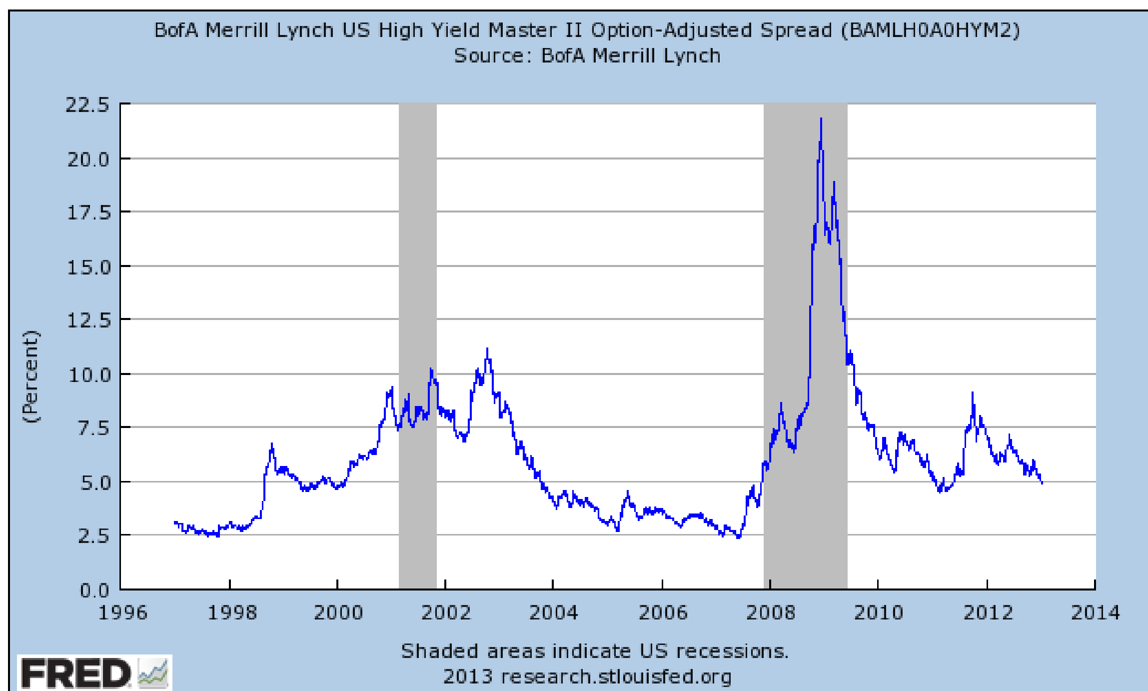
The Philadelphia Trust Company

Investment Commentary **January 2013**

The Fourth quarter of 2012 was historic, and set-up 2013 as a transition year. There will be political leadership changes in the world's largest economies, we will begin restructuring the $4 trillion US health care system, the Federal Reserve will add $1 trillion to the US economy through its quantitative easing program, and the US may adopt austerity measures. These are major macroeconomic themes, which are largely supportive of the economic recovery, but after the S&P 500 advanced over 15% amid GDP growth of about 2%, stock market performance is more tied to government actions than the underlying fundamentals of the economy.

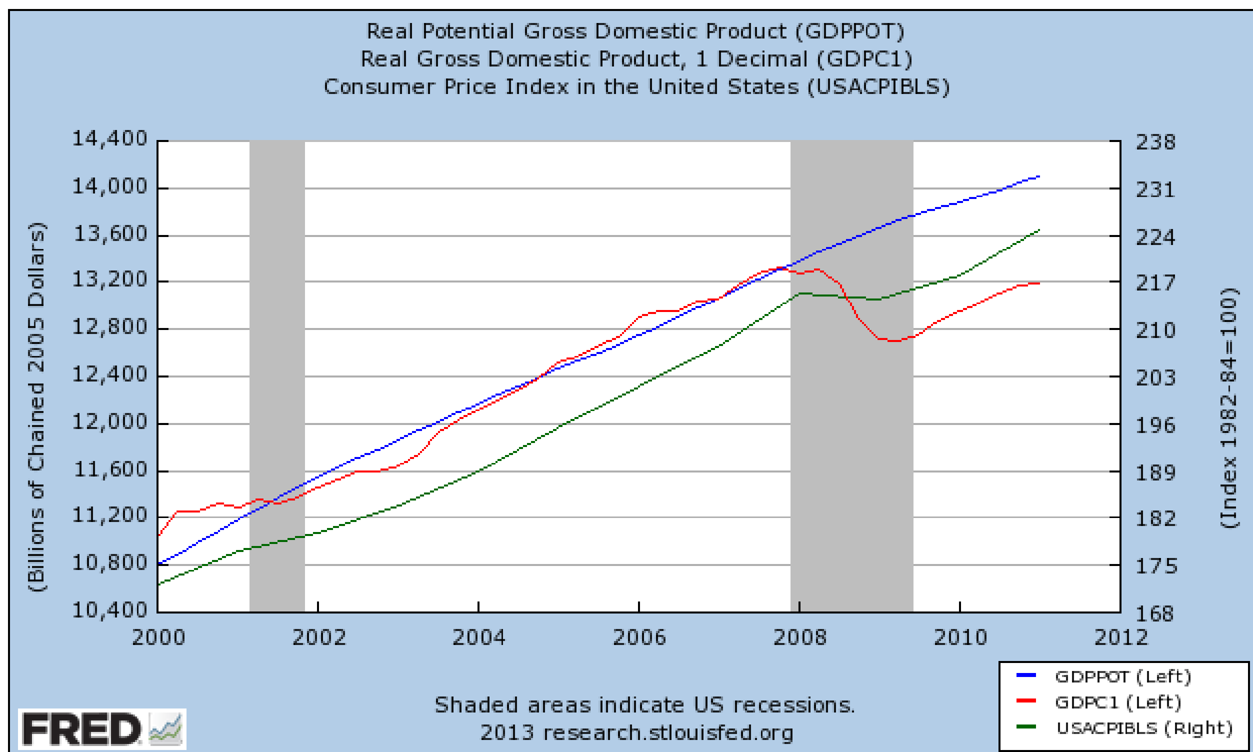
New political leaders came to power in the world's three largest economies (US, China, & Japan), and after German elections occur in September or October, there will be political stability at the most senior level of government for the next several years. It remains to be seen how these leaders will work together, but since the problems are now sovereign in nature and global in scope, geopolitical co-operation is as important as ever. Japanese Prime Minister Abe was elected on a platform that requires him to take over the central bank and massively devalue the currency. Both policies set a dangerous precedent with geopolitics in such a fragile state.

