to-June debacle, but the pattern may be similar.

Expect Higher Market Volatility

The most direct consequence of the Fed's training wheels coming off is a shift to higher market volatility. That does not necessarily entail a bear market, but more significant equity market corrections seem inevitable.

The recent shift in equity market leadership to larger capitalization and more predictable companies should continue for some time. These areas have much more favorable valuations. They also may become the natural focus of investors as market fluctuations become more pronounced. Conversely, the much more volatile smaller-capitalization growth sectors are extremely unattractive, in our view. We fully admit and accept not having been overweight in these sectors last year during a spectacular advance. We could not be more strongly underweight now.

The recent fiasco of the IPO for gaming company Candy Crush (King Entertainment) highlights our concerns. This company sold at a huge valuation. While it owns an incredibly hot and addictive game, there are no barriers to entry in one of the most crowded and competitive markets we know. Anyone with a laptop can create the next hot game, and we have no idea how this company can create a sustainable, competitive advantage.

This IPO reminds us of a similar extreme during the last tech bubble: Pets.com. Remember the infamous and incredibly expensive ads featuring the sock puppet that ran during the Super Bowl? The ads were captivating and funny. But the business model did not work, and the company went bankrupt just 278 days following it's much hyped IPO.

In contrast, many of the larger-capitalization sectors look attractively valued compared to the rest of the equity market. These kinds of companies (think IBM) have huge barriers to entry, recurring revenue streams, and highly predictable and sustainable profits. We believe investors will increasingly migrate to these kinds of companies as volatility increases.

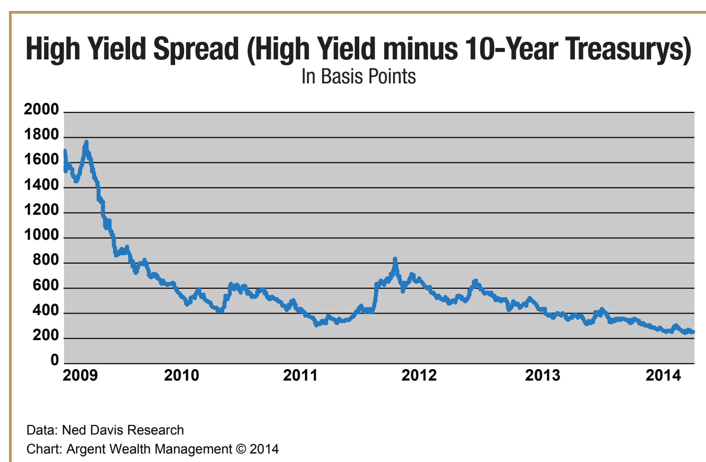
Interest Rates Are Now Set to Rise

We were distinctly not in the consensus of opinion late

last year and into this year that interest rates were certain to increase. That controversial view served us well, as there were some attractive areas within fixed-income and other yield-oriented markets from which we were able to profit. Examples include High-Yield Corporates, Preferred Equity and Mortgage Bonds.

Where we continue to sharply differ from market consensus is that this adjustment to higher yields will not assume a smooth, linear pattern. Much more likely, this shift will be episodic in nature, with periods of abrupt increases in yields and commensurate decreases in bond prices. These periods of sharp adjustments may be followed by longer periods of a sideways pattern in yields. There may well be some substantial opportunities that are created and periods where yields fall again, even if the longer-term pattern is toward higher yield levels.

For now, we believe it is critical to trim exposure to areas sensitive to interest rates. That includes both fixed income and areas of equity markets that are sensitive to rising rates, such as Utilities and REITs.



It is also critical to trim credit risk selectively. Areas such as the High-Yield Corporate market are now at the narrowest spreads relative to Treasury bonds in history. The absolute yields are also the lowest in history. It is not a hard call in our judgment to be reducing exposure now.

