"Words make you think. Music makes you feel. A song makes you feel a thought."
- E.Y. Harburg

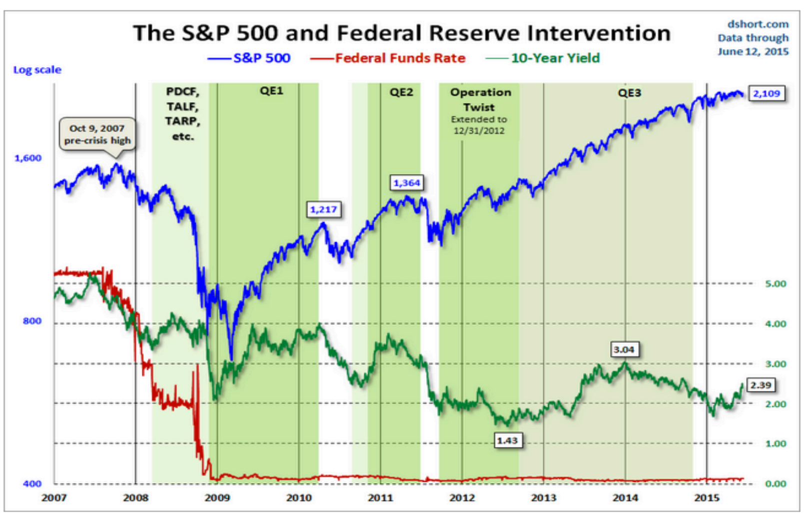
"This next song's about spreading risk in a volatile market by diversification."

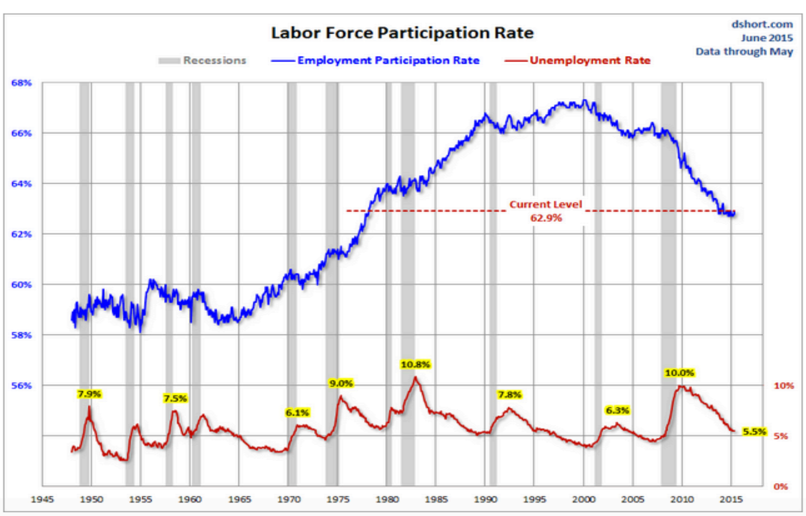
I came to the conclusion a couple of weeks ago, that Thursday had become my favorite day of the week. I am truly sorry Saturday, but Thursday is the day that I take my 1½-year-old daughter Sascha to her music class "Music Together." Teacher Beth leads our class with great enthusiasm and warmth, rain or shine. She encourages our toddlers, nudges the parents and reacts to the ever-changing chaotic yet harmonious classroom environment. Crying babies, misbehaving toddlers and misbehaving parents are part of the game. Through all this, I admire our teacher's humility and willingness to try out new things and then recognize when a song or an activity isn't quite working out as planned. Teacher Beth and other's like her are the true "maestros" of our time.

I enjoy taking Sascha to music class not only because I love spending time with her, but because it is a great place for me, other parents, and of course the children to blow off some steam. I spend the entire hour of class bellowing out melodies and dancing around like a Hare Krishna until I am more exhausted than my daughter or anyone else for that matter. Sascha and I leave the class well balanced. Whatever previous life pressures were building up prior to this has now been released.

The above thought had me thinking about financial markets on our drive home one day. What market pressures have been building up over time? What economic imbalances and misallocations of capital prevail? When, where or how will markets blow off their respective steam? Many market professionals will state that financial markets are part science and part psychology. But I can tell you, as can anyone else whom has spent a decent amount of time investing or trading around a large amount of capital that markets, particularly over the short run are mostly psychological. Fair value or rather perceived fair value is in the eye of the beholder. Very few market professionals will contest the view that unusually loose and unorthodox monetary policy has goosed up traditional investments (stocks, bonds and real estate). ZIRP (zero interest rate policy) has even made its way to the world of fine art as Randall Forsyth of Barron's recently penned in his "Up and Down Wall Street" column.

