▶ Have A Very Happy Thanksgiving!

ISSUE 5 | VOLUME 2 | NOVEMBER 2013

Cadence *clips*

FOCUSED ON WHAT MATTERS MOST.

The Lesser of the Evils

It seems we're in an age of monetary excess, government ineptitude, and over-dependency on financial markets. This month we address what's taken place in Washington, its short and long-term consequences and what it means for investments. We attempt to stay politically neutral and fact-based throughout the tantalizing read. Enjoy :)

If someone told you a few years back that in October of 2013, the inability of government to get along would lead to a government shutdown putting almost 1 million people out of work and a near default on our nation's debt, you probably would have looked at them funny. As though that weren't incomprehensible enough, if they said the stock market would rise sharply through that political and near economic mess, you probably would have told them to schedule an appointment with the best psychologist in the area. Well, both scenarios played out last month in rather dramatic fashion and although a rising market isn't necessarily a bad thing, we're a bit concerned about the longer term implications – and by longer term, we mean anywhere from 1 week to 30 years down the road. We find ourselves having to choose between participating in an irrational market that's highly unstable or playing a bit of defense and paying a price for it.

The political theater and corresponding near default on the country's obligations last month doesn't necessarily mean that the sky is falling and we're all destined for a suppressed and barely tolerable existence going forward. It does indicate however that there are large differences of opinion in Washington that are making it hard for our country to govern effectively. This holds very small but potentially catastrophic risks in the short term if these differences and stubborn adherence to them at all costs prevent the rather routine increase of our nation's debt ceiling which we almost witnessed in October. It also holds longer term risks as the failure to stray from partisan ideals and the reluctance to deliver bad news and tough change to constituents keeps long term issues from being addressed. Either way, Washington doesn't appear to be the well-oiled machine we all wish it were.

Congressional Inaction

The near term issue that captured the nation's attention last month was first the government shutdown, then the debt ceiling debate. The former was the result of Congress' inability to agree on a continuing resolution for the country's budget. This is a procedure that can extend the current funding of government in the absence of an annual appropriations bill that establishes new and updated levels of funding for various government departments, agencies, and programs. It's a little disheartening that this new bill was not completed and passed by the October 1 deadline, and instead the fallback option of a continuing resolution was being discussed. Ironically, failure to agree on a motion to do nothing by October 1 was what put people out of work and is a testament to the political rifts that exist in Washington. And so with over 900,000 government employees out of work, Congress shifted their attention to the debt ceiling deadline of October 17 set by Treasury Secretary Jack Lew. Being a debtor nation that needs to borrow to fund government operations and obligations, every now and again Congress has to raise the limit on the amount of debt that the Treasury can issue in order to continue making pre-authorized payments. A couple words on this procedure to clear up some confusion created by politically slanted media outlets:

- Raising the debt ceiling does not authorize the president to spend at will.
- It does allow the treasury to make payments already agreed upon by Congress.
- It does result in an increased level of national debt since we need to borrow more in order to fund existing programs. The assertion that raising the debt ceiling does not increase our debt is disingenuous and misleading. Debt does increase, but it does so in a way where we're spending money on outlays that were already authorized by Congress.

So with that cleared up, this hoisting of the debt limit has unfortunately become a fairly routine procedure and is normally done without much consideration at all. However, given the strong belief of some members of Congress (political affiliation left to the reader to discern) that government spending is far too high and needs to be addressed now, there was significantly more reluctance to raise the debt ceiling this time around. Right or wrong, some members of Congress felt as though if these spending issues weren't addressed within the context of a debt ceiling procedure, then they may not be addressed in a meaningful way anytime soon. And so political lines were drawn, and the field was prepared for battle. Although there was talk of the initial October 17 deadline being missed, Congress finally came together led by the Senate to raise the debt ceiling by essentially kicking the can on the continuing resolution to January 15 and the debt ceiling to February 7. Just enough time for Congress to rest up, enjoy the holidays, and return to the battlefield with a bit more vigor. We'll be doing this whole thing again. Stay tuned.

