“Unfortunately, there seems to be far more opportunity out there than ability…We should remember that good fortune often happens when opportunity is met with preparation.” - Thomas Edison

The end and beginning of years brings a rash of predictions. Projections of market returns, interest rates, inflation and employment statistics, etc. are splashed across print, broadcast and internet venues 24/7. The vast majority are middling estimates that project average changes. A minority stand apart due to their wide variance from the average. In hindsight, very few are close to the actual results; particularly as it relates to equity market returns or economic forecasts.

With each succeeding year we experience in this business the less prone we are to predict the results of markets in any short period of time. It is truly a guessing game as the markets often have a mind of their own and a propensity to defy logic or rationality for periods longer than we can determine.

What does give us perspective that we find valuable and useful in our planning and strategic investment decisions is attentiveness to cycles and as Howard Marks would say, “...an awareness of the pendulum...” of investor/business attitudes and behavior. As a weatherman it would be the difference between predicting the weather on strictly a daily basis versus predicting the general nature of the climate by seasons. Or as a golfer it would be analogous to predicting the accuracy of each individual shot versus predicting the average score of the round.

One very significant and far reaching cycle in the midst of a secular change is interest rates. It is quite likely that the low yield of 1.66% reached by the ten-year treasury in May of 2013 will mark the end of a nearly 30-year decline in interest rates. And conversely, mark the beginning of a new long-term rise in interest rates.

It will be difficult at best to predict the daily, weekly or monthly changes in interest rates. What is generally true is that interest rates anticipate future economic events, they move swiftly and their cycles from top to bottom or bottom to top are very long-term in nature.

Howard Marks provides a simple but elegant description of the two phases of the credit cycle.

“The process is simple:

• The economy moves into a period of prosperity
• Providers of capital thrive, increasing their capital base
• Because bad news is scarce, the risks entailed in lending and investing seem to have shrunk
• Risk averseness disappears
• Financial institutions move to expand their businesses; i.e. to provide more capital
• They compete for market share by lowering demand-ed returns (e.g., cutting interest rates), lowering credit standards, providing more capital for a given transaction and easing covenants.”
This period typically ends with bad loans being made for poor investments. Much like the period of the early to mid-2000s, anybody breathing could secure a loan with little to no equity investment for a rapidly rising priced asset (residential real estate).

Cycles sow the seeds of their own destruction. When the up-cycle described above melts down the cycle is reversed. And as Marks further describes:

- Losses cause lenders to become discouraged and shy away.
- Risk averseness rises, and along with it, interest rates, credit restrictions, and covenant requirements.
- Less capital is made available-and at the trough of the cycle, only to the most qualified of borrowers, if anyone.
- Companies become starved for capital. Borrowers are unable to roll over their debts, leading to defaults and bankruptcies.
- The process contributes to and reinforces the economic contraction.

These last characteristics are representative of the recent financial crisis. Our best guess is that we are near the end of second set of circumstances above and turning the corner to the first set. Capital has been tight except for only the most qualified. There were defaults and bankruptcies. And all of it led to a severe economic contraction.

It might be stretch to say we are in a full-fledged period of prosperity, but things are gradually improving. Financial institutions, business and individuals have increased their respective capital bases slowly but surely. We are still in a period of tight lending standards, but loosening ever so slowly. Risk averseness remains front and center in the consciousness of lenders and borrowers (and investors) but it is slowly improving. This evidence points to a handoff of the baton from one leg of the credit cycle to another.

As investors it tells us a few things. One is that interest rates are poised to begin moving up for an extended period of time. This change may not be fast and furious; though when the changes occur they will appear to be just that for short bursts of time.

Risk taking and capital allocation tend to go hand in hand. Neither is off to the races at this time. However, there are inklings that lenders, borrowers and business investment are loosening their pocket strings. This increased investment should help propel the slow but progressive move forward in the global economy.

The financial repression for savers should gradually improve with the coming cycle. Yields on fixed income issues will increase during this period. The downside for fixed income investors will be for those who are invested in long dated maturities. The rising yield cycle will force the prices of long-dated maturities down. There will be periods, similar to 2013, where the increase in interest rates will result in total returns of potential negative to flat returns for some fixed income. For example, a bond or bond fund with a yield of 3% only needs to lose 3% of its bond price to have a 0% total return for the year.

We have taken steps in our fixed income portfolios to mitigate the risks of rising rates. Our core bond allocation’s duration is only approximately 3 years as of this writing. Our high yield portfolios are stretched to approximately 5 years of average duration. While our global bond allocations have an average duration of approximately 3.50 years.

We have said many times in the last year our expectations for fixed income are modest. The bottom of the interest rate cycle is accompanied by low current rates and rising interest rates into the future. It doesn’t portend that fixed income is not an appropriate and conservative addition for the balanced investor. What it does mean is that expectations for fixed income returns should be modest with returns in the low single digits for years to come. Our expectations for the next 3-5 year period would be fixed income total returns in the 3.50-5.00% annualized range. It has been said before and remains ever so true today. More investors have lost money chasing higher yields than almost any other thing.
Diversification and strategic asset allocation do not ensure a profit or protect against a loss. Investments are subject to market risk, including possible loss of principal. Gross Domestic Product (GDP) is the annual market value of all goods and services produced domestically by the US. Alternative investment strategies involve greater risks and are only appropriate for the most sophisticated, knowledgeable and wealthiest of investors. High-yield bonds are not suitable for all investors. When appropriate, these bonds should only comprise a modest portion of your portfolio.

The S&P 500 is an unmanaged index of 500 widely held stocks. The MSCI Emerging Markets Index is designed to measure equity market performance in global emerging markets. The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. Barclays Capital U.S. Aggregate Bond Index is made up of the Barclays Capital U.S. Government / Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Based Securities Index, including securities that are of investment grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million. The MSCI EAFE (Europe, Australia, Far East) index is an unmanaged index that is generally considered representative of the international stock market. These international securities involve additional risks such as currency fluctuations, differing financial accounting standards, and possible political and economic instability. The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. It is not possible to invest directly in an index.

The Russell 2000 index is an unmanaged index of small cap securities which generally involve greater risks. The Dow Jones-UBS Commodity Index aims to provide broadly diversified representation of commodity markets as an asset class. The NASDAQ Composite Index is an unmanaged index of all stocks traded on the NASDAQ over-the-counter market. The Dow Jones Industrial Average is an unmanaged index of 30 widely held securities. The Wilshire Real Estate Securities Index measures the performance of publicly traded U.S. real estate securities. The Barclays Capital U.S. Corporate High-Yield Bond Index covers the universe of fixed-rate, non-investment grade corporate debt of issuers in non-emerging market countries. Eurobonds and debt issues from countries designated as emerging markets are excluded. The Barclays Capital Long-Term Municipal Bond Index is composed of those securities included in the Municipal Bond Index that have maturities greater than 22 years. It is not possible to invest directly in an index.

The value of fixed income securities fluctuates and investors may receive more or less than their original investments if sold prior to maturity. Bonds are subject to price change and availability. (P/E) is the price of the stock divided by its earnings per share. The MSCI ACWI ex US Index is an equity index based upon a broad based world ex-US composite market.

Past performance does not guarantee future results. There is no assurance these trends will continue. The market value of securities fluctuates and you may incur a profit or a loss. This analysis does not include transaction costs and tax considerations. If included these costs would reduce an investor’s return. As federal and state tax rules are subject to frequent changes, you should consult with a qualified tax advisor prior to making any investment decision. Raymond James does not provide legal or tax advice on these or any other transactions.

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