Published by SL Advisors, LLC

In Pursuit of Value

April, 2012

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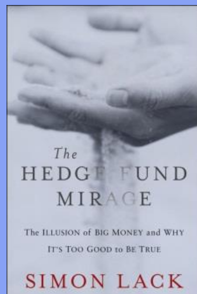
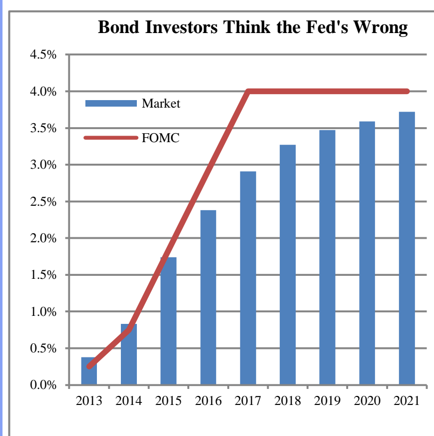


Quarterly Outlook

Investors are living in a time of unprecedented openness by the Federal Reserve. Many readers are old enough to recall the days when "Fed-watchers" would seek to divine the central bank's intentions on monetary policy through its open market operations. If managing reserves, and therefore indirectly the cost of short term financing through the Federal Funds rate, required that the NY Fed conduct a "System RP" and they instead provided somewhat less overnight funding through a "Customer RP", bond traders would immediately interpret an intention by the Fed to raise interest rates and react accordingly. It was subject to all kinds of communication problems – sometimes the Fed wasn't trying to say anything, but Wall Street analysts had got their reserve requirement Math wrong and thought they heard a warning of higher rates. Then the Fed might oversupply short term credit the next day, in order to correct the mis-communication. Somehow this obscure back and forth of action by the Fed followed by reaction from the markets was state of the art central bank communication back in the 80s and 90s. It all now seems so quaint and pointless at the same time. The Fed under Alan Greenspan, following custom, deemed plain English unsuited to its purpose. And Greenspan himself took evident pride at his ability to provide long Congressional testimony using tortured erudition that shrouded monetary policy in a fog and left senators befuddled.

Ben Bernanke has continued a new tradition begun in the latter Greenspan years of communicating quite plainly. Opinions are easily formed on this Fed, because their intentions are so clear. There's no more hiding behind obfuscation. The conduct of monetary policy takes place right out in the open. FOMC minutes are released in a timely fashion; Bernanke holds "town halls" to discuss monetary policy, goes on "60 Minutes" and the Fed now actually tells you, with a fair degree of precision, where they think interest rates will be.

In January, the FOMC released short term interest rate forecasts from all 17 FOMC members. From the published data, it's possible to construct the Fed's own yield curve. A long term interest rate is simply the sum of all the short term interest rates from which it's constructed. Libor rates are visible and can be hedged out to ten years through eurodollar futures. In aggregate they form the ten year swap rate. The ten year swap rate is closely tethered to the ten year treasury yield, which is largely set by the Fed's Operation Twist and its predecessors, QE 1 and 2.



The chart overlays market forecasts of short term interest rates, derived from recent eurodollar futures prices less the typical 0.3% spread to the Fed Funds rate (the blue bars), and compares it with the FOMC's own interest rate forecast (the red line). It assumes the FOMC expects to return to its equilibrium 4% interest rate in five years.

The Fed expects to raise short term rates by the end of 2014. They expect them to go up by 0.5% between the end of 2013 and 2014. Quite recently, the market forecast for Libor rates was that they'd increase by 0.3% during this time. Futures markets didn't expect as sharp an increase as the Fed. Of course, the Fed is only making a forecast, and it's based on GDP growth, inflation, unemployment and

many other variables. Their forecast for these might be too optimistic. But when you ponder for a moment the actions of those bond investors who would accept market interest rates as the basis for their purchases, it's quite bold to insist that buying bonds at yields below the Fed's expected break-even is a sound move. They are telling you, if you'll just listen, that short term rates between now and 2022 will average more than the current yield on a bond maturing at that time. The Fed's forecast may be wrong, but their forecast is obviously a bit more important than yours or mine.

The long end of the yield curve is similarly fascinating. The FOMC's long run equilibrium rate is 4%. This is where they believe short term rates will return when the Great Recession of 2008 is a distant memory and the economy is chugging along at whatever rate it can just short of causing inflationary pressures on wages and other inputs. The FOMC doesn't say exactly when things will be back to "normal". Of course, we'd all like to know. The chart above assumes five years. But the futures market has a different opinion on when that will be, and the answer is March 2022. This is how far out in to the future it's necessary to go in order to reach a eurodollar futures contract that yields 4%. Everything prior to that date yields less, because investors in aggregate believe the economy won't quite be back to normal. Or at least, that's what investors are saying by their decisions to invest, or not, at prevailing yields.

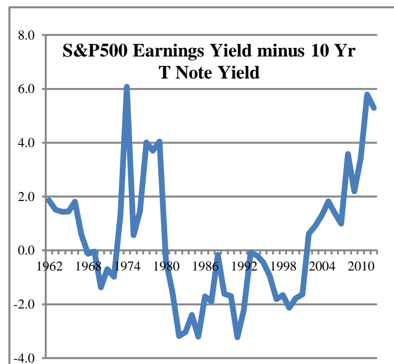
If Bernanke testified before Congress that we still have another ten years to go before the "extraordinarily accommodative" monetary policy was no longer needed, there would be outcry. He would probably be fired, or even impeached. Further fiscal stimulus not even imaginable would no doubt be contemplated. Big things would happen.

Except that he wouldn't say that. Although he hasn't put a date on normalcy's return, everything about his actions and those of his colleagues on the FOMC strongly suggests they are not nearly that pessimistic. Futures markets are pricing in ten years because the Fed has put them there through their buying of treasuries. 61% of net U.S. Federal government debt issuance was bought by the Fed last year. The Fed is maintaining bond yields at levels far lower, perhaps 1-2% lower, than the likely break-even on short term rates over the same period.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

This should be plain to anybody paying attention to the Fed's communications. It doesn't necessarily mean ten year treasuries at 2.2% and related corporate bonds at modestly higher yields are guaranteed to lose money. It may take us more than ten years to reinvigorate the economy, to fully repair all the damage excess debt has wrought over the years. But it is obvious that the Fed thinks today's bond yields are a poor investment. That is a clearer expression of its opinion from the central bank than many of us are used to, and shows how far we've come since the old days of Fed watchers.

We continue to think equities are attractively priced, although obviously not as cheap as they were in the Fall. The Equity Risk Premium, the difference between the earnings yield on the S&P 500 and the yield on ten year treasuries, has narrowed modestly from where it was in September, mostly because the strong rally in stocks has driven multiples higher and earnings yields lower while treasury yields have drifted higher. However, this relationship is still historically wide.



But on interest rates, we believe in siding with the elephant in the room. If last year's buyer of 61% of treasuries thinks yields are too low, that sounds like a view worth respecting. Investors can own a combination of equities and cash divided according to their risk appetite and outlook. But long term bonds, both government and investment grade corporate, are clearly at yields intended to lose you money. The world's biggest buyer is telling you so.

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