BLUE WATER'S Market Perspective

May/June 2013

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We welcome back all of our long-term readers, and in addition we extend a warm welcome to those who are new readers. Here is the Table of Contents for this issue:

We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions.

Also, please visit our revised and updated website at www.bluewatercapitaladvisors.com, and our blog at http://bluewatercapital.wordpress.com.

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Economic Commentary:

Home Sweet Home

By Kevin M. Wilson

The American Recovery Continues In Spite of Everything

U.S. economic data are still mixed, but have been improving in the last month or so.[1] First Quarter GDP growth was revised downward to 1.8%, but U.S. housing and consumer services have done well lately, and sluggish growth is far better than none. Global economic data have been weaker over time, suggesting to some that a global recession is possible; however, in June the data appear to have improved, and perhaps a renewed global recovery led by the U.S. will transpire over the coming months.[2] One thing that makes interpreting the global situation a bit more complex is the fact that the U.S. dollar has been rising, as have U.S. bond yields. A rising dollar trend has commonly been associated with global deflation, and there is certainly plenty of evidence to support such a global trend.[3] For example, inflation rates are declining (while still positive) in the U.S., the Euro-zone, a range of emerging market economies, and China. Price trends for manufactured goods are actually negative (deflationary) in Korea, Taiwan, and China. In the U.S., inflation expectations have fallen dramatically, to only about 2.25% over the next ten years.[4] The implication is that global growth will be slower going forward, and declining commodity prices (except for oil) seem to confirm this.[5] Oil has bucked the downward commodity trend because supply constraints are still important, even in a slow global economy.[6] It is important to note also that there are two kinds of deflation: one that is benign and which represents periods of relative peace in the world, and one that is destructive and commonly associated with financial crises.[7] It is not pre-determined then that this exported deflation is a bad version, and it is reasonable to hope that

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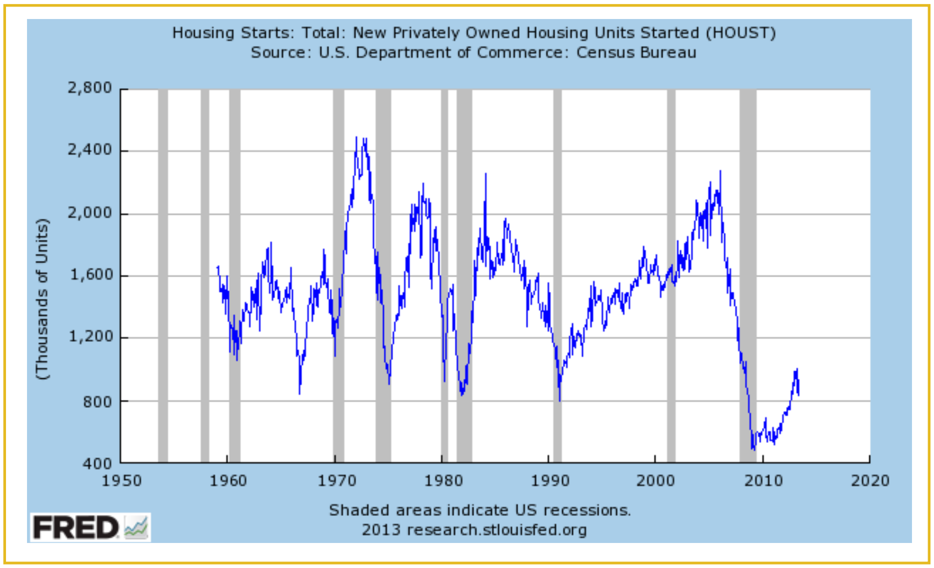
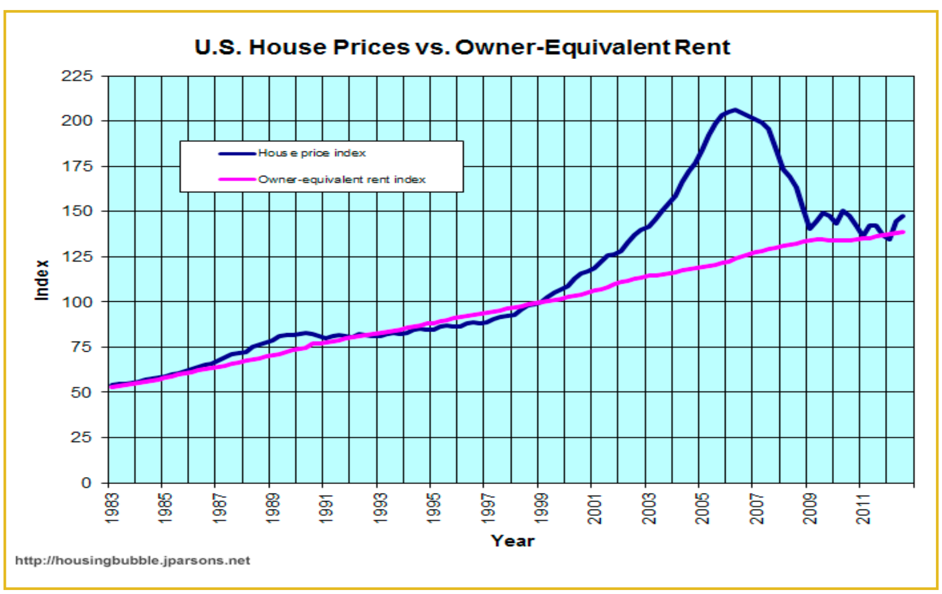
Home Sweet Home (Continued)

