ATR Advisors

ABSOLUTE TOTAL RETURN
THIRD QUARTER 2014 COMMENTARY

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Reality vs. Illusion in Quantitative Easing

The 3rd Quarter of 2014 marked the final chapter in the US Federal Reserve's "QE-3" program. QE-3 represented the third round of the Fed's "Quantitative Easing" programs, in which the central bank purchased a set amount of Treasury Bonds and Mortgage Bonds on a monthly basis.

The program was originally started about two years earlier, on September 13, 2012. It had a positive impact on the US stock market, with the S&P 500 Index up over 35% since the program was announced. In this respect, the market was under no illusion.

However, the program's impact on interest rates is another matter. The market has been under a persistent illusion that QE is "holding down" interest rates, and they will shoot up like a spring the moment the Fed stops QE. This illusion was manifested most vividly during the 2013 "Taper Tantrum" episode beginning on June 19, 2013. On that date, former Fed Chair Ben Bernanke announced his intention to "taper" down the monthly level of bond purchases. Mesmerized by its own illusion that the Fed's QE program had been "holding down" interest rates, the market panicked in fear that interest rates would go through the roof.

Nothing could be further from the truth.

In fact, history shows that at the end of every previous QE program, interest rates actually went down! This is because the true effect of QE was to increase the prospect of inflation. Long-term interest rates are very highly correlated with inflation predictions. So, in every previous case – QE-1, QE-2, and "Operation Twist" – the end of the Fed's bond-buying actually REDUCED the prospect of future inflation. Therefore, long-term interest rates WENT DOWN each time!

This marks the difference between truth and illusion about QE. The pundits on TV spread the illusion that the end of QE will allow interest rates to "jump" up. This is just an illusion. In fact, the end of QE reduces the prospect of future inflation, and therefore long-term interest rates tend to go down.

In point of fact, at the end of the 3rd Quarter of 2014, the 10-year Treasury rate stood at about 2.4% -- which was lower than it had been a year earlier in September of 2013, and well down from its peak of over 3% in 2013. We expect that interest rates will continue to remain subdued for the remainder of 2014. Again, the key reason is that we expect that inflation will remain subdued, and the prediction of inflation is what mainly drives long-term interest rates.

Accordingly, we believe that the Absolute Total Return strategy allows us to take advantage of this illusion, by picking up high-yielding stocks that are underpriced. During the 3rd Quarter, the S&P 500 Index returned about 1.1% in total return (including dividends). But many high-dividend stock sectors actually DECLINED, because of the illusion that interest rates would spring up.

Therefore, we believe that many of the high-dividend stocks we follow are underpriced, and represent significant value at this time.

We have followed this strategy for over a decade now, and by sticking to it we have achieved excellent results: strong total-return -- including dividends, growth in dividends, and increases in stock prices – with significantly lower volatility and drawdowns than the general stock-market. We intend to continue to reap the rewards of that strategy for our investors.