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Investment Management

Mercantile Investment Advisors

For more information or you would like us to review your investment portfolio:

Contact John Ford @

johnfordcfp@gmail.com or

Gloria Bohannon @

gabohannon@herbsmith.com

Markets In Review:

	1st Qtr	12-Mo
Dow	- 0.15%	+15.66 %
S & P	+ 1.81 %	+21.85 %
NASDQ	+ 0.84 %	+30.24 %
10-Yr Treasury	2.72%	
10-Yr Municipals	2.87%	
Fed Funds Rate	0.25%	

Inside this issue:

Ahh.....Spring

There are not many who do not herald the coming of spring. Especially after the winter most of North America has had. As the earth warms up, our memory begins to fade concerning those almost zero-degree wind chills and the extra heating costs of the past few months. As we begin to look around, spring denotes new beginnings. — buds on the trees, green underfoot, and a clarity in the air that you certainly don't get in August.

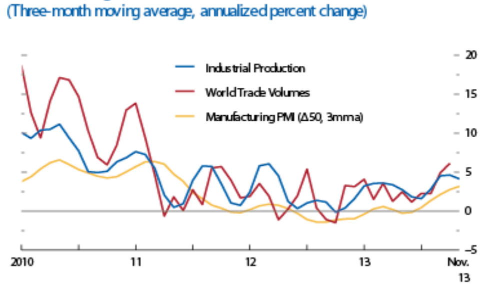
As I contemplate our garden it looks like a blank slate. Tilling has removed all the unwanted over-winter growth and we can add amendments that stimulate the organisms within the soil. There is something hopeful about this time of year, Maybe in our mind's eye we can imagine our crop harvest in 3-4 months.

In the investment world we have planted many a seed. We did the analysis of how deep to plant, is the timing of the year correct, do we anticipate that either dry, hot or wet conditions will be available this year and does our "seed" have tendencies to do well in this environment? So what can we control, what is out of our control, and what is controlled by others?

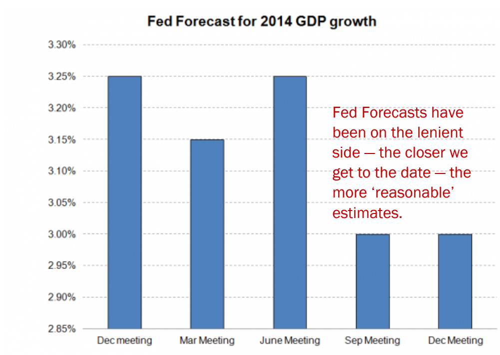
<u>We control</u>: Gardening (*kind of seed, amendments, weeding)*
Industry (*locale, security selection*)
<u>Out of our control</u>: Weather/pests
Economic Environment (*industry or company specific issues)*
<u>Controlled by someone else</u>: Demand for our produce (*cost of the seed)*
Federal Reserve meddling,

So what is the environment we are sowing into?

Figure 1. World Trade Volumes, Industrial Production and Manufacturing PMI
(Three-month moving average, annualized percent change)



Sources: Markit Economics, Haver Analytics and CPB World Trade Monitor.

