The Carnegie Counselor

THE CARNEGIE INVESTMENT COUNSEL NEWSLETTER SECOND QUARTER 2013

Removing the Training Wheels

The stock market was cruising along advancing at a steady pace for most of the first half of 2013, until the Federal Reserve Chairman Ben Bernanke decided to be the lone adult on Wall Street during his speech on June 19th.

His commentary was so poorly received that the stock market, bond market and gold all fell sharply in value for the remainder of the month. There was no place to hide from the fear his comments unleashed. While the Federal Reserve has telegraphed their intent to eventually stop the prolific $85 billion per month purchasing of bonds, the news that they are serious was too much for those hooked on the candy of low interest rates. Lost in the message delivered by Mr. Bernanke is that the economy might be improving enough by year-end to stand on its own without government assistance.

It has been a difficult five-year period to be Chairman of the Federal Reserve, and arguably there is never an easy time for the person who might have the greatest economic power in the world. In hindsight, we were in a housing bubble in 2007 and the fabricated wealth created had to be unwound. Recessions are a natural, though painful, part of the business cycle; however, fearing a depression in 2008, the government took unprecedented steps to limit the economic catastrophe. Ever since, the Central Bank has been conducting an enormous monetary experiment with the twin goals of increasing employment and stimulating the economy. They have used extraordinary measures that have never been tried before, and ending years of easy money will be difficult. The collective efforts of the U.S. Treasury, the Federal Reserve, the Obama Administration and even Warren Buffett helped limit the damage of the ongoing recession. However, when the pendulum is not allowed to swing backwards to its apex, the swing forward is also muted.

Hundreds of smaller banks were allowed to fail over the last five years, but not the "too big to fail" banks. Lehman Brothers and Bear Stearns are gone, but AIG and

Carnegie Expands to Cincinnati

Thomas P. Carroll, CFP

Carnegie enhances its position as one of Ohio's leading investment advisers with the merger of The Alpine Financial Group, effective May 1, 2013. Alpine was established by Tom Carroll in 1996 in Cincinnati, Ohio. Bob Carroll serves as Managing Director, Cincinnati and will lead Carnegie's efforts to expand its unbiased advice offering and help more clients achieve their financial goals. All team members from Alpine are joining Carnegie.

Robert P. Carroll, CPA, CFP®, CDFA™

Goldman Sachs were saved. Fannie Mae and Freddie Mac were taken over by the government at a cost to tax payers estimated to exceed $55 billion. We'll never know what would have happened if the government didn't step forward and save these institutions. We do know that this economic recovery, in terms of growth of our collective Gross Domestic Product, is the slowest in history and the recession the second longest. Typically, coming out of a recession the rate of GDP growth is 4-5%. This economy is growing at a pace of 1-2%; however, the Federal Reserve now believes growth could hit 3-3.5% by 2014. While not exactly an economic utopia, it would appear we are edging closer to a stable economy. With this conclusion, Chairman Bernanke had to make known it will soon be time for the U.S. economy to ride on its own without the training wheels of government stimulus.

Only the short-term focus of Wall Street took this as bad news. Many companies, as well as the U.S. Government, have a vested interest in low interest rates. Higher rates means higher interest payments for the huge national debt we all must pay. For 32 years, bond fund managers have had the wind at their back as interest rates descended lower. It will be extremely difficult to deliver positive total return for bond fund managers as interest rates commence their ascent. The housing market, utility services and auto companies are just a few of the industries that are addicted to low interest rates. The pain of low interest rates is also very real for many constituents. People living on a fixed income or those who have diligently saved money for their retirement (all of our clients) are not receiving the interest they deserve due to the government keeping rates artificially low.

While we've been expecting interest rates to head higher, the drop in the value of bonds over the last three weeks of the quarter is a primer on what we'll see over the next few years. Anticipating this

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result, we'll continue the practice of using individual bonds with short durations to be held through to maturity. In cases where we use bond funds or ETFs, we intend to reduce the average durations and increase the quality of the fixed income positions. While this won't entirely eliminate the impact of bond prices dropping, we'll hope to avoid the losses that will occur in bond funds. Bonds will continue to have a place in portfolios for clients that want preservation of capital and income. If the Federal Reserve is correct and the economy is growing, the total return on bonds will be limited in the future. A growing economy is good for earnings of publicly traded companies, and rising earnings will eventually drive stock prices higher. The second half of the year will be a bumpy ride if the training wheels are removed; fortunately, we'll be going in the right direction.

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