Financial Tailor

April 29th, 2013

Spring Cleaning with the IMF

Author: Benjamin Struck

President

Last week most stocks recovered from their losses while commodities recovered to a lesser extent after last weeks sharp decline. Economic numbers were pretty weak as the government's advance estimate of GDP growth of 2.5% (annualized) was much lower than expected. Durable goods orders were also significantly lower while new home sales continued to remain positive. Although it garnered little media attention, the IMF wrapped up its spring meeting last week in Washington D.C. This week I will examine the statements made in that meeting, but first I will provide a brief history of the IMF.

S&P 500 Index

26.99 **1.74%**

Dow Jones Industrial Average

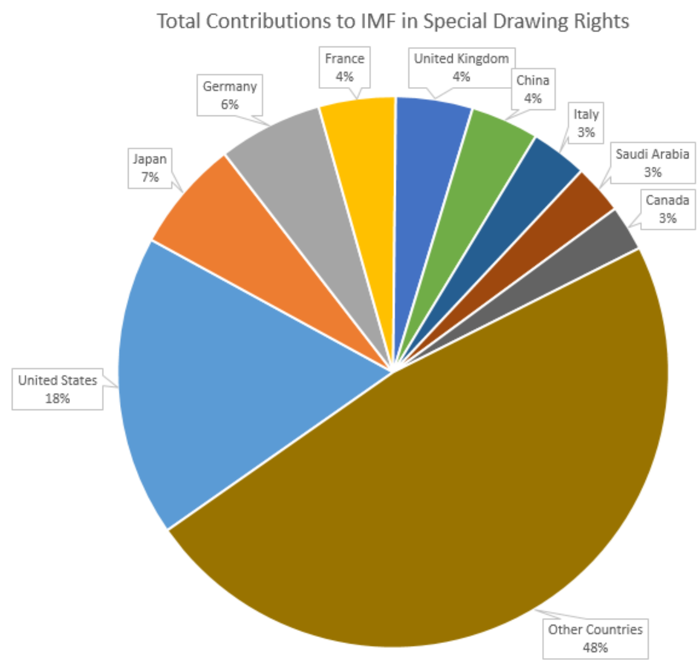
165.04 **1.13%**

NASDAQ Composite

60.06 **2.16%**

Bretton Woods and the origins of the IMF

The IMF arose from discussions at the Bretton Woods conference in 1944 and was officially established in 1945. The goal of the conference was to reduce economic nationalism and protectionism which had been a major catalyst for World War II. The IMF was established to provide loans that would be used in the reconstruction of Europe and to create and manage global exchange rates and international payments. Instead of requiring collateral as a condition for loans, the IMF requires borrowers to institute policy changes that adhere to the requirements set forth by member countries.

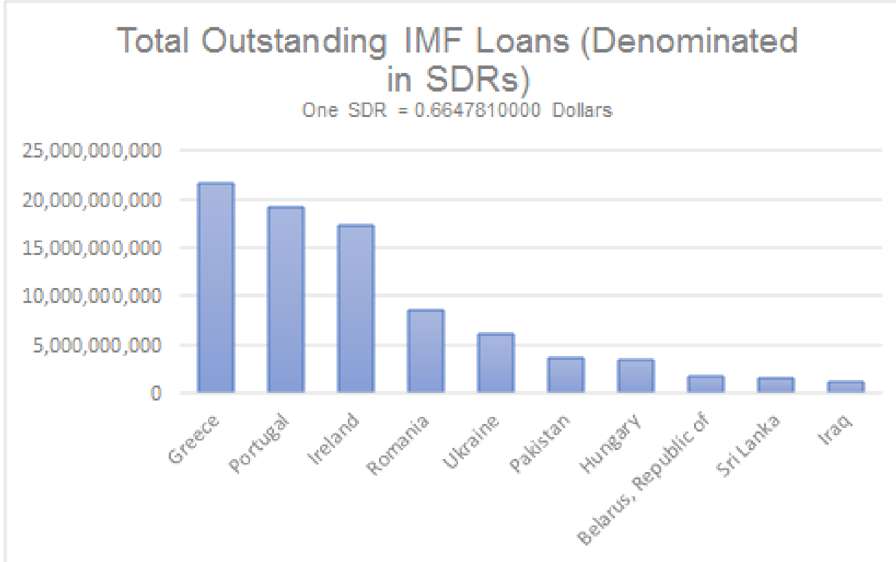


How the IMF is funded

Every IMF member is assigned a quota based on their percentage of the global economy, therefore the United States, Japan, China and the EU are the largest contributors to the IMF. Special drawing rights (SDRs) are the main financial unit used. One SDR was initially defined as 0.88671 grams of gold which was also equal to one dollar, and all other currencies were pegged to the dollar. This changed when President Nixon removed the U.S. dollar from the gold standard in 1971. SDRs are now priced in terms of a basket of currencies made up of Euros, Yen, British Pounds, and US dollars. Each IMF member is required to pay 25% of its quota in one of the four SDR components and the rest in their own currency. The IMF then uses these contributions to make loans to countries when they have difficulty finding financing in the traditional credit markets.