if it is benign, global growth will continue and stock markets will rise.

The main tail risks to a continued global recovery are well known: 1) a Chinese hard landing (recession) in the midst of major reform efforts; 2) a Japanese financial meltdown if "Abenomics" (Japanese Prime Minister Abe's new economic reform and monetary intervention policies) were to fail; 3) a Euro-zone collapse in the midst of a severe regional recession; 4) an emerging markets credit crisis as the strong dollar causes major capital outflows,[8] and 5) a major war in the Middle East that could cause an oil price spike that would crush the global economy as it has several times before. It may be important to note with respect to the fourth of these, that the two most recent major currency crises in emerging markets, Asia in 1998 and Latin America in 1984, were both triggered by strong dollar rallies.[9] Also, as money flows out of emerging markets, it has the effect of exporting deflation to the rest of the global economy, which reinforces the trend.[10] Given all the troubles or potential troubles around the world, the U.S. recovery, though weak, looks like the "cleanest shirt in the dirty laundry." This has attracted big money flows to U.S. equities, with significant amounts sourced from sales of emerging market stocks and bonds.

An unexpected spike has perhaps been driven into the global economic wheel due to the recent dramatic sell-off in bonds worldwide, following comments made by the Federal Reserve's members over the last eight weeks. At the suggestion that the Fed might "taper" its bond buying activity in the fall, global bond markets reacted violently, and virtually every kind of bond on the planet lost money in May and much of June. The drop in U.S. bond prices was the biggest decline since 1994, and the U.S. 10-year Treasury yield has soared by over a percent to around 2.66%. This has raised the cost of borrowing money for home buyers, businesses, and speculators.[11] Some have suggested that this signifies the end to easy money and thus the end to the global stock rally. However, others have pointed out that U.S. stock markets have often rallied under these same conditions, as we discuss elsewhere in this newsletter.





Furthermore, in retrospect a correction to global bonds was in order, especially in emerging markets and the U.S., where valuations were extreme in some sectors.[12]

Home Sweet Home

The U.S. housing market has been improving by leaps and bounds, and **there are clear signs that the housing market bottom is behind us.[13]** For example, the annualized pace of residential investment growth was 14% in the First Quarter. There are a number of factors driving the housing revival, but among them are: 1) low interest rates for mortgages provided by the Federal Reserve's policies; 2) improving employment rates and wages; and 3) greatly improved housing affordability.[14] Housing prices have rallied nationally by around 12% YOY, and both new home sales and existing home sales have climbed substantially.[15] Consumer confidence surveys have soared in the last few months as well, and the NAHB single family Housing Market Index has climbed to its highest point in six years (this index correlates with prospective housing starts by builders).[16] The housing recovery has important knock-on effects also, including better job mobility, and expanded consumption of home improvement goods and services. Household debt has fallen dramatically (mainly through default), and credit delinquencies in general have declined sharply.

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Home Sweet Home (Continued)

Other aspects of the economy have also improved recently, including new orders for capex goods (business growth), small business optimism, improved regional manufacturing surveys for Philadelphia and New York, and greatly improved consumer spending on durable goods. Car and especially truck sales have been soaring, another good sign for small businesses. **Labor's share of national income may finally have stopped falling, which is great news for the Middle Class.[17]** Unemployment rates have fallen a bit, and new jobs are being added at a decent pace. However, with respect to jobs, the devil is in the details. For example, much of the improvement in unemployment can be attributed to a falling labor participation rate, which is caused by people leaving the labor force. Many of these have retired, but millions have been forced out by long-term unemployment with no prospects of a return to the work force. Another portion of the improved monthly jobs data is the result of workers being forced to accept part-time jobs, which the government conveniently counts the same as a full-time job in its headline data. Over-all though, job prospects have improved and this has improved consumer sentiment.

