THE DANA VIEWPOINT

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MUSICAL CHAIRS

Investors are playing musical chairs and the Federal Reserve led by conductor Bernanke are playing the music to the tune of print more money. They stopped the music a few weeks ago and investors were left scrambling as stock and bond prices dropped quickly. It didn't take long for the Fed to start the music again and stock prices recovered. Bond prices also recovered, but not as much. Even the IMF (International Monetary Fund) stepped in and told our Fed that volatility in interest rates would have excessive adverse global implications (don't stop the music). The IMF further warned that our Fed should clearly communicate their exit strategy and its timing. So, the music has resumed, but investors seem a little more wary of finding a chair (exit) if and when the music stops. Odds are the Fed will continue the music but may slow the frenzied tempo to more of a waltz by tapering their monthly bond purchases from $85 billion to $75 billion. Investors may accept that strategy and continue to dance (invest).

Second quarter GDP came in at a plus 1.7%, an improvement over first quarters' 1.1%, but below the Feds objective. Bernanke feels that the economy needs to grow at least at a 2.5% rate to get unemployment below 7%. Second quarter earnings are coming in at levels pretty much in line with expectations and investors continue to favor big name stocks, preferably with decent dividends. A well diversified portfolio takes advantage of the long-term uptrend in stocks that still exists and protects against an occasional downdraft in certain stocks reporting lower than expected earnings.

Fannie and Freddie: What's happening with these two government sponsored mortgage giants that at one time underwrote over two thirds of the US mortgage market? Starting in the mid-1990s Congress encouraged (forced) these entities to underwrite more mortgages in their zeal to provide a house for all Americans. Many of these mortgages were written with skimpy underwriting standards and eventually came to be known as subprime loans. This ultimately led to the collapse of the housing market and the financial panic that ensued. Banks were also encouraged (forced) to join the party, to which Fannie and Freddie happily gave their government backing. While both entities have recently posted record earnings and begun to reimburse the Treasury, this boondoggle originally cost taxpayers $190 billion in bailouts. Many have called for privatization, but most in Congress still want big government to have a hand in providing affordable housing for all who need it. Congress seems content

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to make the same mistake twice. The housing market in many areas of the country is starting to heat up and we would hope Congress would allow private enterprise to step in, even at a measured pace, and return sensible underwriting practices to the market. The economy is not strong enough yet to withstand another housing shock.

Bonds: Bond investors had a rude awakening after the last Fed meeting when Bernanke hinted at lessening the QE3 bond purchase program. To knowledgeable investors that meant a rise in interest rates and a decline in bond prices. Investors under the age of sixty have not seen bond prices decline for any extended period of time. Many investors were not aware that bond prices can be as volatile as stock prices. Long-term Treasury bonds (30 years) hit bottom around 1942 near a 2% rate of interest. Interest rates rose for the next forty years. Anyone purchasing these bonds or newly issued bonds saw the prices of these bonds decline. In the early 80s bond prices reached a peak. The prime rate touched 22% and mortgage rates touched 18.6%. Tell that to your children today and they will probably laugh. For the next thirty years (so far) interest rates have declined (how about a 3.5% mortgage) and bond prices have risen. Bond investors for the last thirty years have not seen an extended decline in bond prices and were not schooled in the inverse relationship between interest rates and bond prices. Many bond investors assumed you bought bonds for safety and income and that prices never went below par, not realizing that if you buy a ten year Treasury today at par to yield 2.7% the price of that bond will decline if interest rates rise. If interest rates on newly issued ten year Treasuries increase to 3.5% no one is going to offer to pay you par for your Treasury yielding 2.7%. If rates continue to rise, the price of your bond will continue to decline. Many investors may have been misled years ago when financial institutions were allowed to carry their bond holdings at par because this is what they would receive at maturity. The recent economic turmoil here and in Europe has brought to light the inherent volatility in bond prices. Bond investing in the past was mostly a process of staggering maturities and your choices were pretty much government and corporate bonds. Bond investing today requires the skill and experience of a professional to guide you through the myriad of products available. As the long-term trend in interest rates moves higher, working with a manager like Dana with an expertise in floating and adjustable rate securities could be very beneficial.

Random Thought for August 2013: "True genius resides in the capacity for evaluation of uncertain, hazardous and conflicting information."

Winston Churchill

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