Inflation Protection May Finally Matter

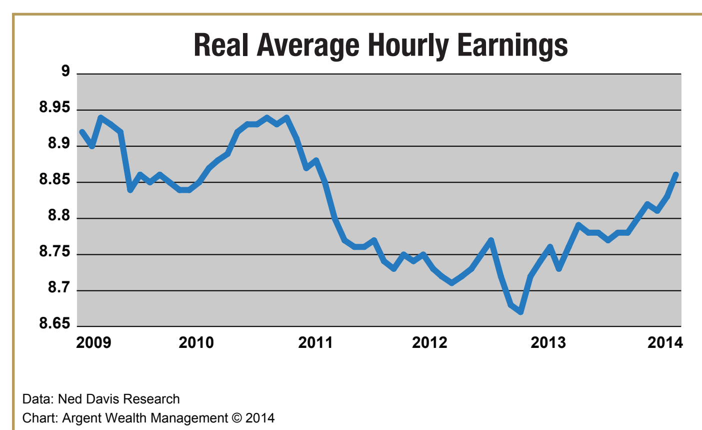
There may be no more confusing and controversial subject than when, and if, inflation will increase. The more traditional economic forecasters have been incorrectly predicting a sharp increase in inflation for some time now. What this more traditional view may have been missing is that "credit contractions," such as what occurred in 2008, are extremely disinflationary. That is why the Fed and other central banks took such aggressive and extraordinary actions. Had these central banks not acted as they did, a complete collapse in the financial system and a depression, not Great Recession, were possible outcomes.

Credit contractions take a long time to work through the economy. By their very nature, every sector of the economy goes through a painful deleveraging process. Debt must be paid down, bad debts must be written off, and balance sheets must be rebuilt. That is true whether you are a consumer, a business (e.g. a commercial bank) or a government.

There is now a growing list of factors that suggest the process of deleveraging is largely complete. Thanks to home prices broadly rebounding, better employment conditions and inflated financial markets, the consumer is feeling pretty good. Bank balance sheets are robust. Loan demand is finally starting to increase. Even the government, particularly state and local governments, is feeling pretty flush.

Inflation may now be closer than we think. Importantly, financial markets will not wait around for actual increases in headline inflationary measures such as CPI. These will be the last inflationary indicators to move significantly. By that time, markets will already have experienced major adjustments.

We are closely watching the leading indicators that would suggest this change is underway. Some of the



best of these early indicators are found in credit conditions (e.g. bank lending standards, corporate credit demand, consumer loan growth) and in wage trends (see chart). A meaningful increase in inflation cannot occur unless credit is expanding and wages are growing.

We are building in and maintaining exposure to certain inflation-friendly asset classes now. Commodities are the first and most significant sector to have some exposure. We have held some exposure here, and it has not been easy or comfortable. More recently, we have been adding Real Estate exposure. Within Real Estate, we think certain areas will (or will not) do particularly well during an increase in inflation. We would expect to continue adding exposure to these promising areas if inflation finally does turn the corner.

Managing Total Portfolio Risk

With interest rates low, credit spreads tight and equity markets highly valued in certain sectors, it is critical to be extremely attentive to the aggregate amount of risk in any portfolio. This is not a time to be stretching for return, in our view. It is a time to be making sure risk is reasonable across all appropriate factors and protecting portfolio value.

We believe the most successful investors will be highly attentive to market risk now. By the time any of these risks are present, it is simply too late to make proper adjustments.

Finally, we look at the anticipated increases in market volatility as a friend, not an enemy. This will create many opportunities for the prepared, prudent investor. It will not lift all boats, however, as when the Fed had the training wheels firmly attached. So it will be critical to construct portfolios in a disciplined and thoughtful manner.

Past performance is no guarantee of future results. Charts presented in this article are not indicative of the past or future performance of any Argent Wealth Management strategy. This article has been distributed for informational purposes only and is not a recommendation or offer of any particular security or investment strategy. Information contained herein has been obtained from sources believed to be reliable.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Argent Wealth Management.

Argent Wealth Management is registered with the Securities and Exchange Commission (SEC) as a Registered Investment Advisor

© 2014 Argent Wealth Management, LLC. All rights reserved.

404 Wyman St., Suite 375 • Waltham, MA 02451
T 781-290-4900 • F 781-290-4920
www.argentwm.com
contact@argentwm.com

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.