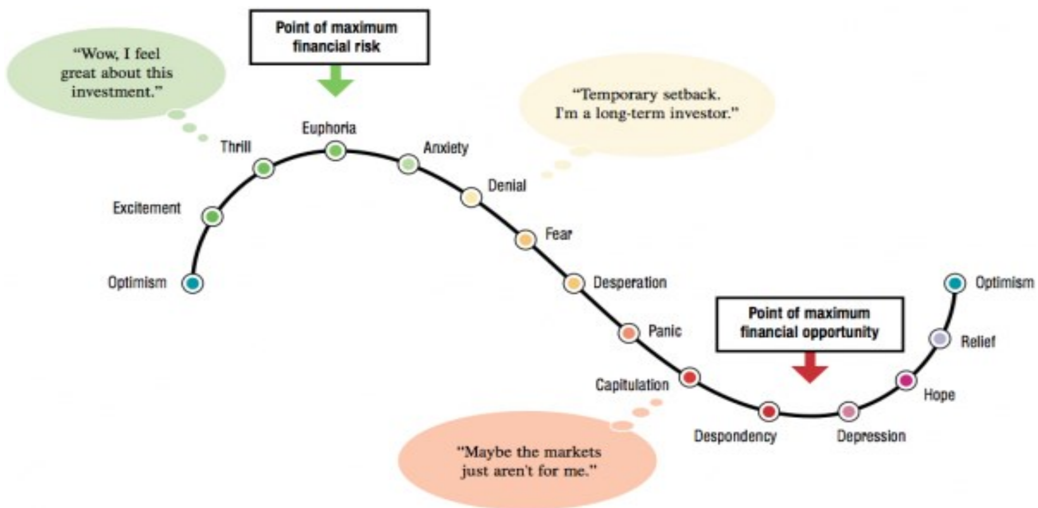


Market Realist

<u>Economy</u>: the US economy is growing, but at a slow pace. GDP for 2013 averaged about 1.9% and the 'hope' is that 2014 GDP will average more like 3%. Inflation is stated at roughly 2%, yet food and energy are well above that. The Federal Reserve is in its 4th year of super-saturated stimulus which they originally used to save the banking system, and now are using to prop up the amount of non-lending going on in the economy. This pumping of stimulus is like turning a fire hose on our just budded seedlings when either rain or drip irrigation would do. They are just hoping some of the water comes to rest in the same vicinity as a seed without washing away the seedbed. As a legacy from one Fed Chair to another, Chairman Bernanke's "taper" may begin to impact the interest rate market just as the economy gets its legs.

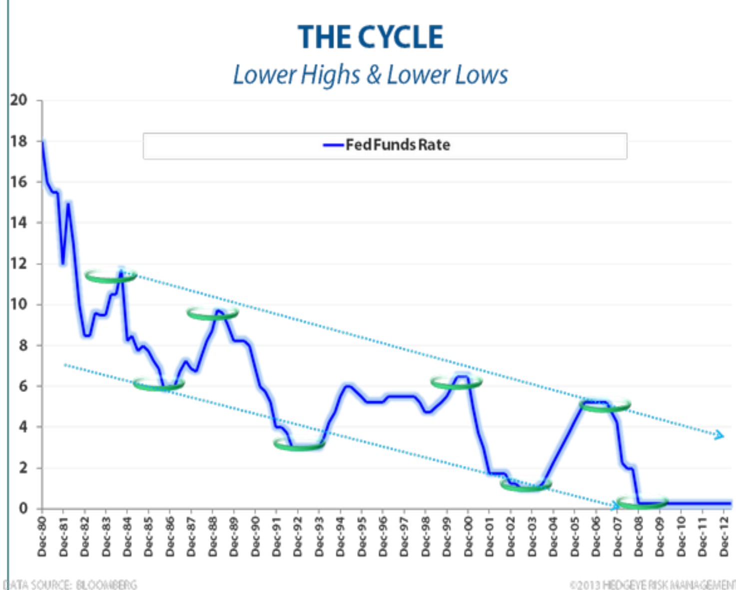
*"An economy hampered by restrictive tax rates will never produce enough revenue to balance our budget, just as it will never produce enough jobs or enough profits." **John F. Kennedy***