Although the consequences stemming from a failure to raise the debt limit could be extremely high, it is rather unlikely given that if at an impasse, Congress can continue doing what they did just last month – punt the issue a few months down the road. The bigger issue to us is one that lies a few more years ahead. According to the Congressional Budget Office (CBO) - a nonpartisan government organization - if we stay on our current path, by 2038 our debt to GDP ratio will be 190%. That's worse than Greece. If you're thinking we can all pitch in and shoulder some of that burden together, well think again. Demographic trends aren't exactly working in our favor. Each of our retirees is currently supported by ~4.4 workers. These are the kind folks who pay taxes into the Social Security and Medicare systems to support our happy retiree. Well, by 2038 that number drops to ~2.7. That's significantly less money being paid into a system designed to support people who are living longer. By that same year, the amount of money that goes toward interest on the nation's debt rises from roughly 12% into much higher territory depending on interest rates – potentially 25-50%. (This 12% includes interest paid to the Social Security Trust fund as well as the Federal Reserve). Anyone who feels this scenario is acceptable really needs to live in a third world country for a bit to get a feel for how it would compare to what we're used to. It would be a completely different existence and we truly need to take steps to address these core issues now.

We won't profess to have all the answers, but the theme needs to be a revamp of Social Security, Medicare and Medicaid, and welfare (the "entitlement" programs) so that they don't require as much government output to sustain in the future, as well as other spending cuts where appropriate. Of course there may need to be revenue increases too in order to adequately fund those expenses deemed most important. These changes are going to be very difficult, unpopular, and a bit painful, but they need to be made. They'll also have negative impacts on economic growth, but make no mistake, the consequences down the road of ignoring the issues would be much worse. Our hope is that Congress has the intelligence, guts, and integrity to do what's right for the future of the country. Based on what took place last month, we have our doubts, but we're hopeful.

Markets Go Higher Regardless

Oddly, the stock market didn't seem to care about all the shenanigans in Washington. It either assumed a deal would get worked out in the end or figured if there was any fallout from the spectacle that the Federal Reserve would increase their efforts to keep markets moving higher. This "bad news is good news" reaction is eerily similar to what we witnessed in the late 90's with the internet bubble. Alan Greenspan's willingness to support markets through lower interest rates was referred to by market participants as the "Greenspan put" since a put is an investment instrument that provides protection against a downward move in the market. With Greenspan at the helm, one couldn't lose. That same sentiment exists today with respect to Ben Bernanke's monetary policy, and yes, they're referring to it as the "Bernanke put".

These are really tricky times to be an investor. We're dealing with a stock market that wants to go up not because the economy is healthy or because corporations are growing their earnings rapidly through innovation and productivity gains, but because the Federal Reserve wants it to. By lowering rates to the point where you just can't make money anywhere else, the stock market becomes the best looking ugly duckling on the pond. Not a real strong investment thesis. In addition, you have the general belief that when the Fed prints money, markets go higher as displayed by the saying "don't fight the Fed". Those following this credo blindly may feel betrayed by the current benevolent, selfless Fed policy down the line. We liken it to venturing into a calm and gentle flowing river only to find a thundering waterfall just down-stream. We don't know what specific catalyst will bring markets down, but it really doesn't matter. The manipulation in itself and excesses it creates will lead to cracks that ultimately give way. In the meantime, who doesn't want the effects of some of that easy money policy in their portfolios? Everyone, including us. The problem is we just don't know when those positive effects will dissipate and it's virtually impossible to leave the party just as the police are pulling into the driveway.

We often hear people say, "I'll just sell as the market starts falling". A logical statement for sure, but it's much more complicated when actually in the middle of that real-time decision. Let's go through the drill. If the market drops 7%, do you sell? If you had done so in 2013, you would have missed almost all of the gains this year. After a number of very small drops, the market came charging back penalizing those who scared easily. Now the market's down 15% and you have the same decision. If you get out and it comes roaring back, then you've made the same mistake as before, only more costly this time. If you don't get out thinking the market will come back, then you may be facing the same decision once the market drops 25%. The reality is, investors typically won't start running for the exits until the market's down so much that they start fearing for their safety and security. This usually takes place after markets have dropped 20% or more as evidenced through fund flow data into and out of stock mutual funds. With that truism in mind, depending on the "Bernanke put" for your investment returns may be a very dangerous proposition. If the past is any guide, it may be best to step aside by taking a much more conservative position and prepare to be a buyer when all those other investors start selling. Is this difficult to do while the market's going up? Sure. Is this a time tested way to manage risk and keep from losing a bunch of money in the longer run? History suggests absolutely.

