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06/10/2014	Value	YTD %
Dow Jones Industrial Avg	16945.92	2.2 %
Vanguard 500 Index	180.56	6.4 %
Vanguard Total Bond Index	10.77	3.1 %

VLMAP: 35% for June, 2% yield

JUNE 11 , 2014

COGNITIVE DISSONANCE IN THE FINANCIAL MARKETS

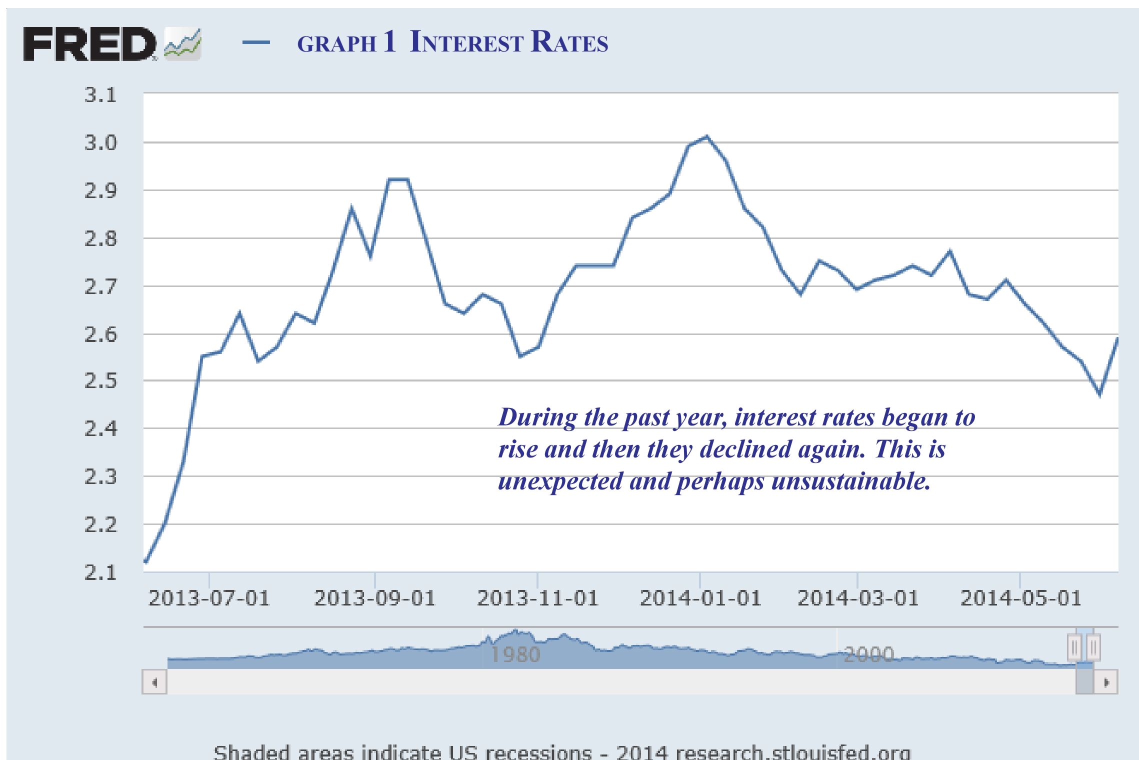
As I write this, the US is on the verge of recapturing all of the jobs lost in 2008. Finally, six years later, we can say that our economy has regained the lost ground of our most recent financial panic.

I'm also reading a report by Samuel Eisenstaedt, the famously accurate nonagenarian former research director of Value Line, which states that the stock markets will finish up 10% from here at the end of 2014.

On the other hand, both the historically proven Value Line Median Appreciation Potential (VLMAP) statistic, and the accurate but rather complex Tobin's Q statistic, are saying the stock market is historically quite overvalued.

Confusion is appropriate here. All these historical indicators are relatively reliable, yet they can't all be right.

To add to this magical mystery tour, we are facing the greatest mystery of all: the completely unexpected 2014 bull market in bonds. This one's a genuine puzzle and it has outwitted some of the best investing minds in the world.



In 2013, the investing consensus was that an improving economy should boost interest rates, at least mildly. But in reality, while the economy HAS improved as expected, interest rates have gone DOWN not UP (GRAPH 1).

Perhaps part of this decline in interest rates is due to short-covering by hedge fund managers who were betting that interest rates would soar, and are now caught on the wrong side of the market trend. Most of the bond market's action seems to be derived from the shared expectation that economic growth and inflation will both be sluggish for the next decade. That's in opposition to the real-world improving economic data we are witnessing. In theory, a stronger economy suggests that yields should be going higher, not lower.

In contrast to this, the consensus implied by our currently rising stock market is that investors think that the economy will grow at a faster rate.

The majority expectations of the bond market and the stock market have thus diverged, and both cannot be right.

Since the bond markets of the world often precede the stock markets in their behavior, this investor disconnect is the 10,000 pound gorilla in the room. We need to be paying attention.

Adding to the complexity is the European Central Bank's decision last week to set their short-term deposit rate at a slightly negative -.10%. This means that they are attempting to force cash-hoarding banks to lend out or invest money outside the ECB. We are certainly in an unknown country now.

I'm also observing one final but fascinating indicator. If we look at the portfolio holdings of bond funds, we can see that average credit quality is declining while average bond maturity is extending. Not all managers are taking this path, but the consensus among bond mutual fund managers appears to be as follows: it is relatively safe to invest in higher-risk bonds because the economy will not go into a recession. It is also relatively safe to extend average bond maturity because the likelihood of interest rate increases is perceived as low.

The best-performing bond mutual funds in the past five years accepted the most credit risk and the longest maturities. The fund managers for these most successful bond mutual funds took gargantuan risks and won hugely. But now these top funds are very risky.

Once again, the assumptions driving investing in the stock and bond markets can't all be correct. Either the economy will grow and interest rates will inexorably rise, or the economy will continue to stagnate, and high risk bonds will be challenged.

Given what we know, here's what we can summarize:

1. The economy isn't signaling that a recession is imminent. In fact it is signaling continued very slow growth. There's no need to move to cash. We simply need to stay diversified.

2. Risks in the bond and stock markets are increasing as investors become complacent. We want to watch what our mutual funds own for us. We may want to weed the garden here by taking out mutual funds which have lopsided portfolios that are at odds with our long term goals.

3. Given all this, it's acceptable to stay relatively low risk and wait for bargains to buy.

4. Cheap money and the additional cash which is forced out of the ECB by that negative deposit rate should push down the Euro, push up the dollar, and feed bubbles in the stock markets and real estate. This means that we want to stay in equities and look for small bargains internationally.

5. Something's gotta give and we won't recognize it until it happens. By the very nature of the world of finance, a large number of people out there are WRONG and when they see that, the herd will stampede. Patience. ■