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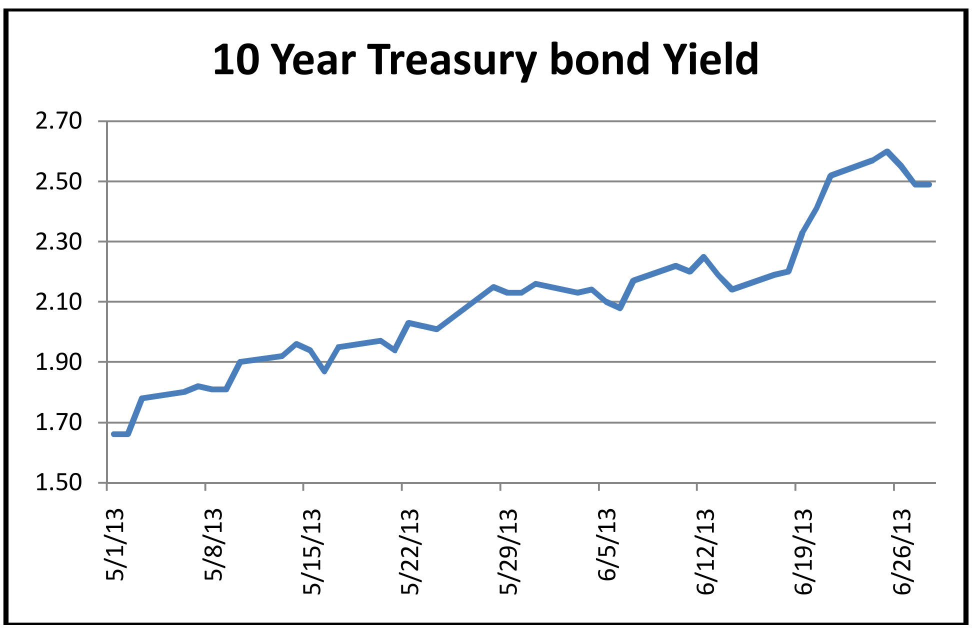
Investment Newsletter – June 2013

Given the extraordinary move in interest rates this quarter, this newsletter will cover what has changed and what has not, and how the various asset markets have been affected. In particular, we'll cover bonds, stocks, gold, and real estate.

A Big Move in Rates - The Start of Unintended Consequences?

As readers of this newsletter know, the Federal Reserve (the Fed) has been the decisive force in markets over the last few years. In the last 2 months, the Fed has been the unwilling catalyst for a huge move in longer term interest rates.



The above chart starts on May 1st when the Fed had a meeting and announced that they could either increase or decrease their bond purchases over the near term depending on economic performance in terms of unemployment and inflation. At the time of the announcement, economic readings were middling, as they've been for quite some time. Thus analysts could conclude that the Fed might possibly stop buying bonds even if growth continued to muddle along as it has. If the Fed reduces or ends its bond purchases, then at that point the reduction in demand for bonds would cause bond prices to drop and yields would rise (interest rates move inverse to bond prices). But if traders think they see a catalyst for prices to move down (the end of Fed buying), they want to sell first. This should push bond prices down ahead of the Fed's move (and yields up). Thus the market tries to get ahead of the Fed.

