Email commentary 06-21-2013: Current Thoughts

When interest rates increase, the market value (trading price) of existing (already issued) bonds declines. Since the first of May, the interest rate on the benchmark 10-year Treasury note[1] has risen from 1.63% to 2.41% (as of June 20th). Consequently, the price index has dropped by -3.8% in about seven weeks.

But rising interest rates can also affect stock prices. Higher interest rates increase corporations' cost of borrowing, lower analysts' current value calculations, and give investors other opportunities for investing. Rising rates are one of several bear market warning signs.

What is surprising to me is that Treasury rates have been rising since May 2nd, but the stock market seemed to shrug it off until Ben Bernanke (chairman of the Federal Reserve Board) spoke on Wednesday. He intimated that the board expects the economy to perform better than they expected just a few months ago. If the economy performs better, the Fed board may let interest rates rise (the rates they control). But a better economy should also bring about higher corporate earnings which can support stock prices. So I think there is a real tug of war going on right now between a continuing economic recovery and rising interest rates.

In the last two market commentaries, I have warned that we should expect a stock market correction sometime this year, probably before the end of summer. It appears that the correction is upon us. We do not have the bear market warning flags flying yet, but of course that could happen at any time. In anticipation of further fallout from the Fed board's comments this week, I am dusting off something I wrote back in 2011, during the last time we had a longer and deeper correction. These are things to keep in mind as we go forward:

1. We (meaning you the client, and we the planners) are not traders. We do not have to make profits every day; in fact, it is impossible to do so. We are long term investors, whether we are taking income from our investments or accumulating for retirement several years away. We must expect volatility which can be caused by many factors.
2. Our accounts are allocated based on risk tolerances of each investor. So, those taking income will have much more of their account allocated to bonds and cash than those who are still in the accumulation mode.
3. The risk tolerances that we use in managing accounts are a ONE-YEAR tolerance. So, the fact that the stock market is down 5% in two days does not mean that it has exceeded our one-year tolerance.
4. Finally, in managing accounts, what we want to try to do is mitigate are the very large declines caused by legitimate bear markets.

As of today, I have not made any changes to the discretionary managed accounts based on the recent turmoil. Of course, the news channels want us to try to read the future into the current events. In my over 30 years of experience observing human behavior and the markets, using the emotional rhetoric we hear on TV and read in the daily papers to project the future is dangerous. Please don't hesitate to call with any comments or concerns.

[1] A 10-year Treasury Note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

Kevin and Joe
