April 17, 2013

"Japan Doubles Down"

I hope you and your family are well since the last time we talked.

A lot has happened in the last quarter. Fortunately, we know the US economy has continued to grow. We won't have an idea how fast until April 26th. Real GDP increased 2.2% in 2012 to $15.86 trillion, compared with 1.8% in 2011. Most estimates for 2013 are still in the range of 2% to 3% growth, and we expect to pass $16 trillion.

Most of the data coming out has been positive. I'll mention only a few points. Housing starts were just reported at 1.04 million, the highest since June 2008. Housing made a positive contribution to GDP in 2012, the first time since 2005, and most economists are expecting another contribution to growth this year. Starts are currently more than 40% higher than a year ago (1). Edmunds.com is estimating US car sales at 15.5 million vehicles this year. According to WardsAuto Group, car sales were 10.6 million in 2009, which was the recession low point. These stats, and many others, show us that the economy has indeed improved and come a long way from the bottom of the recent recession.

There's a strong possibility that the US government's budget deficit will be below $1 trillion this year for the first time in five years. The nonpartisan Congressional Budget Office (CBO) is projecting a total deficit of $845 billion at this time. While this is good news, it's all relative. In the previous four years we have added over $5 trillion to our nation's debt and it seems unbelievable that in 2007 our annual deficit was only $163 billion. Is it any wonder that all you ever hear about is the deficit and Quantitative Easing (QE)?

This leads to what I believe is the number one issue facing investors today and that is the Fed exit strategy. How is the Fed going to bring this extraordinary period of stimulus to an end and what does the timetable look like? This topic is under constant discussion in the financial world today. Some people think this "exit strategy" could start as early as the second half of this year, many others in 2014 or 2015. One Fed governor was quoted as stating this program could continue until 2023 if necessary, and some market participants believe it's already too late and we will never be able to get out of this.

This is not merely an academic question. How this is accomplished (or not) will affect every one of us. History makes it abundantly clear that we cannot continue to create money out of thin air forever. We are devaluing our currency and at some point that will have very bad consequences. There are many ways this program can be tapered off and eventually ended. I've read quite a few different scenarios, but the most important thing to realize as investors is that there will be an increase in turbulence and volatility.

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As soon as the market gets the slightest sensation that the money printing is over there will be a reaction. I view this as unavoidable, and I believe we will basically have to sail through it with some adjustments to help cushion the effects if practical. I don't personally think that stocks or bonds will crash, but they will experience a period of adjustment as the market tries to find the correct value with the winding down of stimulus. I think this is a good thing in the long run and we will be much better off. My understanding of history leads me to believe that the results will be much worse in the long run if we are not successful at exiting QE.

Japan has made headlines in recent days by their announcement of essentially unlimited yen printing. They have been mired in deflationary cycles for so long now they are very desperate. They have announced plans to double their monetary base over the next two years to try and reach a 2% inflation rate. The problems in Japan are absolutely huge and are outside the scope of this letter. However, some very prominent market participants believe that this is literally the beginning of a death spiral of the Japanese currency, the yen. They believe they have passed the point of no return and this can only end with some type of default. You also hear more about possible currency wars these days. Things are very edgy out there, and this massive printing by Japan may force other nations like the US and the Eurozone to follow somewhat against their will. This could blow up the Fed exit strategy and thus, we will be following the news coming out of Japan carefully. While we have recently experienced a notable correction in gold, I think large currency devaluations could quickly rekindle demand for gold as an alternative, and we do not intend to abandon the gold market.

To conclude for this quarter, we are positioned for a continued slow expansion of the US economy. The risk out there still seems much higher than in "normal" times, and we are keeping our portfolios moderate. Please feel free to contact me anytime if you have questions or comments.

(1) www.census.gov

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