Give Me A Trillion Dollars…And I'll Show You A Good Time

With the U.S. Federal Government continuing to buy $85 billion every MONTH in US Treasuries and mortgage backed bonds, the Feds are doing everything they can to stimulate the economy.

Central banks world-wide are taking similar steps to stimulate investors' faith in financial markets. In doing so central banks around the world –US and Europe especially—are ***encouraging movement into "riskier" assets (stocks) in the face of sluggish economic growth, continued concerns about European disruptions and lingering worries about geopolitical risk***. Of course, the fact that interest rates remain anemically low is pushing investors even harder.

There are results and consequences to this activity. If you throw a trillion dollars at something, you will definitely affect the outcomes.

Interest Rates: ***A primary target is to manipulate the fixed income markets by driving up demand—which in turn lowers interest rates***. The result of this is that any investor crazy enough to lend money to the federal government for the next ten years will earn a whopping 1.855% per year—before taxes and inflation. This is great if you are looking to secure a mortgage—and really bad if you are an investor needing interest income. The outcome in Germany is quite similar as a 10-year German government bond yields 1.29%. There are currently 38 nations pursuing a "zero-interest rate" policy.

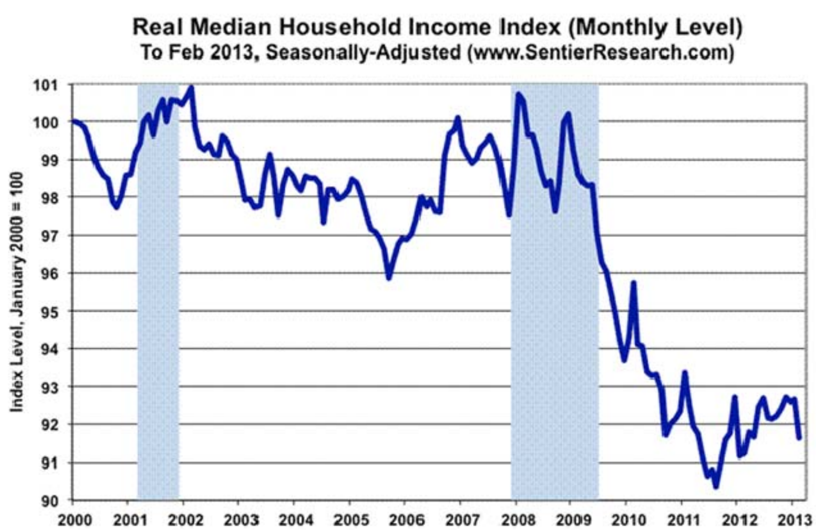
Housing: The ***housing market continues to stabilize***—aided by a gradual recovery and ridiculously low mortgage rates. Home prices in the largest US markets increased 8% in January—the largest gain since 2006. Some of the markets with the biggest price increases were also the ones hardest hit by the downturn in 2008-2010. In general, this recovery is a positive for many parts of the nation.

For the most part, Texas never experienced the big spike in housing prices and did not suffer from the fall either. However, the ***strength in the Texas economy continues to challenge the affordability of housing.***

Inflation: A ***negative outcome of this stimulus is inflation***. We are repeatedly told by the US government that inflation is a benign 2%. We find this very hard to believe. In an attempt to verify our concerns, we reviewed the World Bank's Commodity Price Data which tracks the price changes of 26 different commodities. In many instances, these building blocks of society have tripled and quadrupled since 2006. For the non-math gifted a tripling of prices in six years is a 20% annually compounded increase and a quadrupling of prices over six years is a 26% compounded increase.

Real inflation (the increase in the cost of life as felt by our clients) continues to go up as a result of the US government "printing money." When the government goes into the open market to buy up mortgages and bonds with money it does not have—it must essentially print money which in effect, dilutes the purchasing power of the US Dollar relative to world currencies.

