Second Quarter 2013 Commentary

Last quarter we reported to you that both the S&P 500 and the Dow Jones Industrial Average closed at all-time highs. In the ensuing three months, both indices climbed further still, setting new records in the second quarter. Including dividends, the S&P 500 advanced 2.91% in the quarter, and the Dow increased 2.92%.

April and May were both positive months for the stock market, but June registered a decline due to recent comments from Federal Reserve Chairman Ben Bernanke. Though his remarks about the eventual tapering off of the Fed's bond-buying were widely anticipated, they still sent ripples throughout financial markets around the globe.

While stocks were off slightly after the Fed commentary, the bond market experienced a significant jolt. Rates on 30-year mortgages increased from 3.5% to 4.5% in about a month. Interest rates on Treasuries and corporate bonds are also up, which raises the question of how that will impact the economy overall and the stock market in particular.

Will Rising Rates Cause the Stock Market to Sink?

In a June 27 article, the Wall Street Journal asked various people their views on the matter. The CEO of a construction equipment manufacturer said rising rates cause him to be more hesitant to invest in his business, but the SVP of a large homebuilder says he is unconcerned because the underlying reasons for the rate increase are a stronger economy and an improving job market.

Wider opinions seem to be just as evenly split. Some see impending doom, while others are more buoyant. Invoking the classic Mark Twain quote about how history does not repeat itself but it often rhymes, we can look to the last time the U.S. experienced swiftly-rising interest rates to see if that gives any indication for what's in store for us today.

At the beginning of 1994, the 10-year U.S. Treasury note was yielding roughly 6%, about in-line with where it had spent the previous couple of years. By the end of 1994, that rate had climbed to over 8%, a relatively swift rise, as the central bank raised short-term rates in order to deal with fears of rising inflation.

According to a recent Wall Street Journal article, market reactions were not good. "Bond markets plunged and investors suffered big losses. The fallout helped sink brokerage firm Kidder, Peabody & Co., pushed Orange County, Calif., into bankruptcy and wiped out a hedge fund run by Askin Capital Management that had made leveraged bets on mortgage-backed securities."

All of which sounds like very bad news indeed. However, over the ensuing five years the S&P 500 advanced by an average of 29% per year and U.S. GDP advanced steadily.

The lesson we take from this is that there will always be unintended consequences.

The Farmer and His Horse

Perhaps you have heard the fable about the farmer who had only one horse.

One day his horse ran away, and his neighbors said, “We're so sorry. This is such bad news. You must be so upset.” The farmer said, “We'll see.”

A few days later, the farmer's horse came back with twenty wild horses. His son helped him to corral the 21 horses. The neighbors said, “Congratulations! This is such good news. You must be so happy!” The farmer replied, “We'll see.”

One of the wild horses kicked the man's only son, breaking both his legs. The neighbors were so upset: “We're so sorry. This is such bad news. You must be so sad.” The farmer said, “We'll see.”

Later, his country went to war, and every able-bodied young man was drafted to fight. The war was terrible and killed most of the young men. The farmer's son was spared, though, since his broken legs prevented him from being drafted. The neighbors were happy for him: “Congratulations! This is such good news. You must be so glad!” As usual, the farmer just said, “We'll see.”

Conclusion

In the big-picture macro-economic situation, it is practically impossible to anticipate the outcomes of various stimuli. So we don't even try. After all, there is a very good reason why we refer to them as "unintended" consequences.

We simply focus on the fundamental financial characteristics of individual companies, and we build your portfolio from that analysis. It is a method that has served us well over the years, and we believe it will continue to do so in the future.

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