Longer Term Investment Implications

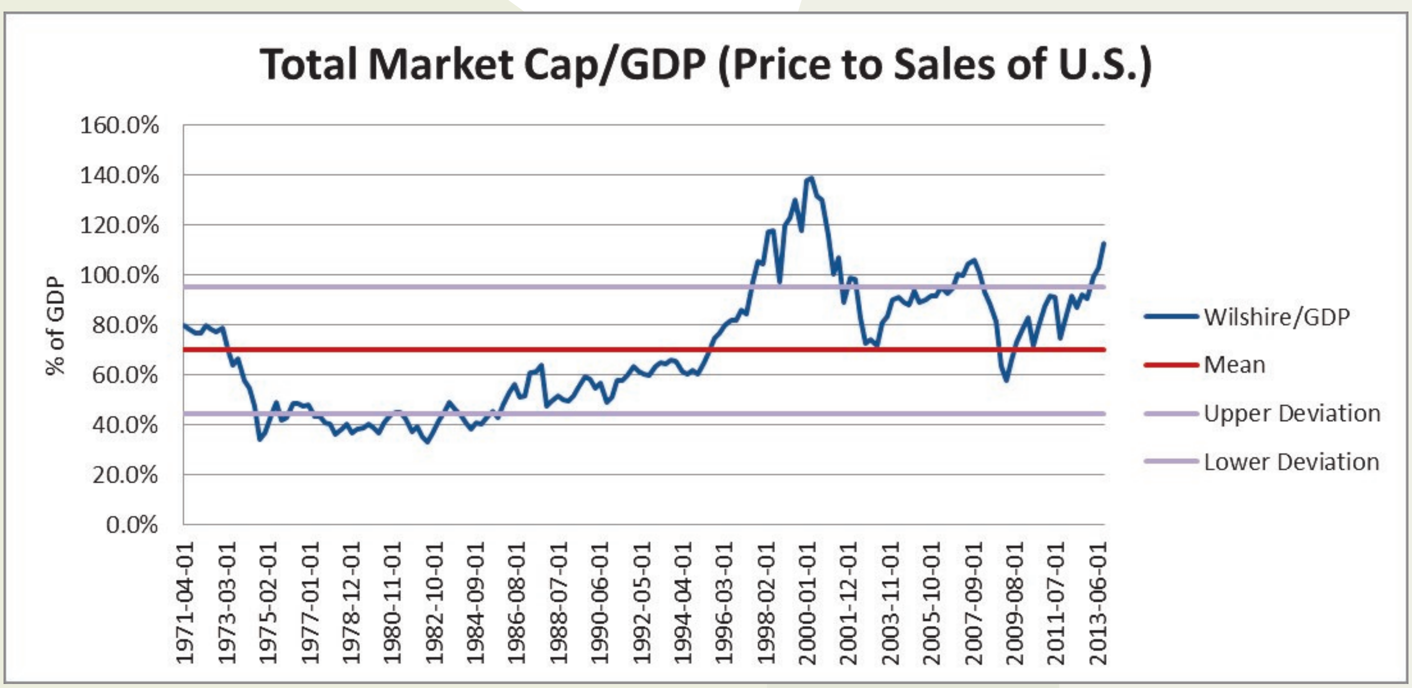
If we address our longer-term structural and fiscal issues in this country adequately, we'll see slower growth as a result. If we don't, we'll still likely see slower growth due to demographic and economic trends that occur over very long periods of time. The slowing or contracting of all the credit created over decades that culminated in tremendous levels of government and personal debt levels will be another cause for headwinds that the economy faces over the coming years. Some economists believe we're facing a future where 2% economic growth will be the new normal as opposed to the 3.2% that we've grown accustomed to. If this is true, markets won't get a ton of help from a thriving economy. Although it's true that markets and economies don't always move in lock-step, they do tend to shadow one another over longer periods of time. Not a real problem if the market was selling on the cheap right now, but unfortunately it's not. When viewed through the lens of market capitalization relative to GDP (the total value of publics companies in the U.S. divided by the size of our economy) we find there may be ample room for a bit of deterioration as the size of the market comes back into alignment with the economy. It's our belief that the stock market as a whole will struggle to make any progress at all over the next 7-10 years as a result of these things. That's not to say there won't be some pretty dramatic ups and downs as we're witnessing now, but overall, it could very well be a wash. If investors make the usual mistake of buying toward the top and selling after a big decline, the next few years could do a fair amount of damage. We need to tread very carefully.

