



The Long & Short of It

Quarterly Newsletter
Fourth Quarter 2013

QE Wins Again

Long overdue, US stocks were up big in 2013. Nearly everything else was down. Bonds, gold, and commodities all fell significantly. As usual, the question on everyone's mind is, "Where do we go from here?" But it feels different this time. The memories of bubbles bursting remain too fresh.

During the quarter—the start of the "Taper"—the process of reducing Quantitative Easing (QE), the Federal Reserve's asset purchase program, was met with celebration. Relief that the Fed saw the economy as finally strong enough to back off the gas, combined with a sense that the coming reduction in QE was not as big as expected, helped cheer investors. Moreover, as is customary, politicians accommodated holiday optimism by proposing nothing controversial. This year they even threw in a budget agreement hailed as a significant accomplishment.

DC Drama and its Impact on the Stock Market

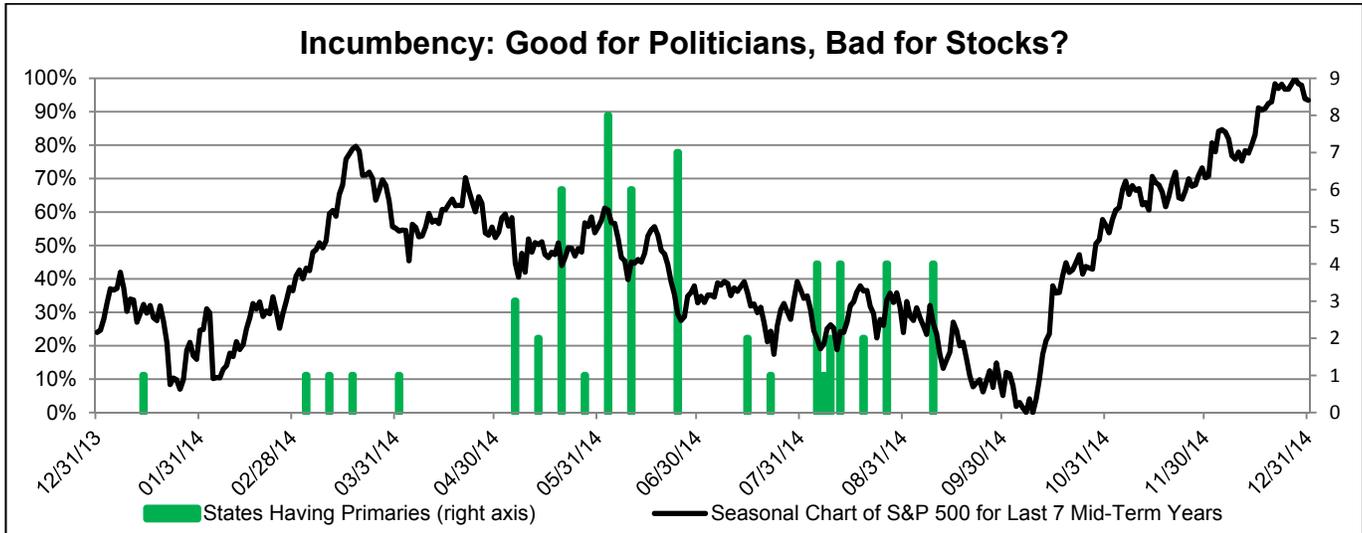
While the healing economy and the assistance of QE propelled solid performance in stocks this year, market peaks and valleys frequently coincided with key decisions regarding the federal budget. Investors watched Washington, DC.

To recap, on December 31, 2012, the economy hit the debt ceiling and the Treasury Department commenced "extraordinary measures" to enable the continued financing of the government. The early January passing of the American Taxpayer Relief Act of 2012 to avert the projected fiscal cliff allowed political attention to shift to the debt ceiling, creating growing optimism that a remedy would be found. On February 4, 2013, President Obama signed into law the "No Budget, No Pay Act of 2013," which put off the US debt ceiling problem through May 18, 2013. No solution was found, so on May 19, the debt ceiling was reinstated at just under \$16.7 trillion. The Treasury began applying extraordinary measures once again. The market responded by peaking on May 21st. The Treasury announced that default would not happen "until sometime after Labor Day." On September 25, the Treasury announced that extraordinary measures would be exhausted no later than October 17, leaving the Treasury with about \$30 billion in cash, plus incoming revenue, but no ability to borrow money. The US Government went into a partial shutdown on October 1, 2013. By October 8, the stock market fell back to the high of May 21 and then began to rally from that point forward. The market seemed to anticipate that the Continuing Appropriations Act of 2014 would become law and fund the government until January 15, 2014.

The short-term and cyclical machinations of the economy and its politics all seem a bit silly. In many ways, very little was accomplished at any of these moments. Yet, these events make up the news of the day and the financial markets paid attention. 2013 was a great example of why we own stocks for the long run even as economic growth remains subdued, yields low, and investor sentiment wary.

2014: The Year of the Midterm

If historic patterns hold, markets should press higher through March after some choppiness in January. Mid-March to late summer should be more challenging as investors digest the primaries. The question here is whether primaries are depressing simply because they introduce uncertainty or because it is depressing that incumbents never get the boot. If it were the former, the market would bottom before the primaries and rally as each one passed and uncertainty lifted. So we will submit that it is the latter, with maximum negativity about the future coming just after the last incumbent is slated to run again.



The majority of the rise for the stock market should occur during the last four months of the year as investors begin to look forward past the election. However, unpredictable and unscheduled events can always take the stock market off its course, so it is worth monitoring events to see what else will drive movement.

One such newsworthy item might be the Affordable Healthcare Act and its impact on the healthcare sector and the broader economy. Nothing drives prices down like an informed consumer. There is little in our current healthcare system that encourages patients to act as informed consumers. The Act does not change this. The benefits of an efficient pricing mechanism will continue to be missing in healthcare. As a result, though more people may be covered now, the government will find itself continually choosing between higher prices and greater limitations on care for individuals. We will monitor what types of care are being excluded or made inaccessible. Modifications that encourage individuals to be informed, to make selections that affect their wallet, or that allow competition across state lines, would be constructive.

In summary, declining inflation rates accompanied by stable-to-improving nominal economic growth produced an increase in real economic growth rates in 2013, propelling equities higher. As we move from “Don’t fight the Fed” to “Don’t fight the economy,” the stock market should prevail as long as inflation does not either: 1) slip into deflation or 2) rise through the current target and proceed higher. History says to look for further market strength to begin as mid-term elections draw near. We continue to monitor and respond to opportunities of valuation, as well as cyclical shifts in investor sentiment.

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