There is also one caveat applicable to all monthly and quarterly government data releases. This is the fact that the initial economic data are estimates, and there are many subsequent revisions to these data. It is well-established that these revisions are often very large, and can even involve changing the sign of the trend in the data. This makes it very strange that the Federal Reserve and other government entities rely so closely in formulating their policy decisions on what turn out to be crude data involving very rough guesses that are subject to at times massive revisions.[18] For example, the initial GDP estimate for 4Q/2008 was -3.8%, but after six revisions the number dropped down to -8.9% (134% worse than initially thought). Obviously, it would have been helpful to have had a more realistic assessment of the severity of the Great Recession in real time, instead of years later. In February of this year, the initial monthly jobs data (Non-Farm Payroll) indicated 236,000 new jobs. By April it had climbed to 332,000 new jobs due to revisions of the February data, about 41% higher. These examples (and there are many others) show that the initial data must be taken with a grain of salt. So although things are looking better, we must remain somewhat less than fully committed until more economic data come in. This of course doesn't drive our market stance, but rather informs it to some extent. We also note that the Obama Administration has rolled back the start date for the Affordable Care Act, which is good news for small businesses that faced substantially increased healthcare costs. Many observers and research firms are suggesting that the recovery will continue to strengthen and that stock markets will continue to climb, and we tentatively accept that on an interim basis. ■

Market Commentary: Taper Tantrum

By Kevin M. Wilson and Dheenu V. Sivalingam

The Fed Decides It Made A Mistake

All risk assets sold off in May and June worldwide, partially as a result of comments made by the Federal Reserve. Essentially the FOMC's members thought better of their previous decision to continue QE (Quantitative Easing) indefinitely at huge volumes, and basically stepped back from what seems now to have been a hasty and ill-conceived promise of support for the markets. Their original premise for the decision last November was that the Fiscal Cliff and imminent budget sequester impacts could cause a recession, so the FOMC acted preemptively to try to fend off that risk. Since then it has become clear that the impacts of the federal sequester have been more drawn-out and less severe than expected (so far). In making their May and June statements about tapering off the amount of bond purchases under QE-3 by the fall of this year, the FOMC may have inadvertently scared the markets more than they intended, and the result was the biggest bond sell-off (rise in yields) in 19 years (since the famous bond rout of 1994). In partial sympathy, stocks and commodities also sold off a bit. The bond re-pricing caught most of the world's largest bond fund managers completely by surprise, since the global inflationary trend was downward (in fact deflationary in many countries), and the Fed had not actually said they were going to raise rates; both of these factors are normally supportive of bond prices.

The bond sell-off was completely indiscriminate, indeed, bordering on panic, as speculators long favored by the Fed suddenly got caught in leveraged bets on bonds and currencies that then had to be unwound. **Bond market volatility spiked to the highest levels seen in over 50 years.[19]** Millions saw their supposedly safe bond assets tank on a temporary basis, and billions of dollars were moved out of bond funds as a result. Nothing the Fed said or did could have justified the degree of panic selling experienced by the markets, if we look at it rationally. But there is obviously no requirement that markets be rational. Indeed, since bond investors are all about risk avoidance, they tend historically to move quickly if they think the Fed is going to tighten. The problem here is that the Fed has not really said that they're going

