April 22, 2014

Global markets experienced an up and down quarter but ended mostly positive despite developments that include Russia's annexation of Crimea, further evidence that China's growth is slowing amidst government efforts to manage a potential credit bubble, the changeover in Federal Reserve leadership, and a general continuation of the slow economic recovery in the United States and Europe.

March Benchmark Returns (Preliminary)

	Mar	1Q	YTD
Large-Cap Benchmarks			
Vanguard 500 Index	0.8%	1.8%	1.8%
iShares Russell 1000	0.5%	2.0%	2.0%
iShares Russell 1000 Growth	-1.0%	1.0%	1.0%
iShares Russell 1000 Value	2.4%	3.0%	3.0%
Mid-Cap Benchmarks			
iShares Russell Midcap	-0.2%	3.5%	3.5%
iShares Russell Midcap Growth	-1.8%	2.0%	2.0%
iShares Russell Midcap Value	1.5%	5.1%	5.1%
Small-Cap Benchmarks			
iShares Russell 2000	-0.7%	1.1%	1.1%
iShares Russell 2000 Growth	-2.4%	0.6%	0.6%
iShares Russell 2000 Value	1.2%	1.7%	1.7%
Other Benchmarks			
Vanguard FTSE Developed Markets ETF	-0.4%	0.1%	0.1%
MSCI World ex USA Index	-0.4%	0.9%	0.9%
Vanguard FTSE Europe ETF	-0.6%	1.8%	1.8%
Vanguard FTSE Emerging Mkts ETF	4.6%	-1.1%	-1.1%
Vanguard REIT Index	0.5%	9.9%	9.9%
Vanguard Total Bond Mkt Index	-0.1%	1.9%	1.9%
BofA Merrill Lynch U.S. High Yield Cash Pay	0.2%	3.0%	3.0%
Vanguard Int. Term Tax-Exempt Fund	-0.1%	2.6%	2.6%
S&P/LSTA Leveraged Loan Index	0.4%	1.2%	1.2%
Citigroup World Govt. Bond Index	-0.1%	2.7%	2.7%
JPMorgan GBI-EM Global Diversified Index	2.8%	1.9%	1.9%
DJ-UBSCI (Commodity Futures)	0.4%	7.0%	7.0%

After last year's blistering pace, U.S. stocks set a more muted tone and eked out a gain for the quarter (after starting the year with a sharp loss in January). Large-cap stocks were up 1.8% while small-caps rose around 1%. Monetary policy continued as a prominent theme as Janet Yellen assumed Fed leadership at the beginning of February and presided over her first policy meeting and post-meeting press conference in March, during which she announced another $10 billion notch in the Fed's gradual reduction of its monthly bond buying. She also indicated, as was widely anticipated, that the Fed's decision to eventually raise interest rates would be less tied to a specific unemployment number and based more on a number of economic metrics. And while she briefly roiled markets by indicating that rates could start going up sooner than the market had foreseen (i.e., potentially mid-2015), she has since reiterated that the Fed would not be quick to eliminate its support and that markets could continue to count on accommodative policy for the foreseeable future.

In terms of U.S. economic growth, the quarter's progress was complicated by severe winter weather that likely depressed some of the short-term indicators of the economy's health. Overall, though, the picture remains one of modest but steady economic growth with a noteworthy rebound in housing (although some data released during the quarter suggest housing may have cooled a bit amidst its generally upward trend) alongside persistently slow-to-recover employment. In particular, long-term unemployment remains very high, part-time jobs as a percent of overall jobs is high, and wage growth has been stagnant until very recently. Toward month-end, the fourth quarter 2013 GDP number was revised slightly upward to 2.6%, which represents a decline from the very strong third quarter 2013 figure, though it falls within the range of +2% growth expected by many strategists. Overall, the positives of modest growth, only a very gradual reduction in monetary support, and a decent corporate earnings season were enough to overcome concern about the Russian situation and some of the more worrisome economic developments abroad.

Among international markets, Japan suffered a steep first quarter decline after its red-hot 2013 gain. One near-term uncertainty is the impact of the country's new sales tax, which goes into effect at the start of April and could have potential to slow growth. European stocks rose slightly on marginally positive economic growth, though the region continues to face very low inflation (and deflation fears) and still-high unemployment. While the European Central Bank did not take material policy action in its most recent meeting, it has indicated a willingness to resort to additional measures to boost inflation if needed. For the quarter, the broad developed international benchmark gained 0.06%.

