KEATING INVESTMENT COUNSELORS, INC.
REGISTERED INVESTMENT ADVISORS FOR INDIVIDUALS, RETIREMENT PLANS, TRUSTS AND FOUNDATIONS

INVESTMENT STRATEGY
JULY 2013

After four years of consistently rising stock prices and falling bond yields, we have seen major shifts in the capital markets over the past two months. These changes are likely to have far reaching effects on some seemingly unrelated asset classes around the globe. For some asset classes, like large high-quality U.S. stocks, these changes should be highly beneficial. Meanwhile, they will be quite detrimental for others such as bonds and emerging market stocks. We have been anticipating this shift for some time and have positioned our client accounts accordingly.

The major shift over the past two months has been the rapid jump in interest rates from all-time low levels. In this brief period, the interest rate on a 10-year U.S. Treasury bond spiked from roughly 1.6% to 2.6%. Consequently, the interest rates on all other forms of debt have also increased. Corporations are paying more to borrow, mortgage rates are increasing, and Treasury bonds are becoming more attractive for investment. Conversely, bond prices have declined and investors are beginning to notice losses, particularly in their bond mutual fund and bond exchange traded fund (ETF) holdings. As a result, these changes are causing large shifts in the flow of investor capital.

The most immediate shift in investor capital has been away from all fixed income investments. As discussed in several past Investment Strategies, investors will move away from bonds as interest rates rise and bond prices decline. At this point, investor capital is only trickling out of fixed income investments. The risk is that this trickle will turn into a flood. Our major fears are for bond mutual funds and, especially, bond exchange traded funds (ETFs). These investments were small players or non-existent during the last sharp rise in interest rates during 1994. Today, they have become a primary investment option for most individual investors. The trouble with these investments is they are very easy to trade, but the underlying securities they hold are not. This is not problematic when money is going into these investments or if markets stay relatively calm. However, these investments have never been tested during a large outflow of investor capital. If investor capital exits quickly, it could result in a situation in which money leaving the fund will outstrip the ability of these funds to sell the underlying assets (bonds). This would create major market disruptions and sharply lower bond prices. Unfortunately, lower bond prices would precipitate even more selling, possibly resulting in a vicious, self-reinforcing, downward spiral. We are not predicting this will occur, but we are very mindful of its possibility.

The second major asset class that will be negatively affected by rising interest rates is not as obvious, but the consequences could be much greater. International markets have benefited tremendously from declining interest rates over the past thirty years. Consistently declining interest rates encourage investors to take on more risk. This means more capital flowing into overseas investments and lower borrowing rates for foreign governments. Governments in developing countries have seized this opportunity to modernize their infrastructure, industrialize, and raise living standards. However, these economies have only been able to achieve these great gains by borrowing cheaply and enjoying a considerable flow of investment capital into their economies. As rates go up and their currencies weaken versus the dollar, these countries could fall into trouble. The protests we are seeing around the world are a symptom of this problem.

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We believe the massive flow of investor capital into emerging markets is unlikely to continue. At the end of the day, investing is a trade-off among different opportunities. For instance, if an investor can make a 5% annual return owning U.S. Treasury Bonds with basically no risk, that investor is unlikely to be interested in a risky investment with an expected return of only 7%. On the other hand, more recent history has the Federal Reserve pressuring interest rates to all-time lows. With the 10-year Treasury bond bottoming at a 1.4% yield, the same risky investment offering a 7% return is far more attractive. This dynamic was actually the primary goal behind the Fed's actions over the past few years. Despite promoting lower mortgage rates and cheaper loans for small businesses, the Fed's main goal was for investors to take on more risk. The Fed has been successful and, as a result, corporate borrowing rates declined, stock prices went up, and capital flooded toward more risky opportunities overseas. In fact, it is estimated that $3.9 trillion of capital flowed into developing nations during just the past four years. Surprisingly, despite this massive surge of capital, international equity markets still underperformed U.S. equities during this period.

What investors will come to realize is that developing markets have been operating with a considerable tailwind over most of the past thirty years due to declining interest rates. If recent trends prove to be the critical inflection point toward higher rates, developing markets will now face a headwind going forward. We are not predicting that some profitable investments will not still be available overseas, only that the easy money has already been made. In addition, over the short-to-intermediate term, investors are highly likely to be disappointed by slowing economic growth in emerging markets and lower than expected profitability for the companies operating there. Many professional managers are already coming to this realization and their actions are being reflected in the global equity markets. The following is a performance table displaying key global equity markets for three periods to June 30: since the beginning of the year (12/31/2012), since the bear market bottom (03/09/2009), and since the last market top (10/09/2007).

	% change since		
Index	**12/31/2012**	**3/9/2009**	**10/9/2007**
China/Hong Kong	-8.2%	83.4%	-26.3%
Germany (DAX)	4.6%	115.6%	-0.3%
Japan (Nikkei)	31.6%	93.0%	-20.3%
Brazil (IBOV)	-22.4%	28.7%	-25.6%
UK (FTSE)	5.4%	75.5%	-6.0%
US (S&P 500)	**12.6%**	**137.4%**	**2.6%**

As you can see in the table, investors have benefited considerably by owning top-quality U.S. companies. Other than a recent surge by the Japanese equity market, the U.S. market has handily outperformed international markets over all three of the periods. Importantly, the U.S. market is the only market to reach new all-time highs.

We believe U.S. equity market outperformance will continue as the U.S. becomes the main beneficiary of dislocated investment capital on the move. Interestingly, a recent annual survey of company executives indicated that the U.S. was the most desirable place for foreign investment.

This was the first time since 2001 that this list was led by any country other than China. In addition to company executives, individual investors have also been moving assets into the U.S. These capital flows have been easiest to see in the real estate market. For instance, in South Florida we have had a front row seat to the influx of international capital. When the real estate market crashed, the Miami condo market had dozens of unfinished towers under construction and it was estimated that the area had 15 years of inventory. Six years later, the Miami condo market has made a dramatic recovery as investors from South America, Canada, and Europe emerged to buy up the properties. Today, there are several new large towers being built in Miami, a turn of events nobody would have believed just four years ago.

Up to this point, the sizable amount of capital that has come to the U.S. over the past few years has not found its way into the equity market. We believe this will change. For conservative investors and retirees leaving fixed-income investments, the most likely destination for these funds will be high-quality, dividend paying stocks. These stocks will provide consistent income for retirees while actually being less risky than the bonds they would be replacing. They currently are yielding as much or more than treasuries and they offer inflation protection. As you know, this is where we already have client portfolios positioned. For performance-oriented investors leaving emerging markets, they are likely to invest more broadly across the U.S. stock market. These investors are likely to focus on smaller, higher growth companies and particularly focus on several of the dynamic trends emerging in the U.S. (housing, the energy revolution, technology). This capital should help fund these emerging trends, boosting the entire U.S. economy.

We would like to point out that the ideas discussed in this strategy are very long-term trends. The purpose of this strategy is to illuminate the fact that investors have grown complacently accustomed to consistently declining interest rates over the past thirty years. Now that we have reached a very significant inflection-point, investors must consider the new challenges that various asset classes will endure. In the very short-term, we expect bond prices to bounce after recent losses (their yields to decline). However, we do not expect rates to go back to all-time low levels and, ultimately, bond prices will decline going forward (rates going higher). Meanwhile, we expect the U.S. equity market and the overall U.S. economy to be the main beneficiaries of the new trends that will be in place for years to come. Importantly, we expect a strong dollar which will further attract capital to the U.S.

Truly yours,

Keating Investment Counselors, Inc.