REVIEW & COMMENTARY
2ND QUARTER 2013

When good news is bad

Certainly the latter part of the second quarter 2013 was even more confusing than normal in the capital markets leaving most investors increasingly confused. In late May, Chairman Bernanke of the US Federal Reserve reassured the markets that while the years of quantitative easing (QE) will eventually come to an end, there was no imminence to the decision and that the Federal Reserve's actions regarding QE would be 'data dependent'. This merely means, at least to us at SIM, that if the economy strengthened sufficiently, he would ***ease*** the process of adding stimulus. Pretty benign comments in our view but the market reacted severely. Gold plummeted, commodities followed lower and bond yields moved dramatically higher in the US. But Mr. Bernanke's comments weren't as damaging as the market interpreted them, in fact, we considered his comments constructive. Add to this China's ruling party's continued success at engineering an economic soft landing, confidence waned and global equities moved lower as did the price of longer term bonds. Indeed, good news was bad for the markets. We aren't quite sure why the market reacted that way but we will try to make sense of it.

First, liquidity in the markets is relatively thin- in other words, volumes are low. This makes the influence of short term traders, computer trading programs, and momentum investors even greater and there appears to be an Old West mentality of 'shoot first, ask questions later'. More importantly while so many investors look to equity markets, the real key indicator is the bond market. US Treasury bonds didn't digest Mr. Bernanke's comments well and 10 Year US Treasury Yields jumped from just over 2% to close to 2.75% in a few days. This was dramatic and shocked investors. The bond market had interpreted Bernanke's remarks that easing was going to be replaced by tightening rather than a moderate and gradual withdrawal. A few weeks later when the Federal Reserve Chairman reassured market participants that no such dramatic reversal of policy was imminent, interest rates eased and equity prices improved as have commodity and gold prices.

China continues to be a great focus of investors. There is ample evidence that the Chinese economy is slowing but it appears that many of those most concerned about it fail to remember that this is the second largest economy in the world, and by their own admission they are intent on slowing their own growth to make it more sustainable. Government officials have been signalling these intentions for quite a while and their intention is to evolve their economy from depending on exports to embracing a more consumption-driven model. It won't be easy but it appears to be reasonably well managed so far. As Chinese Finance Minister Lou Jiwei recently assured a Washington audience that "… there won't be much of a problem to meet our expectations (7% growth) this year." Certainly they have been managing expectations downward; however, it is an enormous economy that will continue to grow at very impressive, though admittedly lower, levels for the remainder of this decade.

So when good news is bad, it doesn't make a lot of sense. When things don't make a lot of sense, those with little confidence react quickly, sometimes with regret. While we think the US economy continues to recover, if anything it may surprise us by its strength given that many investors remain overly cautious and on the sidelines. Certainly sustained weakness won't be a surprise and oddly would be good for the bond market. While we can discuss this another time, this is a classic case when bad news is good. Stay the course, buy good solid companies and invest for the long term.

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