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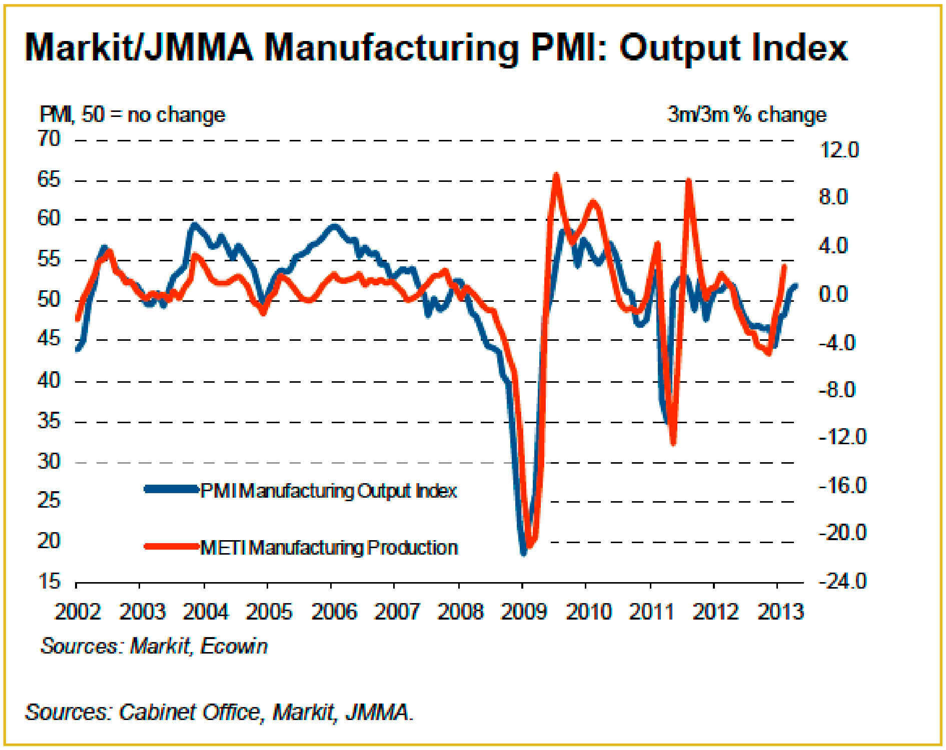
Taper Tantrum (Continued)

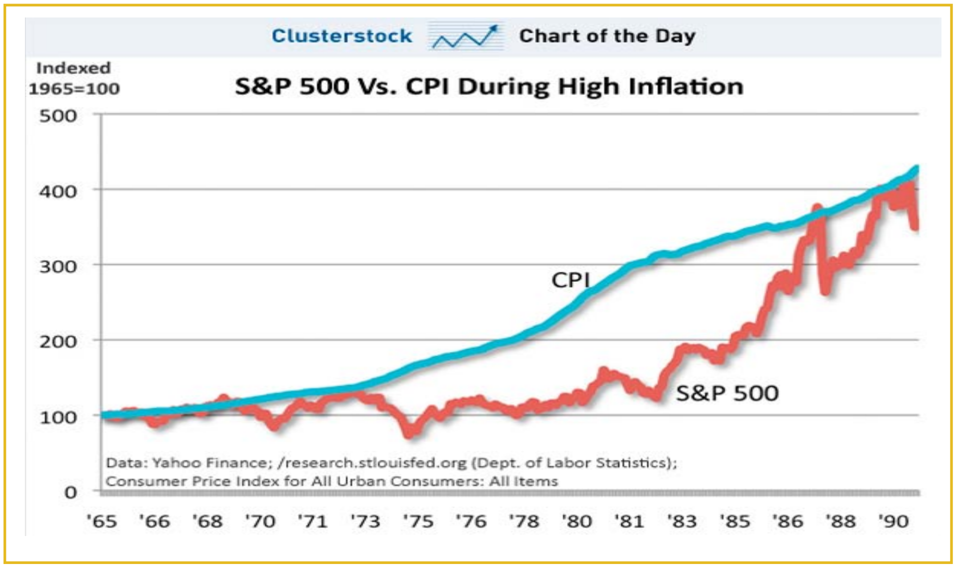
to tighten, merely that they don't intend for policy to continue at the loosest level in history. There is certainly cause now for believing that this may have been the long-awaited top of the 30-year bond bull market,[20] and in any case most traders shot first and asked questions later. Now that things have calmed down a bit, it seems more than likely that since bond markets are now strenuously oversold, a counter-trend rally is now in order. Bond prices probably won't recover all of their losses in such a technical move, but something will be gained for those able to shift to longer durations now that the initial sell-off has occurred. There is a high probability though that the eventual move upward in yields for the 10-year U.S. Treasury will reach 3.00% or more in the near term, and perhaps even 4.00% in the long term, say by 2016.[21]



Sources: Cabinet Office, Markit, JMMA.