On the bond side, we see a smoother ride with the prospect of making small gains, but still below what we're accustomed to. We don't feel rising rates will destroy bond prices quickly as a sluggish economy shouldn't be supportive of rates much higher than they are now, but we certainly can't depend on falling rates to boost returns in bond investments. Over 7-10 years, we feel it's likely that we'll be able to keep a good portion of any interest that bonds generate, while a small portion would be offsetting losses to principal due to rates trickling higher. Not great, but possibly the best of the options for buy and hold investors – certainly those with a low appetite for risk.

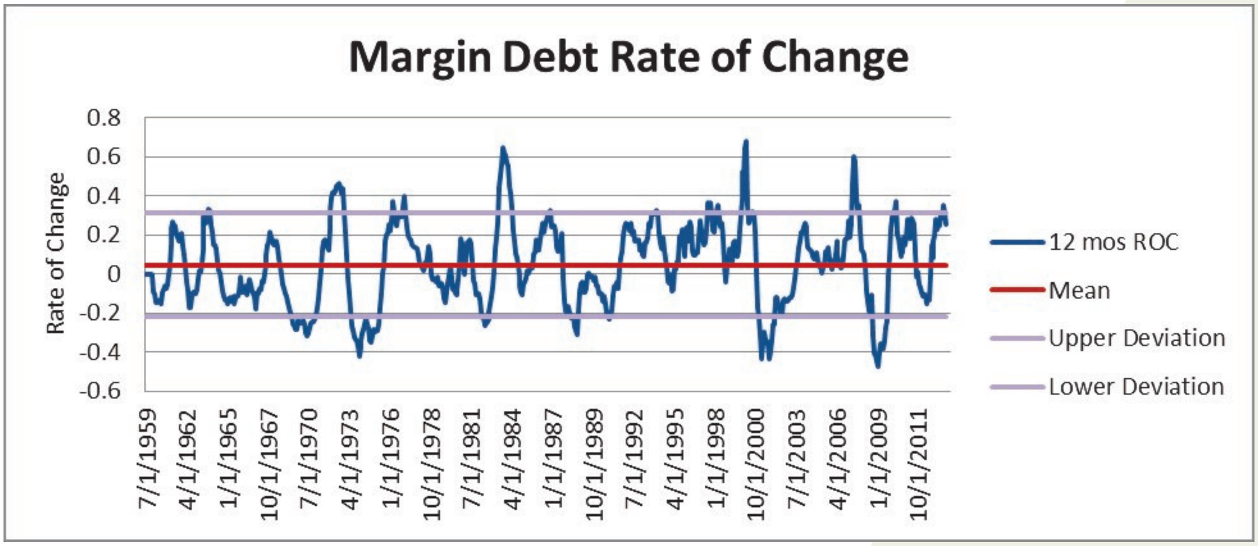
Buy-and-hold index investors may have quite a bit of trouble logging investment gains over the coming years as the benefits of basic diversification shrink. A standard diversified approach that historically has delivered 6-8% returns could struggle to attain 3-4% returns. The road ahead will be one that we're not that familiar with and we'll need to adapt if we don't want it to lead us into a ravine. It's going to take active management and ample amounts of discipline and patience to stay on course. This is not an environment where one can simply dial up the risk level and be rewarded with higher returns. Rather, risk-management has to be employed consistently and risk-taking must be calculated and employed carefully. For as long as markets are irrational, risk management will appear broken. Don't be fooled. Risk management is never broken and one should never be coerced or coaxed into taking risk they can't afford to take. Whether the canoe goes off the waterfall today or tomorrow, the flow of the river will take it there. Regardless of how peaceful the drift seems. Avoiding this outdoor adventure and missing out on a nice day at the river may turn out to be the lesser of the evils.

Signs of Excess

The data below supports the case that the stock market's rubber band may be stretched a little thin. Timing is always the hard part, but if you take a big picture view, there's ample reason to feel that longer term gains may not be as great as some think. In addition, the first chart suggests that things are frothy once again as a result of the Fed's easy money policy. Just as they were in 2000 and 2007.