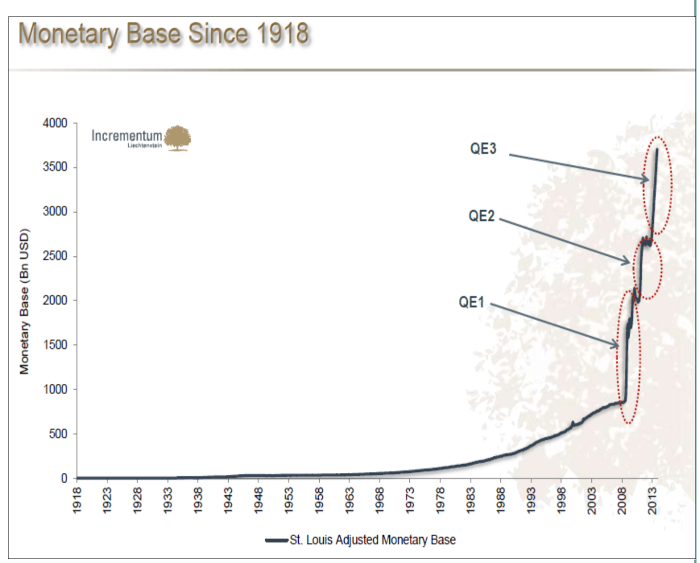
Markets: since the meltdown in 2008-2009, the stock market has marched higher and higher based upon the promise that the Fed won't stop the water canon. The P/E environment is elevated — meaning prices are about as high as they should go until the E (earnings) expands. And the E expands or contracts in response to both macro (GDP) and micro (industry) influences. Even in this spring season the market feels stale. Hard to find new locations to put seed, realizing the soil matters (Matthew 13). The higher the general market goes, the less attractive it becomes for new investment. Conversely, if you already have money in the market, there is a perverse logic of the wealth effect (as prices go higher) even when you have no intention of selling. Below is a very interesting chart concerning investor psychology. The emotional scale ranges from euphoria to despair and everything in between. See if you can spot yourself or the general market. The average investor would rather be at the Euphoria stage than at the capitulation stage. During capitulation, investors like Warren Buffett are backing up the truck to add to their portfolios while the average 'Joe investor' is running the opposite direction.



Monetary Policy: The Federal Reserve either accommodates or restricts the availability of financial resources based upon their monetary policy. In looking at the Fed Funds chart — we can see the Fed is being very accommodative. Another way to measure this bias is money supply (Monetary Base chart). When the Fed announced it was "tapering" it's mortgage purchases, we must remember — buying mortgages and US Treasury securities is not a normal function of the Fed — it is unprecedented! We stand in the midst of the most accommodative monetary policy ever invented. **Making borrowing cheap and investing expensive!**

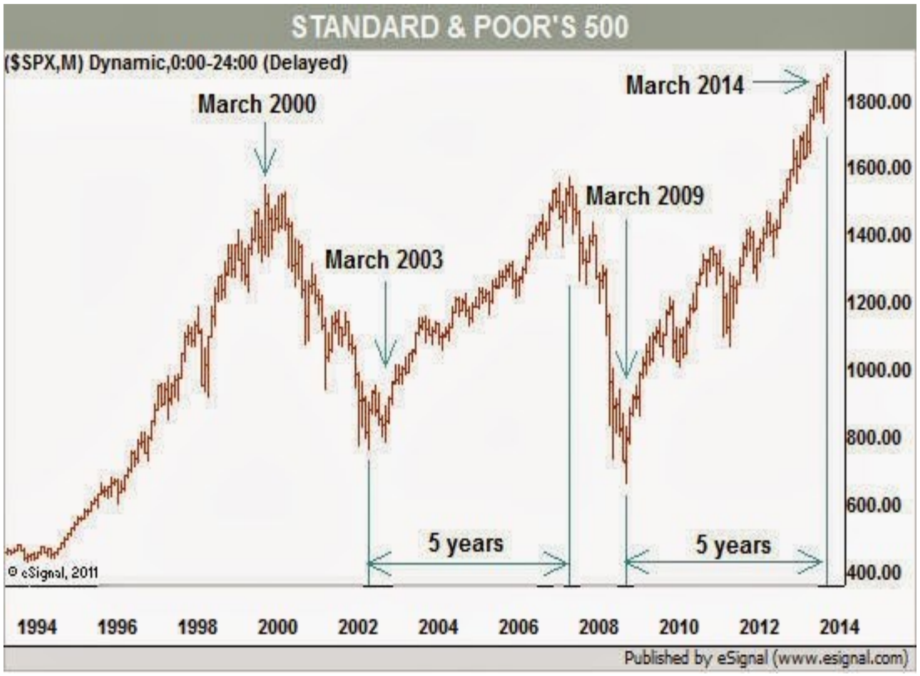
Regulatory: s we have documented in the past, governments can hinder or assist investors with policies that either encourage or discourage the investment environment. Tax policy has a great deal of impact on investment both for the investor and for the company.