Further compounding the inflation discussion is the lack of household income. According to the New York Times, February's median annual household income was 5.6% lower than in June of 2009, 7.3% lower than in December 2007 and 8.4% lower than in January 2000.



Source: John Williams and ShadowStats

Given that approximately 70% of GDP is consumer spending—***it is very difficult to have a meaningful economic expansion when the average house is bringing home less cash—and worse—the money they are bringing in is buying fewer and fewer goods and services***.

The increase in the cost of living continues to be one of our main concerns in managing portfolios for our clients. This is especially true for clients that are retired and cannot go back into the workforce to replenish their purchasing power.

The Stock Market: As the bell rang closing out the first quarter, both the S&P 500 and the Dow Jones Industrial Average indices sat at new all-time highs. In general, our clients did well last year and have continued to benefit from the advances logged in 2013.

Foreign investments did not do as well. The MSCI EAFE (tracks developed markets outside the U.S.) returned less than half the return of the Dow. Emerging markets lost ground in the quarter, with the MSCI ***Emerging Markets price-only index declining 2.1% in dollar denominated terms***. We have had little direct exposure to these markets for since July of 2011. Although we know there are opportunities outside the US—we do not believe there is sufficient clarity to warrant pursuing these markets directly at this time.

The US rebound from the lows in March of 2009 has been nothing short of miraculous. And although this rebound is not a signal that all is well in the world—it has significantly bolstered the balance sheets of our clients.

The US continues to have significant hurdles to overcome. ***Real unemployment continues to be quite high as the Labor Participation Rate is at 63.5—the lowest level since 1978***. Furthermore, despite the sequester—we have yet to do anything meaningful to curtail the expenses associated with social entitlement programs (Social Security, Medicare & Medicaid).

Despite this, our long term clients have benefitted from diversified portfolios that stayed invested—therefore benefitting from the rebound.

We continue to believe that ***the stock market offers the best "relative" value in the world today—for long term investors***. However, that does not mean that the stock market is a panacea. Conversely, the stock market was a far better value in March of 2009—when it was at its most volatile. As more and more investors flood into the stock market—especially the US stock market—it continues to drive up risk and drive down return potential.

We continue to hold a good amount of liquid securities. These assets will provide lower returns—but they offer stability and options in the long term management of a portfolio.

Furthermore, ***the stock market is not nearly the bargain it was just a few years ago***. Additionally, as other investors come off the sidelines and pile money into stocks—it will cause stock markets indices to go up—but not for fundamental reasons.

Ironically, current profit margins are 70% above the long term norm. This sounds like a good problem to have—and it is—but it is most likely to be relatively short lived. Usually, profit margins will revert back to their long term averages. We believe that the current margins are due to corporations running very lean and not reinvesting for long term growth. This will boost profit margins over short time frames—but can be harmful over long time periods.

Another metric which gets our attention is the ratio of total market capitalization to Gross National Product and Gross Domestic Product. Both ratios stand about 104% today. This is not necessarily a "danger, run quickly" figure—but it reiterates that the US stock market is not the bargain it was a few years ago.

In the early '90's these ratios stood at 50% (indicating buy heavily) and in 2000 they stood at more than 150% (highly overvalued).

Although we do not look at broad macro-economic figures to make individual investment decisions—we still pay attention to the overall values in everything we do.

Acknowledging the challenges we face in the world of investing today—we remain cautiously optimistic.

One final note—April marks Sather Financial's 14th anniversary. It has been an amazing, challenging and very rewarding 14 years. However, without very loyal and fantastic clients—we would not have a reason to exist. Given this, we hope you will join us at our annual client appreciation get together on Thursday April 18th at Fossati's (101 S. Main in Victoria). Drinks and snacks will be served from 5PM until 8ish.

We hope to see you there.

Sincerely,

Dave

Warren

Dave Sather, President
CERTIFIED FINANCIAL PLANNER™

Warren Udd
CERTIFIED FINANCIAL PLANNER™