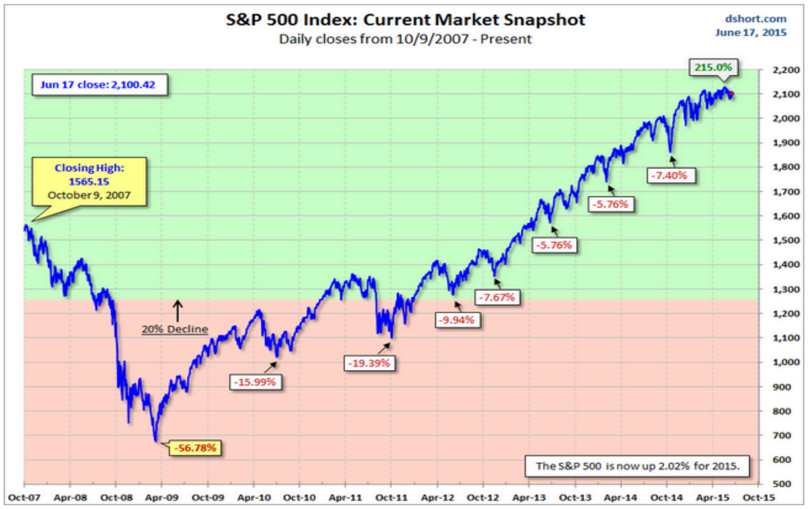
It is my belief, that the central bankers of the developed world have been united in their motivation to get anyone with savings to exchange that cash for investment assets (stocks, bonds, homes, fine art, etc.). It appears they believe this action will trickle down to an increase in consumption, which will in turn increase inflation "the good kind." This policy sends the following message to those with access to capital, "Hand over your dollars for assets today, because tomorrow you will be exchanging far more dollars for those very same assets. All aboard!" To their credit, this part has worked out well for a segment of the population, as anyone with eyes can attest to here in the San Francisco Bay Area. For those of you who prefer a more scientific approach, I have included the below chart (see Figure 1) of the S&P 500 pre versus post Fed intervention. But now what? According to a [Pew Research paper] written June of last year, US GDP growth out of the 2008-09 recession has exhibited the slowest growth rate of any of the five-year periods they examined. Yes, the unemployment rate is back down to 5.3% but the labor force participation rate at 62.9% (see Figure 2) hasn't been this low since the late 1970's. No wonder the market seems to be betting that a normalization of the Fed Funds rate this cycle will be far lower than anything we have seen in the past.





Based on my above views the logical next step here would be for me to pronounce the coming collapse of asset prices. Well, life is rarely black and white and when it comes to markets my experience dictates that the obvious choice is usually the wrong choice. Sure, if one judges the stock market by the CAPE (Cyclically Adjusted Price Earning Ratio) popularized by Yale's Robert Shiller or the Q ratio which was developed by Nobel Laureate James Tobin the market is expensive. However, this tells us very little with regard to timing. Outside of retirement, many people are also planning for short or medium term horizons, and therefore waiting for a long-term financial time series to mathematically mean-revert at some point in the future, becomes a fools game in the context of living one's life. Louis Vincent Gave of GaveKal Dragonomics said it best in a recent interview he gave to Real Vision TV. "As an investor you are not paid to forecast, you are paid to adapt. It is the guy who adapts the fastest that wins."

Yes, the recent stock market rally is long in the tooth and no one should be surprised to see a near term pullback of at least -5% (see Figure 3). Beyond this however and barring any significant unanticipated tightening of monetary policy, this market, I am thinking, still has legs to move yet higher.



The well respected Jeremy Grantham of Grantham Mayo van Otterloo (GMO) a fund that steered clear of the late 1990's technology stock mania had this recently to say in their quarterly letter.

> *"A key point here is that in our strange, manipulated world, as long as the Fed is on the side of a strong market there is considerable hope for the bulls. In the Greenspan/Bernanke/Yellen Era, the Fed historically did not stop its asset price pushing until fully-fledged bubbles had occurred, as they did in U.S. growth stocks in 2000 and in U.S. housing in 2006. Both of these were in fact stunning three-sigma events, by far the biggest equity bubble and housing bubble in U.S. history. Yellen, like both of her predecessors, has bragged about the Fed's role in pushing up asset prices in order to get a wealth effect. Thus far, she seems to also share their view on feeling no responsibility to interfere with any asset bubble that may form. For me, recognizing the power of the Fed to move assets (although desperately limited power to boost the economy), it seems logical to assume that absent a major international economic accident, the current Fed is bound and determined to continue stimulating asset prices until we once again have a fully-fledged bubble. And we are not there yet."*

In the meantime, I believe investors must adapt or perish. When all markets are going up it can be easy to become complacent and pat oneself on the back. Now is not one of those times. Now is the time, I believe for investors to reduce some of the risk in their portfolio that is consistent with their long-term goals. This means moving target allocations for risk assets that have disproportionally benefitted over recent years to the lower bound of their acceptable range. This means giving alternative strategies and investments a look. This means, despite what you may have heard or read, U.S. government bonds do have a place in a diversified portfolio and are not dead.

Finally, I have included a couple of video links here (Part 1 & Part 2) to a recent interview Carl Icahn gave on the re-released program "Wall Street Week." Educational and entertaining at the same time, (I have been told "edutainment" is the word) Mr. Icahn, one of the top investors of our time walks us through his upbringing and his view on markets in his typical blunt style. Enjoy.

Sincerely,

Justin Kobe, CFA