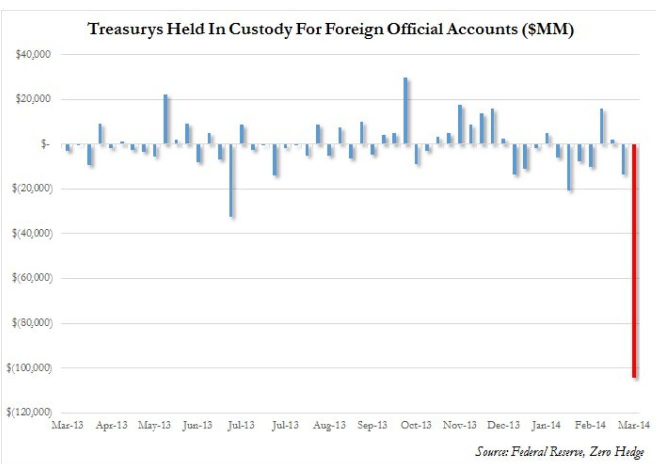
Various administrations have either helped or hindered the process by attempting to level or tilt the playing field in one direction or another. Lower or no capital gains tax rates encourage investment. Conversely, higher tax rates and market manipulation which discourages savings and investing and encourages borrowing and spending makes for an uphill climb at best. We seem to be in the time period where the investor is not being rewarded optimally through tax policy or through interest rate levels. In such a case, history would dictate more of a premium return profile for the market instead of a historically expensive one.

Foreign Factors: Just like gardening, other factors can impede or damage our crops. Ukraine. Who would have thought a country in the middle of eastern-Europe could cause all this disruption. And Russia, hosting the Olympics games so well, yet acting like a bully. Markets don't like unsettled politics. Also with the flows of capital being international, when China cuts back on their buying of US Treasuries — the slack has to be made up somewhere (probably not from Moscow). We also are in a competitive currency situation with all the fiat currencies throughout the world. With everyone able to print at will — the market can be at the whim of some Treasury minion from Tokyo or Brussels when a bad policy becomes reality.



Risk/Reward: An investor's challenge is to used the investment resources in an optimum way. It can be a great balancing act. On one side is the reward. Let's take as an example the 10-year US Treasury Note currently yielding 2.75% maturing in 2024. If held to maturity, the market says the return you will anticipate for the next 10 years is an annual return of 2.75%.. If you look at it in 1-year increments, your return may still be 2.75% for the 1 year, but if interest rates have risen to 3.75%, the value of the bond will fall by roughly -(5.7%) giving you a loss for the year on that investment.

Lets compare that to Microsoft stock. Microsoft is paying a 2.78% annual dividend, which has grown by 16% over the past 5 years. The market price of Microsoft at its highest point was in 1999. With an adjusted stock price of $58.38 and a current market price of $40, you would have lost annually 1.23%, buying at the worst possible time and holding the stock. If you would have bought at any other time — you would have been collecting an increasing dividend and an ever increasing market value. This is the dilemma in which investors find themselves.



The obvious bias of the Fed is for the investor to pump money into the equity markets. Meanwhile, they are is offering virtually free money to any of its banks in the off chance that someone might have an idea that was worthy of new capital. But, much of corporate earnings have gone to buy back their own stock in attempts to keep the stock prices up as well as executive bonuses.

