Financial Tailor

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Rate Reversal

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President

S&P 500 Index

-47.01 **-2.87%**

Dow Jones Industrial Average

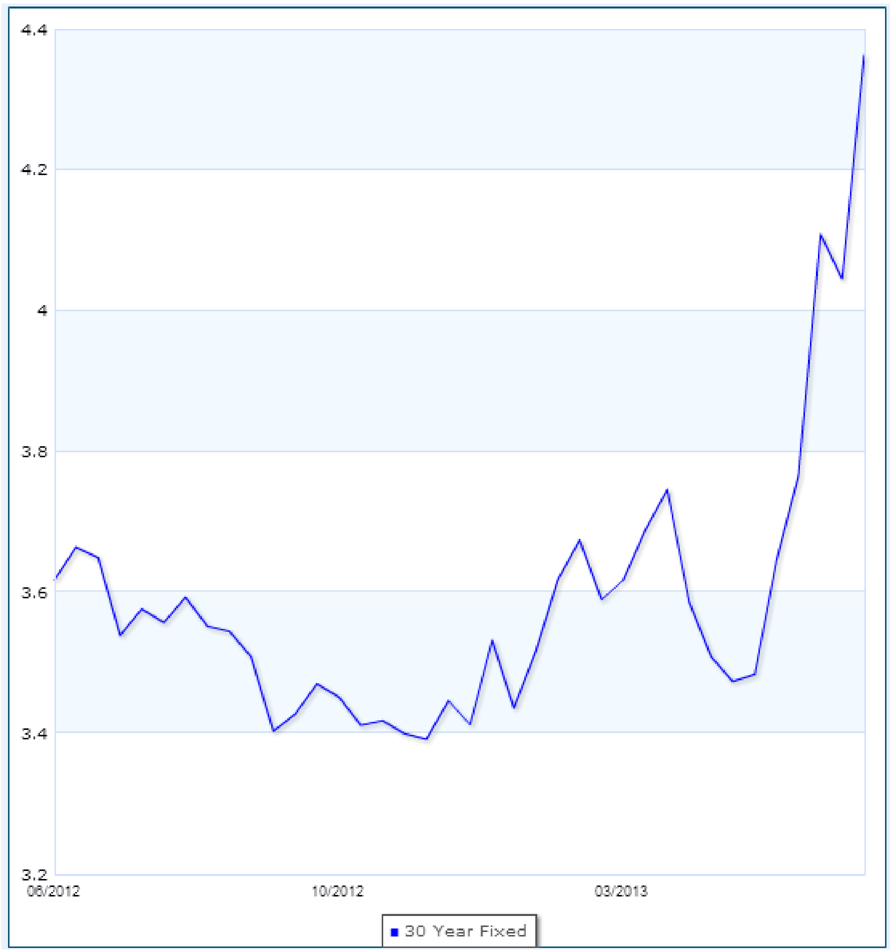
-390.24 **-2.57%**

NASDAQ Composite

-95.98 **-2.78%**

30 year Fixed Mortgage Rate

Source: Bankrate.com



Last week's selloff was broad based and applied to nearly all asset classes. As we discussed in a previous newsletter, many were worried about the possibility of the Fed "tapering" it's bond purchases. On Wednesday, the Federal Open Market Committee (FOMC) released their policy statement on Wednesday, which was unchanged from the previous statement. That is, the Fed will continue to purchase $40 billion dollars of longer term treasuries and $45 billion dollars of mortgage backed securities every month. They did not announce an ending or tapering of this policy. Immediately following the release of the statement, the market became volatile and then began falling rapidly. Bernanke held a Q&A session after the event which led to speculation on the part of journalists and market participants. While he did not announce that he would slow the pace of bond purchases he did say that a continued recovery in the economy could help push unemployment lower, which would make it possible to then begin slowing monetary easing. Rather than focusing on the drop in the stock market, we will focus on interest rate changes and how that might affect the economy going forward.

Mortgage Rates

For years we have been hearing commercials on why now is the time refinance because mortgages are at all time lows, but with the recent selloff in the bond market this may be coming to an end. If demand for 30 year bonds fall interest rates for 30 year bonds will rise proportionately. Mortgage investors are basically the same as 30 year bond investors, they are trading a lump sum of cash in exchange for an income stream at a predefined interest rate. In his speech, Bernanke highlighted housing as one of the strongest sectors. However, rising rates since his speech may lead to slower growth.