Emerging markets have been beset by ongoing concerns about economic growth alongside macroeconomic instability in countries such as Ukraine and Turkey. These issues have continued to weigh on markets, leading to small first quarter losses for emerging-markets stocks (though our actively managed emerging-markets funds were positive).

Core bonds were among the quarter's stronger performers with the Vanguard Total Bond Market Index—our proxy for overall bond market performance—gaining 1.9%. Yields on the 10-year Treasury declined from 3% at the end of 2013 to 2.73% at quarter-end. Even as the Fed continued its tapering, bonds likely got some benefit from their relative safe-haven status in the face of geopolitical tensions in Ukraine as well as concerns over slower economic growth, primarily in emerging markets. As corporate fiscal health remained robust and bond defaults low, corporate bonds across the credit quality spectrum were strong performers, benefiting our portfolio holdings that take on credit risk as part of their strategy. Municipal bonds were another bright spot for the market as they outperformed taxable bonds in the quarter amidst improving economic health for states and municipalities, and an absence of the headline-based scares (e.g., Detroit's default announcement, etc.) that affected last year's results.

BUT WE HAVE NOT YET ACHIEVED NORMAL STATUS

In investing, there is always something to worry about. However, with a long investment horizon, which we have, things generally turn out fine. So, in normal times we'd generally be optimistic about the economy and the markets. But we are living in a period without historical precedent. We are still in the midst of an unprecedented monetary policy experiment, which has resulted in the Fed having a huge balance sheet. How that unwinds, or whether or not it will even fully unwind, and how the Fed will normalize interest rates such that lenders once again have an incentive to lend to productive investments are big unknowns, and they introduce considerable uncertainty.

Uncertainty does not always have to lead to bad outcomes. The Fed's creative monetary policy experiment (or QE) thus far has led to a surprisingly benign deleveraging process. For that we feel fortunate and thankful. As investors, the experiment's success thus far—and its positive effects on financial markets—have helped better meet our return objectives. But we should worry that the steps taken to make the deleveraging process benign may have unintended consequences that neither we nor anyone else, including the Fed, can fully understand or anticipate. If the Fed were effective at predicting consequences, then the excesses leading up to the 2008 crisis would have been at least mitigated if not completely avoided.

One key question investors struggle with is, can the Fed unwind its huge balance sheet and normalize interest rates without major disruptions in the markets?

Milton Friedman taught the world that the "transmission mechanism" for central bank policy worked through the quantity of money injected into, or subtracted from, the economy. It now appears many members of the Federal Reserve don't believe this anymore. According to Fed Chair Janet Yellen, the Fed plans on ending bond purchases later this year, and then, *without unwinding QE*, start to raise the federal funds rate. By moving this way, the Fed is making the case for a *permanently larger* balance sheet and *hoping* it can use interest rates to manipulate economic activity. But if banks expect excess reserves to stay in the system longer, perhaps even permanently, it is almost certain they will become more aggressive about lending even as they move up their expectations of when and how much short-term rates will rise. This, in turn, would boost the money supply sharply, driving up asset prices, economic activity and inflation in the months and years ahead.

Historically, most economists have talked in terms of the federal funds rate when communicating about Fed policy. But it's not because short-term rates are important by themselves, but because short rates rise and fall as the Fed manipulates the supply of reserves. A lower interest rate typically means more money growth and therefore more liquidity in the economy. Interest rates are a way of measuring money growth, like the mercury level in a tube measures temperature.

Quantitative easing has complicated things. The Fed built massive excess reserves in the banking system by buying bonds and creating deposits to pay for them. And with so many excess reserves in the system, the overnight federal funds rate has been pushed to near zero. Normally, these deposits would have resulted in a surge of lending (in turn, multiplied by the banking system), which would have boosted the M2 money supply. However, banks have been unwilling to use the lending capacity created by the new deposits.

This has happened for many reasons. First, banks are reluctant to lend when the Fed made it clear for years that the extra deposits were temporary. Second, Dodd-Frank hyper-regulation and new capital standards have squeezed banks' desire to leverage their balance sheets. Third, artificially low interest rates make it less attractive to lend.

The result: the Monetary Base has grown at a 32% annualized rate since September 2008, but the M2 money supply has only grown at a 6.7% rate. And as Milton Friedman taught us, it's M2 that matters, not the monetary base. That's why stated inflation has remained relatively low.