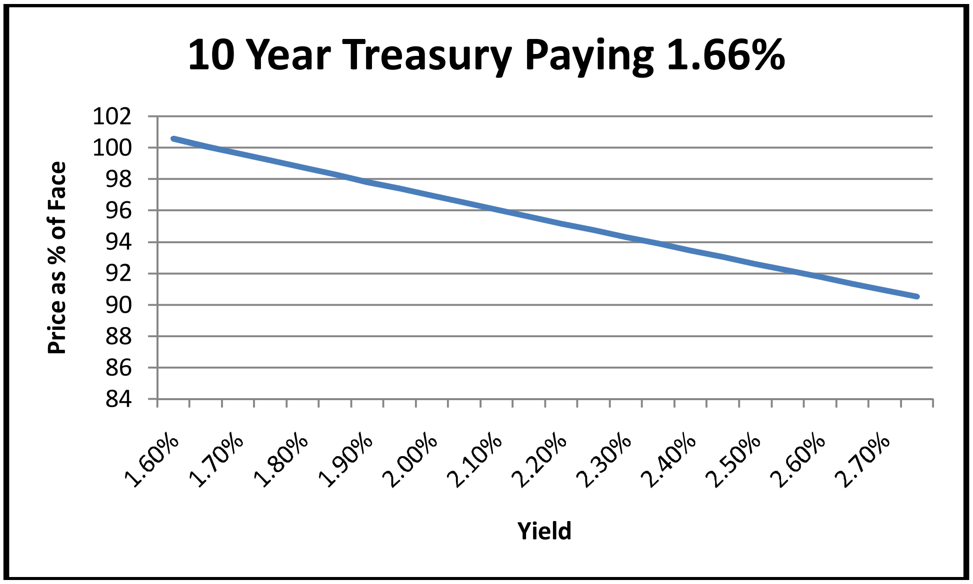
At the news conference after the June 19th Fed meeting, the Fed Chairman said that if the economy progresses as they expect, they will reduce bond purchases slowly and eventually end them – by mid-2014 assuming unemployment falls to about 7%. At the same time he vowed that short term rates would stay at zero until unemployment falls to 6.5% - most likely not before 2015. In communicating these policies the Fed was simply restating existing policies. The fact that the market reacted with a huge sell off in bonds was surprising to them. In fact the spike in rates runs exactly counter to their goal of gently easing off the monetary stimulus; a large part of the their interest rate suppression has been unwound by the market in one fast move.

As shown in the chart above, the 10 year Treasury bond yield increased by .83% over the last 2 months: going from 1.66% to 2.49%. The 30 year mortgage rate went from 3.35% to 4.46% - up by 1.11%. Almost half the mortgage rate change came in the last week – the biggest such move since 1987. These are very big moves. Because low long-term rates push up demand for interest sensitive long-lived assets, like real estate and cars, the rate move works against the Fed's goal of stimulating the economy. Clearly there is no easy way to get out of the position they are in.

According to the May 1st financial statements of the Federal Reserve, they held over $3 trillion worth of long term bonds. As any trader knows, you cannot easily unwind such a large position without pushing down bond prices significantly. This problem is compounded for the Fed because, unlike other market participants, they tell everyone what they're doing before they do it. The Fed will incur very large losses in the second quarter and probably much more going forward. These may exceed the losses from the rest of the government bail outs combined. (Those losses were mainly the unintended consequences of the government's mortgage guarantees issued by FNMA and FHLMC). Based on the interest rate sensitivity of 10 year U.S. Treasury bonds as of May 1st, I estimate that the Fed's losses in May and June were more than 7% - i.e. over $210 billion. A large part of this will offset prior unrealized gains, but it is likely that the Fed's net losses will exceed their total capital of $55 billion.

Impact on Financial Markets

As mentioned above, anyone holding 10 year Treasury bonds would have lost more than 7% in market value over the last two months. The interest sensitivity of bonds is measured approximately by duration. (It is approximate because interest sensitivity is not exactly linear for large moves). The 10 year Treasury had a duration of 9.25 based on its 1.66% yield on May 1st. Using duration we estimate the price impact of the change in yield at 7.68% (=.83% * 9.25). As shown in the price graph on the next page, the move from 1.66% to 2.49% results in an actual price drop of 7.31% (from 100 to 92.69) – just a bit less than our approximation.



There are many different long term bonds in the market. Shorter maturities and higher yielding securities have lower duration – less price sensitivity to changes in yields. The table below shows market returns (price change and dividends) for various types of fixed rate Taxable Bond Index - Exchange Traded Funds (ETFs).

