MIRACLE MILE ADVISORS

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THE FED'S DRUGS ARE WORKING BUT WITHDRAWAL WILL BE TOUGH

The positive momentum of the US Equity Markets in the second quarter (now up over 15% for the year) has reinforced a bullish air of invincibility. The economic indicators (especially housing) continue to get better but the real credit goes to the Fed's strong prescription of rock bottom rates combined with massive bond purchases. In contrast, Emerging Markets have continued to lag US Equities by a surprisingly large margin despite their higher growth rates and attractive valuations. Ultimately, the capital markets will need to wean themselves off the Fed prescription before it turns into a full blown addiction.

The conundrum is that the patient is indeed getting better and really needs to stop relying on high doses of these drugs which have other side effects. However, taking away the stimulants will most likely trigger short-term withdrawal symptoms or at worst, a relapse.

KEY ECONOMIC INDICATORS

- *Home prices see the largest gains in six years* with prices rising 10.9% in March compared with a year ago (S&P/Case-Shiller Home Price Index)
- *Jobs increased 165,000 in April* (unemployment rate of 7.5%). March number of 88,000 was revised to 138,000.
- *Consumer confidence strongest in over five years in May* (both for Conference Board and University of Michigan)
- *Retail sales rose 0.1% in April*, after a surprising 0.5% drop in March

Historically, most equity rallies are led by growth sectors as they signal the early stages of an economic recovery. The recent rally, by contrast, has been led by more defensive sectors such as Utilities. As a result, many strategists and experienced investors continue to doubt the sustainability of this rally and remain cautious regarding the potential effects of Fed policy shifts. So far, however, no one can question the fact that the Fed has successfully forced investors into higher yielding assets that are literally "bubbling" with cheap financing.

Everyone knows this game of musical chairs will eventually end - the trick is to participate without being the last one standing. Overall, we believe the end to unlimited Fed support will start to price into the markets beginning in Q3. This repricing of risk will likely include a stronger equity correction as investors get skittish and take profits. Once investors feel comfortable that a true economic recovery is underway, we expect to see a more normal rotation into early stage growth sectors that have been lagging like Technology and Materials.

MIRACLE MILE TACTICAL SHIFTS AND THE IMPACT OF RISING RATES ON BOND PRICES

Key highlights of Miracle Mile tactical trades in recent months:

- Added the Volatility Index (VXX) for a short-term hedge before Gold collapsed in April generating an average 17% return in a week
- Sold Utilities last month after a 15% gain this year with an additional 4% dividend
- Rotated into Energy after the pullback in April with gains over 10%
- Added Technology (dividend weighted) that yields 3.5% per year with additional total return upside
- Last week the Fed signaled it will begin discussing tapering its bond purchases (at the next few meetings). The reaction was quick with an immediate one day sell off in the S&P 500 as well as the Japanese Nikkei. We used this brief respite to add to our Developed, Non-US Equity exposure (EFA) while slightly reducing our exposure to Emerging Markets. The Japanese Central bank is going to continue taking their cue from Bernanke who remains accommodative.

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The impact of a change in Fed policy on the equity market is somewhat unknown but the impact on the bond market is much more clear-

Bond prices will decline and yields will rise. Over the past year, we have been slowly reducing our fixed income as discussed in our previous note and adding to more variable (or flexible) yielding securities such as Preferred Equities and Bank Loans. The remaining fixed income exposure is high in credit quality and short in duration - with very low current yields but with the ability to move up the yield curve as rates rise.

A quick analysis of a 5 year duration bond portfolio (which is still considered fairly short) should give all investors pause. **The average rate increase over the past cycles has been greater than + 3%:**

- 1% rise in rates, 5% decline in value
- 3% rise in rates, 15% decline in value
- 5% rise in rates, 25% decline in value

Now imagine the downside to longer duration bonds and lower quality credits; it is going to be ugly. The losses will be in the double digits, and will take a significant time to recoup (generally until maturity). We cannot stress the importance of duration in bond portfolios. Duration is a measure of how sensitive the value of a bond is to changes in interest rates.

A FINAL THOUGHT ON THE MACRO PICTURE

Economic indicators have continued to improve but the steep appreciation in US Equities is still predominately tied to Fed policy and when that policy changes or even hints at changing, the markets will react. We keep in mind John Hussman's quote, "Quantitative easing is not rocket fuel. At best, it is a bungee cord."

While we have continued to participate in the current market run up, we are becoming much more cautious in our shorter-term outlook. A good, but little used indicator for measuring cheap financing is margin debt.

NYSE margin debt is close to an all-time high, with the previous high being in 2007. Clearly we don't foresee another economic collapse, but we do see a reason to be cautious. As always, we remain vigilant as we monitor the global macro realities driving today's markets. We will continue to tactically take profits for our clients while using pullbacks in the equity markets as opportunities to reposition portfolios for the longer-term.

Source: Schaeffer's Investment Research Inc.

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