With $2.6 trillion in excess reserves in the banking system, the Fed can't control the federal funds rate as it did prior to 2008—using supply and demand pressures—by adding or subtracting reserves. One major problem is that, by law, the Fed can't pay interest on the reserves held by Government Sponsored Enterprises (GSEs) like Fannie Mae and Freddie Mac. So, these firms lend their reserves to other banks at a lower rate than the Fed is paying banks on reserves.

If the Fed lifts the interest rate it pays banks on reserves, the GSEs might charge more and boost rates, or they might not. As a result, the Fed is experimenting with a system of "repos" —where the Fed, in effect, would borrow the excess reserves of the GSEs at set interest rates. Using this new tool, the Fed will *try* to manipulate short-term interest rates throughout the financial system.

This gets around the law that says GSEs can't earn interest on reserves, and it will probably lift the federal funds rate. However, it still does not fix the problem of massive excess reserves in the system and, more importantly, it telegraphs that the Fed is willing to let excess reserves sit in the system for much longer. Banks, in response, will likely become more willing to boost lending. And right on cue, commercial and industrial (C&I) loans have grown at a 23% annualized rate in the past two months, while the M2 money supply has jumped to a 9% growth rate.

Economists expect this to continue. Money growth should accelerate further and, because the Fed believes Friedman was wrong, or because it thinks GDP needs to rise significantly to get to potential, it will allow this to happen. As a result, that sugar high caused by Fed policy we have heard about for so long, looks like it may finally arrive.

The downside of all this is palpable. If money growth takes off and threatens inflation, the Fed will attempt to stop it by raising interest rates. The hope will be that by raising rates, banks would view loans as less attractive than holding excess reserves. But, if short-term rates go up, so will other rates and banks would still have an incentive to boost loans.

If the Fed finds itself in this cycle, it could be forced to raise rates faster and further than it would have in the past. Or, the Fed may start operating like China's central bank, which means it would regulate loan growth or use other means of central control. In the end, it is excess reserves that are the real problem, not the level of interest rates. Milton Friedman was not wrong, and trying to run a central bank like a regulatory body creates big risk.

The bottom line is that there appears to be an increase in liquidity—potentially a large one—heading the economy's way. That's good for stocks over the next year or two, but after that the dangers of a stock bubble will rise appreciably.

CONCLUDING THOUGHTS

Five years after the worst financial crisis since the Great Depression, we should feel fortunate to be where we are. The overall economy and our portfolios would be in far worse shape if our concerns related to deleveraging were realized.

Yes, there are still lots of problems. Unemployment is much higher than stated in reported numbers given historically low labor-participation rates (the long-term unemployed). Real incomes for average Americans are not growing. Our policies seemingly continue to cater to the financial economy rather than the real economy. It is unclear how our large public debt and long-term fiscal obligations, including Social Security and Medicare, will get sorted out and how it will impact financial markets and our portfolios. Margin debt on the New York Stock Exchange is at record highs and we are seeing frothiness in the technology sector.

There's a whole laundry list of concerns and uncertainties that we must always weigh in our investment decisions. The question we must ask is how material are these risks and what's the likelihood of them playing out. Moreover, in the current period of extremely low bond yields where there isn't a lot of cushion against a recession or an economic shock, the need to insure against downside risks is greater than when yields were higher. Ultimately our asset class weightings—and, specifically, our willingness to take on equity risk—rest on our view of return and risk potential for the asset class as well as the objectives and risk threshold of each of you. These are the foremost, and ongoing, considerations as we manage portfolios to achieve your goals.

Thank you for your continued trust and confidence.

Highest regards,
Stegent Equity Advisors, Inc.

Loyd J. Stegent
President

Enclosures

Past performance does not guarantee future results. Investors cannot invest directly in an index.

Compliance Disclosure: **As required annually by the Securities and Exchange Commission, we make available copies of our updated Firm Brochure "Form ADV Part 2A". In compliance with those regulations we have enclosed the page from our Form ADV Part 2A labeled Item 2, indicating all material changes, if any, as well as our Privacy Policy.**

Our complete brochure may be requested by telephone at 713-840-9300x4 or email at Loyd@StegentEquity.com.

Additional information about Stegent Equity Advisors, Inc. is also available via the SEC's web site www.adviserinfo.sec.gov.