We're already back above levels we saw at the peak of the market in 2007. Could we go higher? Sure, but if we believe that relationships revert back toward their averages over time, we won't stay higher forever which suggests these market gains may be temporary.



Forward Returns		
	12 mos	24 mos
Upper Deviation	1.1%	0.0%
Lower Deviation	6.1%	17.1%

The charts above illustrate the rate at which margin borrowing has changed over a 12 month period. As you can see, returns for the subsequent 12 and 24 month periods on the S&P 500 after a rapid increase in brokerage account borrowing aren't stellar.

May November bring you an abundance of life's most valuable assets—health and happiness! See you next month!

Important Disclosures

This newsletter is provided for informational purposes and is not to be considered investment advice. Cadence Wealth Management, LLC, a registered investment advisor, may only provide advice after entering into an advisory agreement and obtaining all relevant information from a client. The investment strategies mentioned here may not be suitable for everyone. Each investor needs to review an investment strategy for his or her own particular situation before making any investment decision.

All expressions of opinion are subject to change without notice in reaction to shifting market conditions. Data contained herein from third party providers is obtained from what are considered reliable sources. However, its accuracy, completeness or reliability cannot be guaranteed.

Examples provided are for illustrative purposes only and not intended to be reflective of results you can expect to achieve.

What was the first Thanksgiving dinner like?

Today, the traditional Thanksgiving dinner includes any number of dishes: turkey, stuffing, mashed potatoes, candied yams, cranberry sauce and pumpkin pie. But if one were to create a historically accurate feast, consisting of only those foods that historians are certain were served at the so-called "first Thanksgiving," there would be slimmer pickings. "Wildfowl was there. Corn, in grain form for bread or for porridge, was there. Venison was there," says Kathleen Wall. "These are absolutes."

But determining what else the colonists and Wampanoag might have eaten at the 17th-century feast takes some digging. To form educated guesses, Wall, a foodways culinarian at Plimoth Plantation, a living history museum in Plymouth, Massachusetts, studies cookbooks and descriptions of gardens from the period, archaeological remains such as pollen samples that might clue her in to what the colonists were growing.

Our discussion begins with the bird. Turkey was not the centerpiece of the meal, as it is today, explains Wall. Though it is possible the colonists and American Indians cooked wild turkey, she suspects that goose or duck was the wildfowl of choice. In her research, she has found that swan and passenger pigeons would have been available as well. "Passenger pigeons—extinct in the wild for over a century now—were so thick in the 1620s, they said you could hear them a quarter-hour before you saw them," says Wall. "They say a man could shoot at the birds in flight and bring down 200."

It is possible that the birds were stuffed, though probably not with bread. (Bread, made from maize not wheat, was likely a part of the meal, but exactly how it was made is unknown.) The Pilgrims instead stuffed birds with chunks of onion and herbs. "There is a wonderful stuffing for goose in the 17th-century that is just shelled chestnuts," says Wall. "I am thinking of that right now, and it is sounding very nice." Since the first Thanksgiving was a three-day celebration, she adds, "I have no doubt whatsoever that birds that are roasted one day, the remains of them are all thrown in a pot and boiled up to make broth the next day. That broth thickened with grain to make a pottage."

In addition to wildfowl and deer, the colonists and Wampanoag probably ate eels and shellfish, such as lobster, clams and mussels. "They were drying shellfish and smoking other sorts of fish," says Wall.

The colonists did not have butter and wheat flour to make crusts for pies and tarts. (That's right: No pumpkin pie!) They had a lot of meat instead. Meat without potatoes, that is. White potatoes, originating in South America, and sweet potatoes, from the Caribbean, had yet to infiltrate North America. Also, there would have been no cranberry sauce. It would be another 50 years before an Englishman wrote about boiling cranberries and sugar into a "Sauce to eat with. . . .Meat." Says Wall: "If there was beer, there were only a couple of gallons for 150 people for three days." She thinks that to wash it all down the English and Wampanoag drank water.

Source: http://www.smithsonianmag.com/history-archaeology/Ask-an-Expert-What-was-on-the-menu-at-the-first-Thanksgiving.html#ixzz2ieIJ4UeI

CADENCE WEALTH MANAGEMENT