The Dollar Rises in Sympathy with Bond Yields, Changing Prospects for Stocks

The Fed's taper talk caused a massive re-evaluation of risk exposures, and most traders and investors chose in response to lower their risk allocation in the near term. This is generally supportive of the U.S. dollar, as is a higher yield for bonds, and as might be expected the dollar has rallied in the last few weeks. Anticipating this we have staked out dollar positions in some portfolios. Right on cue, huge volumes of money have recently flowed out of emerging market stocks and bonds and into cash, much of it held as dollars.[22] This may be an intermediate term trend, meaning there's a long way to go yet. What are some of the impacts for investors if the dollar rises substantially, with bond yields also rising? First, as just noted, emerging markets will probably fare poorly. Second, U.S. companies with largely domestic operations will outperform relative to Blue Chips with large international revenues. Third, within the U.S. market, certain sectors should outperform, including technology, energy, consumer discretionary, industrials, and financials, in descending order.[23] **Perhaps the biggest surprise for many investors will be the probable acceleration of the stock rally <u>once things settle down and a significant stock market correction is behind us</u>.**

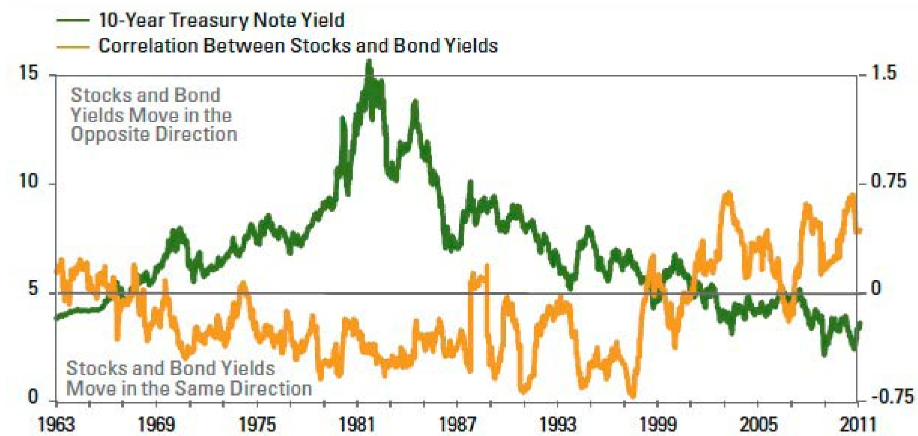


Market history implies that rather than stopping the rally, bond yield normalization and a rising dollar should actually improve the breadth and power of the intermediate term stock rally.[24] In the best major example, rates normalized after the 16-year bear market that lasted from 1966 to 1982. Following a final 12% stock market correction in August of 1982, stocks (S&P 500) then soared over the next five years, returning an average of 13.7% per year. In an older cycle which began after a 21.4% drawdown in the spring of 1942 (caused by the Pearl Harbor attack and its aftermath), bond yields normalized and stocks vaulted at a 9.4% annual rate for the next five years, even though a world war was being fought during most of that period. Looking ahead then, we expect a near term correction, but then a perhaps years-long rally as conditions normalize and growth returns to the economy. ■

Wealth Management Commentary: Implications of Higher Rates for Retirees

By Ted A. Pavlovich and Kevin M. Wilson

The recent spike in bond yields and interest rates will have a real impact on your current and future retirement plans. Federal Reserve Chairman Ben Bernanke's recent announcement of the probability of tapering back on bond purchases in the fall (under QE-3) sent shock waves through the bond and stock markets. Volatility is back, and with respect to bonds, it's the biggest it's been in over 50 years. Bond fund total returns for the year (interest income plus or minus price movement) actually went negative last month for almost every kind of bond or bond sector on the planet. So much for the supposedly "safer" parts of your investment portfolio. Many of us can remember only one other instance that is comparable: the infamous bond meltdown of 1994.



Source: LPL Financial, Bloomberg data 2/4/11

Central banks in 2008 began pumping cash into the world economies, warding off likely deflation and forcing stock and bond prices higher. Investors put over $1 trillion (!) of new money into bond funds while pulling over $250 billion out of stock funds over the last five years.[25] But, now, as discussed earlier in this newsletter, the barest hint that the Fed might taper off their pumping of liquidity sends the bond markets into a panic. The market's increasing nervousness is actually natural, given the artificially low yields bonds have had in the last few quarters. It would be naïve to think that the transition to normalized rates from the extremes we've experienced recently will be completely smooth. In fact, one of the things that has kept us up at night is the prospect of an even more disorderly reversion in bond yields than we've already witnessed. However, some of our reading on the subject has discovered research work suggesting that a total meltdown is very unlikely, and that much of the rate adjustment volatility is actually now behind us.[26] That does not mean that rates won't rise any higher, just that the most violent part of the transition may be over. Indeed, looking ahead we expect rates to hit 4% for the 10-year Treasury by 2016 or sooner.