As the global financial crisis evolves, sovereigns have become the key players in the market via monetary policy, fiscal policy, and open market operations, and their efforts to diminish the impact of the economic slowdown on the economy, may have planted the seeds of the next crisis. Low interest rates and abundant capital is funding businesses and capacity that are not profitable when interest rates and the cost of capital are higher. Risk is being shifted, not destroyed, and while a lot of risk has shifted out of the private sector to the government, investors are reacting to this environment with a short term focus. Policies have reduced liquidity risk, interest rate risk (in the near-term), and lowered volatility, while increasing political risk, market risk, currency risk, and inflation risk in the longer-term. The risks being assumed by the private sector ultimately relate to purchasing assets at inflated prices and long term returns falling short of objectives.



When money flows into a market, prices move higher, and expected returns decline. The chart above shows that the spread between high-yield ("junk") bonds and US treasuries is nearing levels only seen during the technology and housing bubbles. Yield conscious investors have an insatiable appetite for these bonds, reflected in the record $812 billion junk bond issuance in 2012, which is more than 20% higher than the previous record set in 2007. The misallocation of capital, caused by policy makers is occurring on a massive scale, and while the junk bond market may be over heating, there is no apparent catalyst to cause an immediate correction.

With the Fed Funds rate near 0% for 4 years in a row and quantitative easing in its third iteration, the Federal Reserve is well down the path of "extraordinary" policy measures. The Fed has made the unemployment rate the trigger for interest rates, but signaled that it could end quantitative easing sooner. Monetary policy has been enacted under the assumption that employment is the transmission mechanism for inflation, with the Output GAP (Potential GDP – Actual GDP) signaling the need for accommodative policy, and the inflation rate signaling the ability of the Fed to act. While $1 trillion in additional liquidity (assuming current policy hold throughout the year) may seem like overkill, the chart below shows that the $3 trillion expansion of the Fed's balance sheet since the crisis began has had little impact on closing the output gap (the difference between the blue line and the red line).



There is some debate among the investment community about whether Chairman Bernanke will attempt to move monetary policy to a "neutral position" before he departs (his term ends in 18 months), in order to leave his successor room to operate. This would likely mean an end to QE in 2014. The question is whether it is the size of the Fed's balance sheet that matters, or if it is the daily flow of $4.5 billion in liquidity into the market, that is achieving the objective of lowering interest rates forcing investors to take risk they would otherwise wouldn't.

Complex systems survive through a balance of efficiency and resilience. While our economy is highly efficient, the prolonged dependence on governmental accommodations is damaging our system's resilience.

The Philadelphia Trust Company's Equity Composite is positioned for stability amid the transitions discussed above. Monetary policy is extremely accommodative, and while conducive to economic stability, it disproportionately benefits weaker, more indebted companies. The mis-pricing of risk is causing some investors to focus more on short-term returns, than long-term risk. The Philadelphia Trust Company avoids exposing our clients to unnecessary risk, by investing in companies with sustainable cash flows that generate excellent returns over the cycle, and trade at attractive valuations. Managing risk is as important as managing returns, and these values should continue to serve our clients well as the market and investment landscape evolve. We will remain nimble and take advantage of the short-term focus manifesting in current markets, to position our clients for long-term success.

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