Type and ticker	May + June % return	Comments
Total Bond Market – AGG	-3.54	All taxable bonds mixed
Intermediate Maturity: 5 - 10 year - BIV	-5.45	Govt. & Investment grade
Long Maturity: 20 year avg. – BLV	-9.51	Govt. & Investment grade
Intermediate Maturity High Yield – JNK	-4.45	Below BBB rated
Short Maturity High Yield – SJNK	-2.24	Below BBB rated
Emerging Markets High Yield - EMHY	-8.83	Below BBB rated
Agency Fixed Rate Mortgage Backed - MBB	-2.74	Includes all maturities

Clearly it has been a rough two months for all bond investors. Domestic high yield bonds held up better than government and investment grade issues because the higher interest payments reduce the interest rate sensitivity (duration) of these bonds. The lesser moves in domestic high yield indicate that even though the overall level of rates is rising, the risk premiums are moving very little. Like domestic bonds, emerging market high yield bonds also have lower duration, but these have been hit by a general rush of investors out of all emerging market securities.

The small loss shown in the table above for mortgage back securities (MBB) may be a bit misleading because this index includes all mortgages with 1 year or more remaining. If we looked just at new 30 year mortgages the value decline would be much greater – probably in the range of 8 - 11%.

The category least susceptible to changes in interest rate levels is floating rate loans. An ETF of floating rate loans (ticker BKLN) lost 1.04% during May and June.

In the world of tax exempt bonds, maturities tend to be longer and rates are low because these bonds are investment grade and tax exempt. Thus they have high duration; prices are very sensitive to changes in interest rates. As an example, a California Municipal Bond ETF (CXA) lost 8.24% since April 30th. Because municipal bonds are mostly held by individuals, and market psychology is very negative right now, it is very hard to sell municipal bonds in the current environment. This lack of liquidity is contributing to the exaggerated move in municipal bond prices and yields.

Closed End Funds (CEFs) are another type of security suffering from the intersection of low liquidity and retail investor selling. These funds hold portfolios of bonds and use embedded leverage. They trade on exchanges but because they cannot be directly traded for the underlying bonds, they can trade at discounts or premiums to the underlying value of their bonds. According to data from Lipper, the median discount from portfolio value went from 1.55% May 3rd to 5.95% on June 21st. Discounts on equity CEFs are even larger. These are very large discounts relative to the last couple of years and almost surely represent a good buying opportunity.

Except for volatility just after the last Fed meeting, the overall stock market as represented by the S&P 500 index has been unaffected. The index was up .55% over the last two months. This is somewhat unusual because rising interest rates are unambiguously bad for stocks. Rises in rates directly increase costs and they indirectly lower the value of future cash flows via discounting. In a late stage bull market cycle, such as the one we are in, rising rates often lead to significantly lower stock prices.

While the overall market index is doing fine, the high dividend yield sectors of the market (where investors have gone for "bond substitutes"), have been hit by heavy selling. This includes business development companies, utilities, real estate investment trusts (REITs) and especially mortgage REITs that operate like banks by borrowing money to invest in mortgages. Since short term rates have not moved, these entities' profit margins are not threatened. In fact, because mortgage rates are going up, the mortgage REITs should see better spreads and profits as they reinvest in new assets. While these companies try to manage their interest rate risks, it's likely they suffered some capital losses in the 2nd quarter. Two of these companies that we follow ended the quarter priced at less than 75% of book value. Given the favorable impact on income going forward, these companies are worth buying even if they show losses of 25% (which seems unlikely).

Gold has been declining for some time and the rise in long term interest rates above the inflation rate has accelerated its decline. Gold dropped 16.2% over the last two months of the quarter. It fell 23% for the quarter – its biggest quarterly decline since 1974 when owning gold was legalized in the U.S. Gold has reached such a low level that gold mining companies will now begin to cut back on capital spending at higher cost mines - thereby reducing future supplies. Given that it takes years for gold miners to adjust to big gold price moves, their stocks must decline even faster than gold. An ETF of gold miners (ticker GDX) is down 19.3% since April 30th.

Residential Real Estate Market

The supply of houses for sale has been constrained for quite some time. Builders drastically reduced construction since the financial crisis. Owners who owe more than their house is worth don't want to sell and banks are not anxious to sell foreclosed houses at a loss either. In the Bay Area there is very little possibility of building many new houses in any case.