What is the immediate impact on a bond portfolio of all this volatility? Recently, 10-year bonds were losing a full one-tenth of a percentage point of dollar value for each one-hundredth of a percent of interest rate increase.That's right: a ten-to-one ratio. So imagine what could happen to Treasuries if rates continue to increase, all the way back to a more natural 4%, from the current 2.66% (which is already about 1% higher than it was in April). The expected future losses in a portfolio of medium-term bonds would be around another 13.4% of its value. That's a risk most people holding the classic 60/40 portfolio do not appear to understand. However, this should really not be too surprising to bond investors of the past decade, due to the fact that 85% of their total returns have been from the flip side of the same coin: price appreciation as rates went ever lower over time.[27]

How can investors prepare in order to minimize the damage and maintain cash flow for retirement needs? On a general level, it will be necessary to increase diversification across asset classes and strategies, especially with respect to assets that do better in a rising rate environment. But more specifically right now: most investors should consider lowering their exposure to traditional longer term bonds. That's where the price volatility is likely to be the greatest. Especially for retirees that look to bonds as the safe, stable anchor of a portfolio, it will be necessary to adjust your thinking. At a minimum you should switch to shorter term bonds and even allocate more money to cash. A currency bet (the dollar, for example) might also be very helpful. Within the bond universe it will make sense to allocate some of your asset mix to bank loan (floating rate) funds, as these are able to more or less keep up with rate increases. Certain types of dividend-paying real estate assets may also be very important to asset allocation for retirement cash flow. It will make sense over time to allocate substantially more of your assets to dividend-paying stocks than you have typically, in order to off-set the loss of dividend cash flow caused by cutting back on bond allocations, and moving to shorter term bonds. In the foreseeable mid-term future then, after the current correction, we believe stocks should outperform bonds and yet will still be a good source of dividend income.

Please feel free to call us to discuss strategies for rising interest rates

Special Topic:
The Sun Also Rises

By Kevin M. Wilson

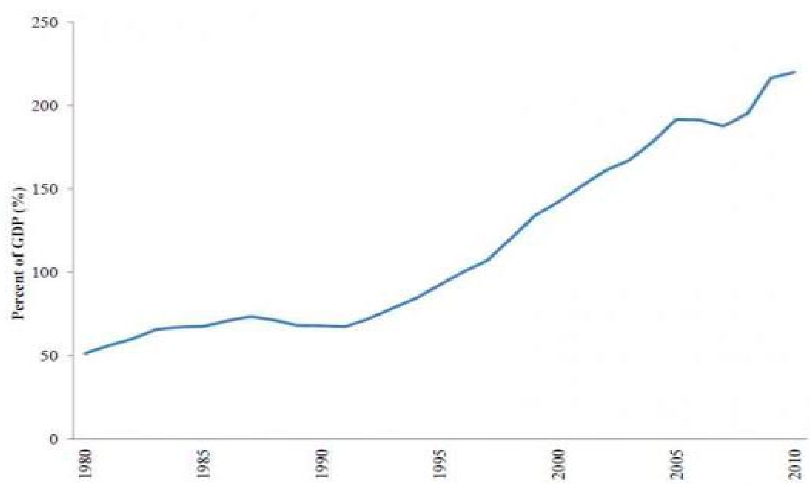
Japan Attempts To Do A Complete Reset

The Japanese government has really shaken things up in the last eight months or so. After Japan's new Prime Minister Shinzo Abe took office late last year, he launched a three-fold attack ("three arrows" strategy) on the status quo, which can be characterized as a debilitating 20-year stretch of deflation, recessions, bad stock markets, ever-increasing government debt, and zero economic growth. Japan's public sector debt is now above $10.08 trillion in an economy that is one-third as big as that of the USA.[28] Abe's first act was to name a new Bank of Japan (BOJ) leader, Haruhiko Kuroda, and other BOJ governors to send out the first arrow: Quantitative Easing (QE), i.e., bond purchases with digital money, on a massive scale. This was intended to help get deflation to end and inflation to begin, in part by causing the yen to fall dramatically. So far, inflation hasn't moved in the right direction yet, perhaps because it's too early to expect major changes, but the yen has fallen from 79.38/dollar to 99.17/dollar, a drop of about 25% since November. This has had a profoundly positive effect on Japanese stocks, especially for those of companies involved in international trade. The second arrow of the strategy in Abe's quiver is the rationalization of fiscal policy, i.e. higher consumption taxes and lower spending. Major action on this front awaits the results of July's parliamentary elections, which should give Abe a strong enough hand to enact major legislation. The third arrow in Abe's quiver is a growth strategy based on structural reforms. These might include corporate tax cuts, changes in lending rules, and trade liberalization.[29]

