INVESTMENT UPDATE
NEWSLETTER

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Fiscal Chicken and Mixed-Bag Markets

Looking backward, briefly: summer brought a broad re-stabilization of financial markets after their late-spring walloping. The Fed talked down its tapering intentions and has delayed moving toward normalized monetary policy that would pull short-term interest rates up off the floor. Bonds mostly stopped bleeding (or at least the bleeding no longer looks arterial), and even foreign stock markets clawed higher after a first half vastly more favorable to domestic equities.

As for the fiscal game of chicken playing out in Washington DC right now, I'll try to avoid adding to the noise by detailing my take, and instead summarize thus: Unfortunately, whatever the outcome, it's unlikely to be clean or lasting; *fortunately*, it's very unlikely to lead to an outright debt default (which would benefit no one). We expect that instead of accelerating into a head-on collision, our elected leaders will grudgingly agree to defer confrontation temporarily; even if neither swerves, both will hit the brakes. That said, if both parties underestimate their momentum, there is a non-zero probability of accident. But in all likelihood, the government shut-down and debt ceiling theatrics will abate till another time, and Congress will get back to what both sides seem always to rediscover as their common ground – spending away future generations' financial flexibility.

Political business-as-usual will free the capital markets to refocus on a couple other things in particular: first, on Janet Yellen's nomination to chair the Federal Reserve and what that means for monetary policy (low interest rates for longer, is the consensus); second, on Third Quarter earnings season, which we expect will show a continued moderation in corporate profit growth.

Going into the last quarter of the year, we find a less troublesome investment opportunity set than faced us before the late-spring tumble restored attractive valuation to a swath of areas.

In the bond markets, pricing is about as sloppy as we've seen since the financial crisis – many issues, even high quality ones, seem to have detached from benchmark rates in a way that won't last – and this opens a window for building yield back into portfolios without turning a blind eye to risk. Detroit's mid-summer bankruptcy (hardly a surprise) spooked weak money out of the muni sector; municipal bonds are selectively attractive again and trading on top of Treasuries where you're willing to shoulder duration. Foreign bonds also offer opportunity, though that remains a market where we cede selection to managers who make it their focus.

The equity markets are a mixed bag. On the whole, domestic large capitalization stocks look fairly valued on a recent period basis (trailing twelve-month earnings), rich on a normalized basis (cyclically-adjusted 10-year Shiller P/E), and potentially scary on a normalized basis adjusted for profit margins feeling gravity's pull. Low beta, high quality stocks and lower quality stocks have diverged, with the latter surging in defiance of poor fundamentals; the former hold more promise going into year end.

In equity risk, we prefer emerging markets stocks (EM) over small- and mid-cap domestics (SMID). The SMID caps look downright bubbly, trading near a 28 P/E (whereby you pay almost $28 for a dollar of earnings). Contrast that with EM stocks priced at less than 13 times earnings. While the emerging markets face headwinds from the threat of Fed tapering, Yellen's appointment moves back the time table on that, and in any event, the damage done to EM stocks so far in 2013 discounts for it. Whereas SMID bears risk but not much likely reward, EM brings risk that's priced to compensate you for taking it. Altogether, over time the prices you pay in the markets mean more than any political madness of the moment.