The Fortnighter

June 21, 2013 - Issue #20

Al Gair, MBA, CFP, CIM
Vice President &
Associate Portfolio Manager

Bonnie Walmsley
Associate

2500 - 666 Burrard Street,
Vancouver, B.C. V6C 3B1

T: 604.665.5526

E: al.gair@rbc.com
E: bonnie.walmsley@rbc.com

www.gairwealthmanagement.com

In continuing with last issue's discussion of interest rates and bond yields, I don't think I've ever seen a time where so much focus has been on the actions of the US Federal Reserve Board (the Fed).

You have probably heard the term "quantitative easing" (QE). This is where the Fed buys fixed-income securities to keep interest rates low and (hopefully) stimulate the economy (don't forget where the money comes from - they print it!!)

This had, understandably, got inflation bears and gold bugs excited (i.e. worried). Too much stimulation can potentially lead to long-term inflation and currency devaluation. But, so far, so good. Inflation doesn't appear to be re-surfacing and the US dollar seems to be strengthening along with its economy. Gold prices have fallen, largely because when the U.S. dollar goes UP, gold prices tend to go down.

What's "worrying" is the effect of all this stimulation and artificially-depressed bond yields on the stock markets - it's been a big part of the four-year bull market. Low rates on cash and bonds make alternative investments, such as stocks, look more attractive - especially when a lot of those stocks are now paying dividends in excess of what (even 30-year) bonds pay.

Every time the Fed hints that they may be backing off QE, the markets go into a swoon. The fact that most companies in the US are actually doing quite well, business-wise, seems to be secondary. Everyone is watching the Fed.

As the US economy recovers, the Fed will see less and less need to "prime the pump" and will gradually reduce their bond-buying program. Eventually, QE will be halted all together and then, some time after that, the Fed may actually start tightening again.

This transition period is going to be a very anxious time for the stock & bond markets. I mentioned earlier that stocks have been in a "bull" market for the past four years. Well, it's been a bond bull market for close to 30 years!! (Rates fell initially as inflation was wrung out of the system and investors demanded a smaller "inflation premium" in bond yields. More recently, rates have fallen over economic worries, risk aversion and central bank stimulus).

I believe that the great 30-year bull market in bonds is over - and with it the days of getting double digit returns on corporate bond funds, REITs, and low-growth/high P/E stocks like pipelines and utilities.

And that's not necessarily a bad thing. When the Fed eventually winds up QE3 (or QE4 or QE5) it will be because the economy is largely back on its feet. And that means a healthier backdrop for the types of companies we're always looking for - good businesses with healthy earnings. Just hold on for a bit of a bumpy ride.