This is an impressive list of reforms and economic goals for any government to try to achieve. Much could go wrong of course. For example, bond yields on the JGB 10-year have soared from 0.33% to as high as 1.00%, before stabilizing recently at about 0.85%. This move has inflicted massive losses on banks, insurance companies, and pension funds. The JGB yield increase has also already had the additional effect of raising the level of annual debt service paid by the government by over $3 billion. If rates were to normalize to just 2.2%, debt service would consume 80% of Japanese tax revenues each year.[30] Clearly this idea of initiating inflation has some pitfalls associated with it. On the other hand, even the highest recent rate for the JGB is still lower than it was two years ago. So perhaps this more or less benign result will continue. Hedge fund manager Kyle Bass is concerned however about what he calls the "Rational Investor Paradox." If you are a bond investor or major fiduciary institution in Japan, and the government told you it was going to cause rates to increase dramatically, would you continue to hold long-term bonds that could lose huge portions of their principal? Apparently the answer is no, since there were weeks of panic selling once QE began in earnest in May.

The BOJ stepped in with additional bond buying to stabilize the situation, but it is not hard to imagine a future scenario where the BOJ is forced to "print" many trillions of yen more than they planned on in order to keep their inflation target in sight without inducing panic. The numbers involved are likely to be staggering, and the result will be a major episode of currency devaluation. Of course, this could easily get out of hand. Author John Mauldin thinks that the Japanese will need to depreciate the yen by at least 15% per year in order to achieve their goal of 2% inflation. Along the way, Japan will in effect be exporting deflation to the world. Indeed, we already see plenty of evidence that this is happening. It will also be very lucky if a full-fledged currency war does not break out, with all of this competitive pressure on major exporting countries. There are additional knock-on effects on the liquidity available to other Asian economies, similar to the problems that arose prior to the Asian Financial Crisis of 1997. Furthermore, there has been some unexpected turbulence in global stock markets, as Japanese investors did the opposite of what was expected. Many thought that Japanese investors would be forced by a falling yen to buy emerging market stocks and other international stocks in large quantities. What happened instead is that Japanese investors decided to take large windfall profits by selling their foreign holdings and converting them back to yen.[31] This contributed to a global stock swoon in May and early June.

Japanese Debt/GDP Ratio



The Sun Also Rises

Looking ahead, it is difficult to see how Japan can pull off the exquisite balancing act of achieving higher inflation and economic growth without causing either: 1) a bond market panic and associated financial

