MV Capital Management Thought Leadership

Summertime in Wonderland

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It's a sign of the world in which we live. On a day when the political conversation in the swamplands alongside the Potomac River is all about the debt ceiling, and the nasty powder keg that will blow up in the face of the global capital market if US policymakers play chicken and allow potential default scenarios to come swarming out of Pandora's box – on this day the yield on the 10 year Treasury note…falls below 3%. That's right. Investors are so concerned about the stability of the Treasury market that they…buy more Treasuries. One has to search long and hard for a metaphor that drives home just how surreal this all is. So here's one. Imagine a wild-eyed young man sitting behind the wheel of a vintage Mustang, revving the engine noisily, looking at various cars and pedestrians along the road in front of him., getting ready to shift into gear and floor the gas pedal. The young man's auto insurance agent is standing next to him. "I am taking note of your behavior" says the insurance man. "And so, I am going to lower your rates. No deductible. Congratulations!"

Here is what really concerns us, though. What happens when – or if – reality returns from Wonderland and investors actually decide that Treasuries *are* a risky investment? What happens then? Because right now markets are following a strange pattern called "Risk On / Risk Off". Risk Off days are those when Treasury yields plunge, the dollar goes up, equities and commodities (usually) go down. On the Risk On days the opposite happens, and investors clamor in frenzied rain dances for shares of LinkedIn. Wednesday was a big-time Risk Off day – the major US equities indexes fell by more than 2% and bonds rallied. But so far in 2011 the two alternative eigenstates have been balancing each other out – risk assets are mostly (though by no means uniformly) higher for the year to date, but just when they seem ready to burst out of the gate for an extended rally we have a few Risk Off days to keep things tempered.

The problem, though, is that amidst the ongoing talk of debt ceiling crisis scenarios, Eurozone sovereign debt with junk ratings, possible downgrades to Japanese bonds and Uncle Sam's own credit card on negative watch from the ratings agencies – amidst all this talk we have to face the fact that Risk Off really isn't "Off" at all, in the sense that there are traditional safe harbors in which to moor the boats when the storms come in. We have talked about this in earlier posts this year – the Treasury bond really is not the risk-free asset in the way that it has traditionally served. In fact we would call this phenomenon something a bit different: Financial Risk On / Economic Risk On. Here is what we mean by that. The global capital marketplace now is dealing broadly with two types of risk. One is Economic Risk – this is about the pace of growth in the US and Europe struggling to break out of the 2% range, Japan in another recession, the growth engine markets of China, India and Brazil on a temporary pause, inflationary threats over here, persistent unemployment over there, policymaking gridlock and uncertainty everywhere.

So when investors sit up and take note of this uncertainty they go into Risk Off mode. But financial risk is still very much "On", as evidenced by the debt-related problems we categorized in the previous paragraph. In effect investors are buying putatively "safe" assets out of habit and because they can't think of anything else to do with their money, short of imitating so many Russian grandmothers and shoving it under the mattress. As long as investors keep coming into the bond market when they need a break from Economic Risk On, then things stay pretty much as they are now. But when they come into the safe harbor and have to confront Financial Risk On straight in the face – well, that is likely to be an unpleasant day for anybody with exposure to global capital markets broadly defined.

The question on everybody's mind, of course, is: What To Do? It is a very challenging time to be managing investment portfolios. Every imaginable asset class seems to have its own tailor-made case for being unduly risky, from government bonds (potential bubble) to technology stocks (potential bubble) and all manner of commodities, emerging markets assets and so on. Our approach to this challenge thus far has been to spread our portfolio allocation weights as broadly as prudently possible across as many investable asset classes as are available within our clients' risk-return positions. We believe that approach works well in the Risk On / Risk Off world of today – money swings back and forth between these different asset classes and we try to maintain enough checks and balances to keep things on even keel.

We are also running through scenarios of the practical consequences of a Financial Risk On / Economic Risk On situation, where the traditional safe havens no longer play their role. Here's the thing, though. Capital has to be invested somewhere. Trillions of dollars are not going to disappear under grandma's mattress. Where those dollars go – if not to the traditional havens of Treasuries and the US dollar – is most likely a question of relative (real or perceived) risk characteristics between asset classes. Having all the eggs in one basket – whatever that basket might be – is probably more inadvisable an approach today than it has ever been, and rest assured we will never be employing that approach.

With warm regards,

Masood Vojdani
President

Katrina Lamb, CFA
Senior Investment Analyst

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MV Capital Management, Inc.
4520 East West Highway, Suite 400
Bethesda, MD 20814
www.mvfgroup.com
(301) 656-6545 tel
(301) 656-2722 fax