The low supply did not have any effect for quite a long time because demand was greatly reduced by the financial crisis. There was the psychological impact on potential buyers of realizing that prices can and are going down. In addition, it became much more difficult to qualify for a mortgage.

Meanwhile, a large number of former homeowners became renters and the Fed pushed mortgage rates down to increase affordability and thereby increase demand for housing. This dynamic caused rents to rise while home ownership costs were declining. Eventually we reached the point where investors saw adequate returns to buying up and renting out foreclosed houses. That eliminated the demand deficit and put a floor on prices. With that floor in place and interest rates still dropping, price started to rise. This, in turn, alleviated buyers' concerns about dropping prices and caused a large segment of people to jump in to the market. Hence our second boom in housing demand was created.

In the Bay Area, the demand spike was reinforced by a boom in the technology economy which put a lot of cash in potential home buyers' pockets. We are now in the middle of a buying frenzy with multiple bids above asking on every property listed on the market – even the ones that need $200,000 in repairs. People are desperate to lock in low mortgage rates on an asset with seemingly large upside and little downside. The median home price in San Francisco just hit $1 million. This market is out of equilibrium. But it will not be so forever.

Consider the impact on demand in the Bay Area of the recent rise in mortgage rates from 3.35% to 4.46%. Those rates are for conforming mortgages which are not large enough for the median house. Let's tack on .15% for the cost of a jumbo loan (above $625,000). So we will look at the buying power with rates at 4.61% versus 3.5%. These days the median home buyer is likely to be a couple with combined income of say $150,000. This is roughly the 78th percentile of San Francisco households; If you make this much, 22% of households make more than you and 78% make less (63% of the population rents). There are lots of cash buyers but they are not the ones who determine whether demand exceeds supply. At 3.5%, our median home buyer would qualify for a loan of $794,000. Adding in a 20% down payment, their maximum purchase price is $992,500 – pretty close to where the market bids were 2 months ago. If they bid today, with the mortgage rate at 4.61%, they can borrow $682,000. Assuming the same down payment of $198,500 (now more than 20%), they can bid $880,500.

The above arithmetic shows a decrease of 11% in a median couple's ability to bid for a house. So interest rate rises will reduce demand for the "stretch" buyers who are the marginal bidders in the housing market. It will take some time for this to work itself into the market because there is so much excess demand and momentum right now. But if rates stay high, price rises will slow and possibly even reverse in the closing statistics reported 6 months out.

Investment Analysis and Strategy

We had been carrying a relatively small position in mortgage REITs prior to the downturn. Valuations and yields have become very attractive and we have boosted our positions to take advantage of the sell-off. We like other high yielding equities but prices have not declined enough yet for us to deploy cash to those assets. Likewise we had reduced emerging market equities to low levels in anticipation of the China slowdown that is bringing these prices down. We see the huge decline in emerging market equities as a buying opportunity – but only in a few selected markets where valuations have reached attractive levels.

As many of you know, we use a substantial amount of closed end funds to implement our fixed income strategies because of the extra returns available using these securities. We must endure higher volatility for those extra returns and that's exactly what is happening now. The silver lining of this is that the cycle of discounts and premiums provides opportunities to make extra returns by buying when discounts widen and selling at premiums. In other words, today's discounts turn into tomorrow's extra returns. So, we have been shifting money from ETFs into discounted CEFs.

In last quarter's newsletter, I explained what I call the New Normal. I pointed out that a significant rise in interest rates would slow the economy and cause the Fed to reverse the rate rise. What I had in mind was short term interest rates as those are the only ones directly under the Fed's control. Still, the rapid rise of longer term rates triggered by the Fed's words (rather than actions) will provide a test of my analysis. The Fed's attempts to calm the market and talk back down long term rates is an early indication of what I expect to come – efforts to get interest rates back down to rescue the economy yet again. Given that view, yields available to us look very attractive and I expect good returns on fixed income going forward.

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