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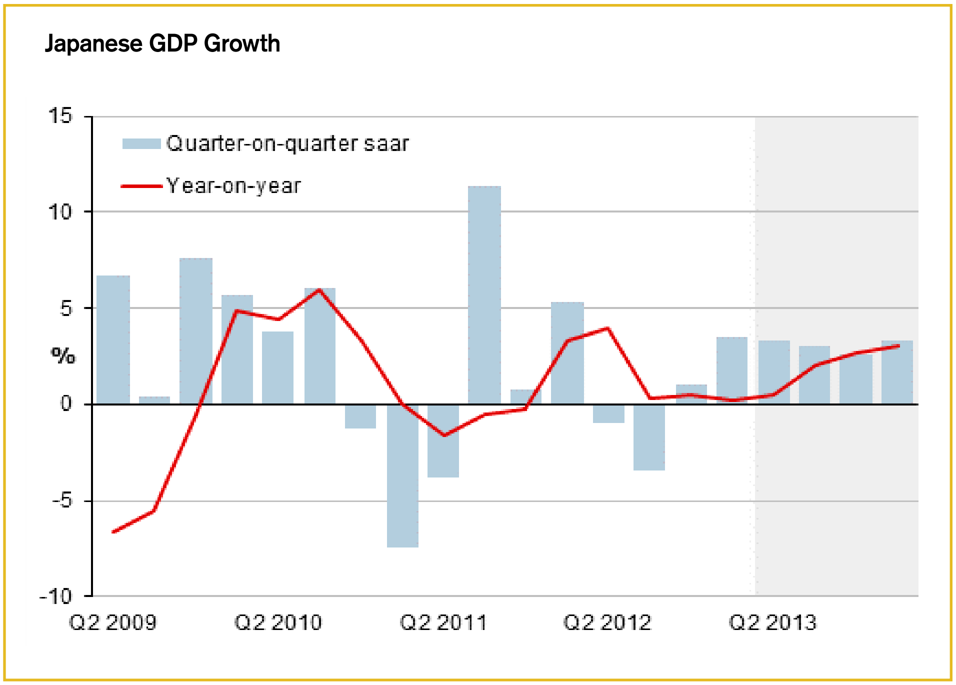
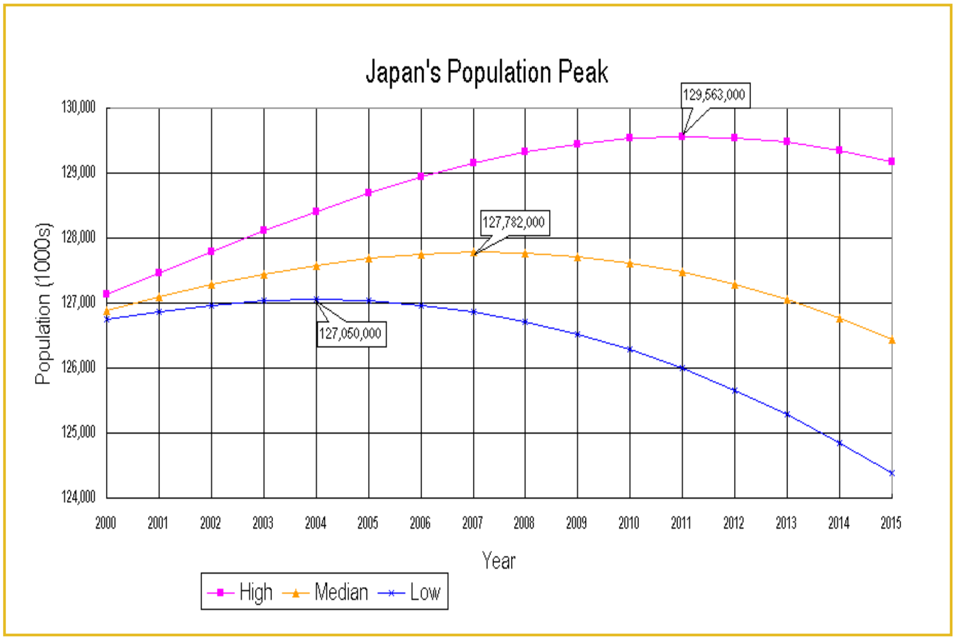
The Sun Also Rises (Continued)

Japanese Prime Minister Shinzo Abe

crisis; 2) government insolvency; and/or 3) catastrophic currency devaluation. As John Mauldin says, **this may be the most desperate monetary policy experiment ever undertaken.** With respect to Japan's goal of restoring growth to their economy, it has also been pointed out that there are only two ways for an economy to grow: 1) increasing the working-age population; and 2) increasing productivity.[32] This is going to be challenging for Japan, because the first of these is really out of the question. Japan's population has been shrinking for quite some time, and projections indicate that this will soon accelerate. With regard to the second option, that of higher productivity, one way to increase productivity is to allow employers to streamline their companies by firing non-essential or inefficient workers. This would of course not be very popular. Another way to increase productivity is to reduce average wages, another not too popular idea, but one the government has already tried with government workers. So there are obvious hurdles to get over in the area of increasing productivity, but the Japanese know they will have to do it to succeed.

In any case, early signs that at least corporate spending habits and public sentiment have been improving are encouraging. For example, GDP grew at an annualized 3.5% last quarter, a big change from previous years. Retail sales have soared recently as well. The market share Japan lost to Korea over the last twenty years has started to reverse in parallel with the falling yen. This is boosting Japanese corporate profits and should help with the growth question. There are plans for a certain degree of deregulation as well, which could boost productivity. Prime Minister Abe understands that he needs all three of his arrows to hit the target in order for his grand strategy to work. The Japanese people appear to support his efforts. Early signs are good, and there is a certain degree of inspiration provided by the knowledge that failure will have catastrophic consequences. The Japanese have been world class leaders in productivity enhancement for decades, so it may not be wise to count them out. I think the sun may rise in the east for a rejuvenated Japanese economy in the years ahead.





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Also, please visit our website at www.bluewatercapitaladvisors.com, and our blog at http://bluewatercapital.wordpress.com.

Please attend our next "Monthly Market Review" if you can; we'd love to see you, your relatives, and your friends there. The next scheduled meetings will be held at 5 pm - 6:30 pm on September 19, 2013 at our offices in the Medical Arts Bldg. ("Top of the MAB"); and on October 17 at a Location TBD. We run meetings every month for ten months, but we don't run the meetings in July or August due to vacations. If you can attend in September or some later time, please RSVP to Blue Water.

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