What the IMF is doing today

Recently the IMF has been most active in the European Union. It has been activley involved in restructuring the struggling peripheral countries in Europe. The IMF along with the European Commission, and the European Central bank is often referred to as the troika. They were instrumental in determining the conditions of their loans, that is, they were responsible for establishing the austerity policy. Austerity is a euphemism for spending cuts and tax increases, which has proved insufficiently opaque for the IMF and they will now be transitioning to the new term “fiscal consolidation”.



Highlights from the Global Policy Agenda

The IMF released the Managing Director’s Global Policy Agenda which outlines their concerns for the global economy and how they should be handled. While the document is quick to point out the shortcomings of policy approaches it is short on details for how they should be handled instead. I will focus on only a few topics in the agenda, but you can read the full text here.

In the U.S., the IMF would like to see a removal of the debt ceiling and a plan to manage medium and long term entitlement issues. In other words, the IMF sees that the United States is unable to afford its long-term entitlement programs like Medicare and Social Security and would like to see reforms (cuts). However, the IMF does not want the United States to use the debt ceiling as leverage in these negotiations.

The IMF is most concerned with Europe, where they see a need for Outright monetary transactions (OMT) and direct recapitalization of the banks. The Euro is still overvalued because they have yet to “recapitalize” (bailout) their banks, which will surely require additional money printing. Surely a direct bailout for the banks is not quite what the Spanish protesters were clamoring for.

One of the most contradictory sentences in the agenda was this:

“Countries should press on with needed bank and corporate balance sheet repair to help mend monetary transmission and improve the flow of credit to SMEs, as well as implementing structural reforms to rebuild competitiveness and widen the tax base.”

Let me rewrite this so that the contradictions are more clear:

“Countries should encourage banks and corporations to hoard cash and reduce their risky assets while somehow making more loans to riskier small and medium sized businesses. Countries should also provide stimulus, but cut entitlements and raise taxes.”

Conclusion

While the IMF is staffed with some brilliant economists and powerful world leaders, it often telegraphs ideal yet impractical solutions. The IMF will surely continue to play an increasing role in the restructuring of European Policy, but will likely have little impact elsewhere simply because the IMF only has leverage to affect policy when all other lending has dried up.

Strategic Allocation

Conservative Aggressive

RISK SCORE	1	2	3	4	5	6	7	8	9	10
Debt	66	54	48	40	33	27	19	15	8	8
Short Term	28	21	19	16	14	10	7	5	3	3
intermediate term	20	21	20	15	13	11	7	5	3	3
long term	9	7	7	7	4	4	4	4	2	2
floating	9	5	2	2	2	2	1	1	0	0
Equities	18	27	33	41	47	51	59	64	71	71
small cap	3	4	8	8	13	14	17	21	27	32
mid cap	3	5	9	14	14	17	23	24	26	28
large cap	12	18	16	19	20	20	19	19	18	11
Other	16	19	19	19	20	22	22	21	21	21
Reits	8	10	10	10	10	11	11	10	9	8
Commodities	5	6	6	6	7	8	8	8	9	10
currency	3	3	3	3	3	3	3	3	3	3
total	100	100	100	100	100	100	100	100	100	100

The Strategic allocation represents what should be the long term average of a portfolio. That is, the average allocation of the portfolio should adhere to these risk allocations. Different asset classes will outperform during different market conditions. This allocation will change slowly as new information comes to light that will affect the long term performance of certain asset classes. We expect that portfolios that are more aggressive will outperform conservative portfolios over a longer period of time, but will experience a greater amount of volatility.

Overweight short term debt, particularly for more conservative clients. This sector should reduce interest rate risk as well as market risk in the portfolio.

Overweight intermediate term debt, we prefer higher quality corporate bonds to replace treasury exposure.

Overweight Long Term Debt, this asset class has been slowly rising even when the market rallies, which is a sign that the current stock rally may be due for a pullback. This overweight recommendation is temporary as the long term consequences of holding treasuries could be disastrous.

Overweight on floating rate debt, we are expecting slow and steady appreciation on floating rate notes.

Neutral Small Capitalization Stocks, we are recommending a neutral holding of smaller companies with strong balance sheets and little need for short term debt financing.

Neutral Mid-Cap Stocks, we apply the same logic to this asset class as to small cap stocks.

Neutral Large Cap Stocks, We are looking for companies with strong fundamentals, reasonable valuations and steady dividends in this sector .

Neutral REITs, we will look to add to our position in REITs during periods of deflation.

Neutral Commodities, we recommend a neutral holding in commodities to reduce the impacts of future inflation.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are currently holding higher levels of cash.