So how much longer can this market keep up its trajectory? As the Fed begins, even on a modest basis this "tapering" it has given the market something to contemplate. How much impact has the current monetary policy had on stock prices? Will interest rates begin to rise as the Fed curtails it's purchases? Who is going to step into the breach in funding the deficits over the next few years as a larger percentage of funding must come from somewhere else? (Chart to the left).

There are market forces such as supply and demand that can be used to solve these issues. Up to now, the Fed has manipulated both sides of that equation. As tapering happens, they may find it necessary to allow these market forces to work. This should put into play higher interest rates, more competitive alternatives for investors, and stock market opportunities that appear because the market becomes more balanced.

Another market principle that seems to be in play is the law of diminishing returns. Low interest rates have encouraged all the buyers to buy and borrow now rather that putting the purchase off for a year or two. Eventually the marginal buyers default and demand falls off with the distortions causing a collapse in demand and a weakening of the quality of loans being made. This pattern can be found in all areas of the economy as free money can't address the real issue (too much debt), but it can lead us into a greater magnitude during the next collapse.

We continue to believe that investing in tangible assets and companies, preferably paying a dividend, is a more prudent way to invest in this environment. There is no telling what the fate of our US dollar will be (or when). If the forces of supply and demand are allowed to operate, we would rather not be holding all US cash. That is why you will find commodity companies, mining investments, oil and natural gas and pipeline companies in our portfolios. The value of these companies is not predicated upon the strength of the dollar or how much money-printing is going on. We remain convinced that it is also prudent to hold high-quality fixed income securities with short durations as a hedge against the risk of a market drop. We do realize that the return profile of these securities may not be as attractive as they have been historically. But we do want the return **of** our money as well as some return **on** our money.

The real question is?

The 70s band Chicago was prophetic with their hit "Does Anybody Really Know What Time It Is?"

(I don't) Does anybody really know what time it is
(Care) Does anybody really care (about time)
If so I can't imagine why (Oh no, no)
We've all got time enough to cry

Solomon knew, Ecc 3: There is an appointed time for everything. And for every event under heaven —

A time to give birth and a time to die; A time to plant and a time to uproot; A time to tear down and a time to build up. A time to weep and a time to laugh; A time to mourn and a time to dance. A time to search and a time to give up as lost; A time to keep and a time to throw away. A time to tear apart and a time to sew together; A time to be silent and a time to speak A time to love and a time to hate; A time for war and a time for peace.

When will the American people say "**no**" to forced-fed debt?
When will the people say "**no**" to more and more liberties being stripped away?
When will investors say "**stop manipulating the system**?"
When will something big enough happen that the Fed cannot come to the rescue?

Determining the days and times is crucial — we can see all the signs of the times, yet as my friend/philosopher Don Brown states "Don't tell me what's going to happen, just tell me when."

John J. Ford, CFP(TM)

For further analysis and up to date charts and commentary, visit our website: www.herbsmith.com

Mercantile Investment Advisors

2650 Meacham Boulevard

Phone: (817) 831-6133

Fax: 817-831-7900

Email: Johnfordcfp@gmail.com

Mercantile Investment Advisors was formed in 2003 to provide professional investment management for Mercantile Partners of Fort Worth.

Since that time MIA has added individual clients and Trusts to become a full service investment management firm currently managing $200 million in client investments.

In 2006, Mercantile purchased Herbert R. Smith & Company of Wichita Falls, Texas and operates it as a subsidiary of Mercantile Investment Advisors with staff in Wichita Falls and Fort Worth. In 2012, MIA was purchased by management.

Mercantile is a SEC registered investment advisor providing fee-only investment services to the private investor assisting you with asset allocation and risk/reward optimization.

If you would like additional information concerning private investment management, or an ADV part II, please contact: Johnfordcfp@gmail.com.

John J. Ford, CFP™ (817) 831-6133.

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