Un-Addiction

June 21st, 2013

In June of 2012, I wrote a short market commentary entitled "Systematic Addiction". In that piece, I discussed the counter-intuitive market reactions to economic data being observed at that time. Essentially, negative economic news was causing the market to rally in expectation of additional monetary stimulus, or quantitative easing (QE). When economic news was positive, the market would also rally, as it had very little fear of an end to QE. In the short term, it seemed to be a "win-win" situation. However, in my view, investing in such a market could prove dangerous as it would require the ability to know when to exit the market (before a QE exit was announced).

Fast-forward one year. **It is my opinion that the markets are now experiencing the mirror opposite of systematic addiction, something I have decided to call "Un-Addiction"—the painful process of withdrawing from the QE addiction.** The world is now keenly aware that quantitative easing will have an ultimate end date. While economists and market analysts have varying opinions on when the stimulus package will/should be removed, it appears that the market's reaction to that impending action has already begun.

In the following paragraphs, I would like to explain what I see as three consequences of the un-addiction process:

1) **Increased volatility in bond, equity, and commodity markets**: Just as the short-term side effects of systemic addiction appeared to be a "win-win", I believe the short-term side effects of un-addiction are likely to be a "lose-lose". Positive economic news now implies a quicker withdrawal of QE. Negative economic news is simply negative --- especially since it disappoints the euphoric high expected by the ~~addict~~ market. In short, I believe the market may react poorly to both positive and negative economic news going forward.
2) **Interest rate normalization:** The Fed currently purchases $85 billion of residential mortgages each month. This roughly equates to the total supply of new mortgages created and issued by our banking system. In doing this, the Fed has been able to control and reduce interest rates on residential mortgages. However, now that the Fed has announced it is considering a plan to taper mortgage purchases, the bond market is reacting preemptively. Interest rates are rising sharply in anticipation of the point when the Fed ceases to control the mortgage market. We appear to be moving from an interest rate environment that has been fairly easily manipulated by the Fed --- to a more traditional one that

will be mostly market driven. This is good news for the long term health of the economy, but reinforces consequence #1 in the short term as stated above.

3) **Increased recession potential:** The sheer size of QE is breath-taking and is historically unprecedented. Nearly every major developed country in the world is trying the same QE experiment. Yet after 3+ years, we have very anemic growth by historical standards here in the U.S. and around the world. There is a risk that this anemic growth is the consequence of QE and not the consequence of a globally healing economy. Ultimately, as QE is removed --- we will get to find out!

   I am not forecasting a repeat of the Great Recession (2008). I am observing that it has been 5 years since that recession --- and a normal business cycle recession seems reasonably possible at this point**.** I am still bullish on real estate with a cash flow yield, the energy sector, and an "on-shoring" trend in manufacturing. However, interest rate normalization will negatively affect highly leveraged business models. Further, the increased market volatility may dampen consumer confidence and cause further hesitancy by corporate America. These trends could ironically complete a self-fulfilling prophecy of economic downturn.

In conclusion, it appears that the Un-Addiction process has begun. This marks a significant shift for the world of investments. Volatility is on the rise. Interest rates are rising / normalizing. In such a fragile economy, it seems prudent to consider that the risks of economic recession are somewhat higher, even if they are still not the base case. As always, please feel free to contact me with any thoughts or questions.

By Jeremy Boynton, CFP ®
Founder, Laureate Wealth Management