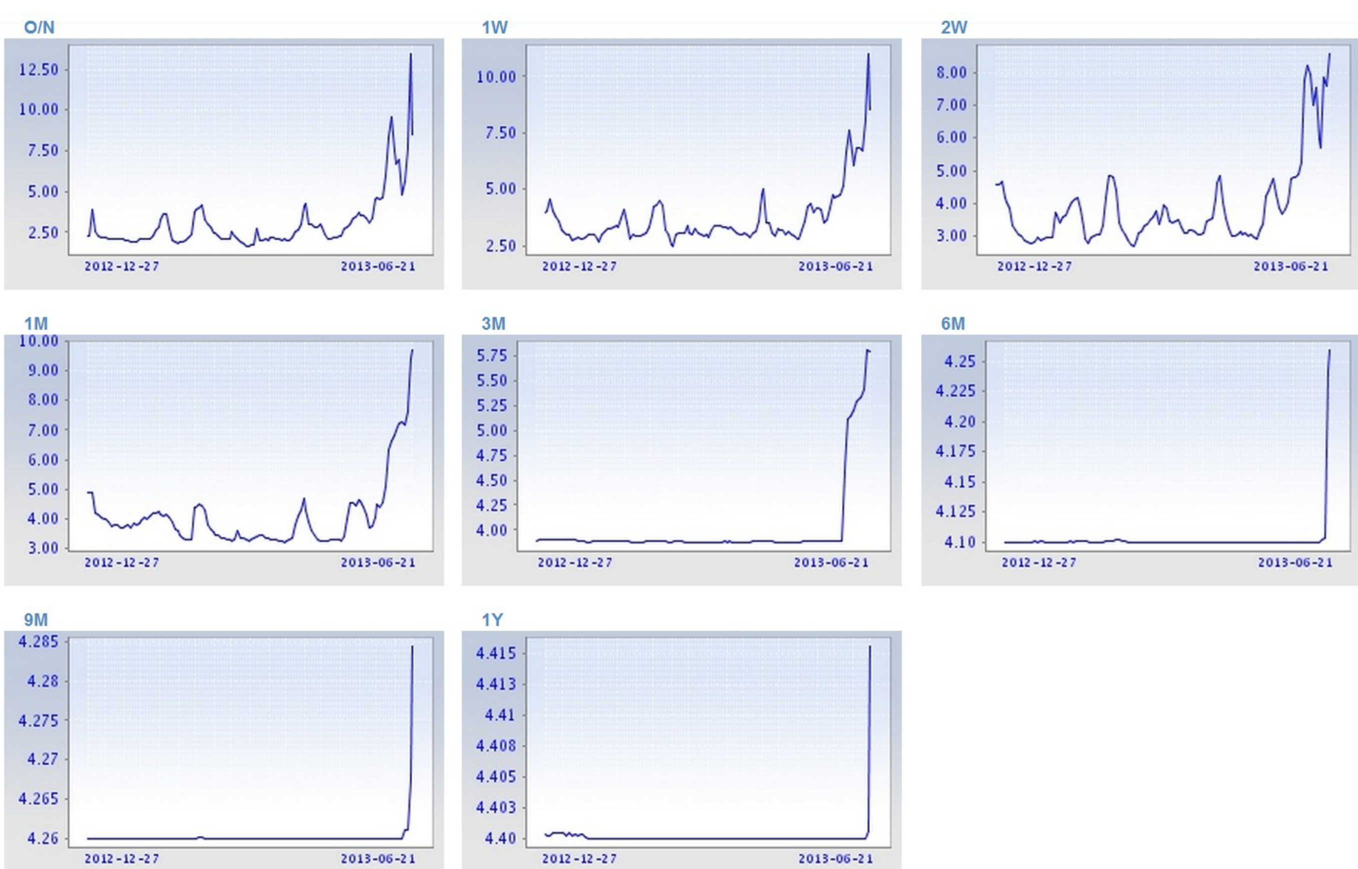
If you were considering purchasing a new home, you would first want to make sure that you could afford to do so. If rates were still at 3.5% your monthly mortgage payment before taxes and insurance would be $898.09. However, with rates at 4.25% that monthly payment rises to $983.88. This change may be enough to dissuade people from purchasing a new home. An alternative theory is that once the public realizes that interest rates are rising there will be a surge in applications from people who are looking to lock-in mortgages before rates rise any higher. Let's now change gears and look at an even more dramatic interest rate spike overseas.

SHIBOR

You may have heard of LIBOR (London Interbank Offered Rate) from the price-fixing scandal, but unless you are a global analyst you have probably never heard of SHIBOR (Shanghai Interbank Offered Rate). SHIBOR is simply the rate at which banks lend to other banks in China. A sharp rise in SHIBOR is significant because it means that banks do not trust other banks enough to lend them money. This is similar to the U.S. crisis in 2008 which eventually led to the bankruptcy of Lehman Brothers and caused widespread panic in nearly all asset classes. While the U.S. housing bubble was bursting, China began inflating their own asset bubble. They are now facing a difficult conundrum. Do they ease money to reduce SHIBOR rates and prevent a huge collapse, or do they add additional liquidity to the system, which would help in the short term, but only exacerbate the long term problem?

There are many uncertainties with respect to interest rates and it is safe to assume that the rapid rise in global interest rates was unplanned and unexpected by the Fed. As long as unemployment remains high and inflation is subdued we expect to see indefinite easing from the Fed.

SHIBOR Rates YTD (O/N = Overnight)



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.

Neutral intermediate term debt

Overweight Long Term Debt, this asset class has been oversold as a result of market expectations of Fed tightening, we are slowly purchasing more long dated treasuries and TIPS at the the higher yields.

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.

Underweight Large Cap Stocks, We are more selective with large cap stocks, and will try to avoid those companies with a larger exposure to the Chinese economy.

Neutral REITs, we will start looking to slowly increase REIT holdings now that selling has begun.

Neutral Commodities, we believe that we are now in a period of deflation, and that the selloff in commodities is largely tied to China. This selloff is likely overdone especially with respect to precious metals.

Currency - We are underweight the Euro. We continue to recommend protecting any exposure to the yen. We are currently holding higher levels of U.S. dollars, but will begin reinvesting those dollars on continued weakness.