Quarterly Point of View
Dovish Double Down

April 18, 2016

Recovering from major surgery is a process that takes time, and pain associated with a surgical procedure often requires the prescription of pain killers. Pain can interfere with a patient's ability to participate in recuperative activities, such as deep breathing and walking, which help prevent complications that could delay a recovery, or prevent it altogether. The goal with any treatment utilizing pain killers in recovery, however, is to taper as quickly as the patient's physical and emotional state allows - not to foster a condition where the substance becomes a necessary and permanent part of life. Side effects can create problems, at times worse than the original issue for which surgery was required. Even with a gradual tapering of pain killers, the patient will still experience some withdrawal symptoms including: anxiety, increased heart rate, high blood pressure, sweating, nausea, and insomnia. Though keenly aware the patient will suffer some form of withdrawal, it should not affect a doctor's logical decision to pull the prescription within a reasonable time frame, avoiding addiction and dependence.

Perhaps the Federal Reserve should have attended medical school. Monetary policy focused on zero interest rates (ZIRP) and rounds of 'quantitative easing' were 'pain killers' the Fed prescribed to help the economy heal after the damage inflicted by the global financial crisis eight years ago. In the years after 2008, that policy was legitimately needed, and no doubt helped end the so-called Great Recession. The issue for some time now, however, is that the doctor continues to administer these drugs despite the patient having been out of the hospital for many years.

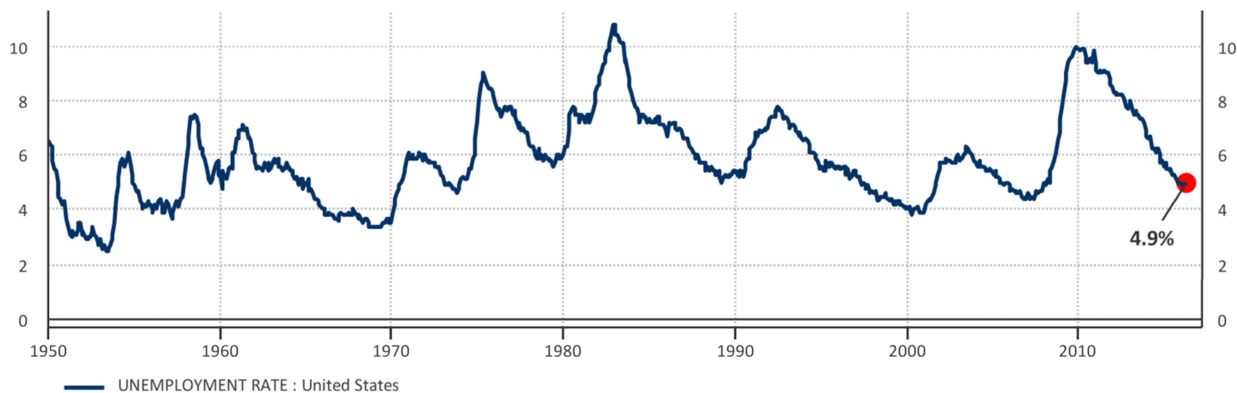
Please forgive my regression once again to this subject. I've written about it before from a similar perspective, but it remains a highly important topic for investors, in my view.

After embarking on the ZIRP path almost a decade ago, the Fed has attempted just one quarter percentage point increase, only to recoil at the faintest withdrawal symptoms – anxiety and increased heart rate, coupled with a routine market pullback. Now the Fed 'doctor' is talking reassuringly to the patient that the weaning from the medication will slow down again and possibly stop altogether. After officials decided to leave interest rates unchanged at their March meeting, Federal Reserve Chairwoman Janet Yellen delivered a speech to the Economic Club of New York on March 29th and said, "Given the risks to the outlook, I consider it appropriate for the committee to proceed cautiously in adjusting policy."[1] Most observers felt the Fed had set a course to begin a series of rate increases prior to their March meeting, and when pressed about the change in the projected path for interest rate increases after her New York speech, she further stated, "The major thing that's changed between December and March that affects the baseline outlook is a slightly weaker projected pace of global growth…global developments pose ongoing risks." It is difficult to respectfully describe how utterly inane those words sound. After almost a decade of keeping interest rates at *zero* a 'slightly weaker' estimated pace of global growth is now the excuse for not altering a policy that was enacted for an emergency situation? Global developments pose 'ongoing risks'? Of course they do, they always have and always will. The economy and

market have expanded and succeeded just fine over the last century and more, despite all the 'ongoing risks' that were passed through in that time.

As posed in previous letters, a question needs to be asked - what is more out-of-the-norm, the condition of the economy, or the Fed's policy to address it? The answer seems clear: Fed policy. Any benefits the economy might now see by keeping a hyper-accommodative monetary stance in place are not commensurate with the risks this prolonged, out-of-the-norm, policy presents. Artificially low interest rates for extended periods invite speculation and distort decision making, creating unintended, long-run consequences. Meant to be a tool to stabilize the economy, ultra-low rates for this long may instead be destabilizing, feeding asset bubbles.

Created in 1913, the Federal Reserve was established to provide the nation with a safer, more stable monetary system. In 1977, the Federal Reserve Reform Act was passed, creating the dual mandate of promoting maximum employment and price stability. 'Maximum employment' is admittedly a grey area, but the current rate of 4.9% in the first quarter (illustrated in the chart below) is well below peak unemployment of 10.1% during the financial crisis and even below the measurement's 50 year average!



Source: Thomson Reuters Datastream, Martin Capital Partners, LLC

An excuse often posited to rebut the idea of raising interest rates is the comparison to post depression decision making in the 1930's, when a premature increase in rates during recovery sent the economy back into recession. The differences, however, are noteworthy. Unemployment remained above 14% eight years after the crash of 1929, while consumer prices had fallen by a cumulative 18%[2]. The situation at eight years post crisis today sees unemployment below 5%, and consumer prices have risen a mid-teens percentage on a cumulative basis. Charles Plosser, the President of the Philadelphia Fed until his retirement in 2015 said, "There are many indicators that tell us rates are too low. There is no precedent in history to have rates at zero. I think we are behaving in a way which is outside of historical norms, and that should make us nervous."[3]

The Federal Reserve rarely intervened in the financial markets of the past, yet today, takes on roles seemingly outside of its mandate with a hubris that is worrisome. The concept of 'risk manager,' under the guise of *macroprudential* regulation, is now being adopted, though this authority does not appear to be granted by law. Outlining the 'purpose of the Federal Reserve,' the Fed's website now includes this third bullet point: "Maintaining the stability of the financial system and containing systemic risk that may arise in the financial markets." The irony is that the systemic risk they seek to contain is fostered, in large part, by their own decisions as a powerful body able to set the price of money, i.e. interest rates.

The real 'systemic risk' that's being germinated, however, is one of moral hazard. This form of risk, as we've written about before, operates under the premise that people insulated from risk behave differently than people exposed to risk. In other words, if an investor who's making a decision believes to any degree that they may be 'bailed out' or 'backstopped', they will take more risk than if they believe that is not the case. With the Fed

hovering over things outside of their decreed purview, they foster the assumption that they are always there, and will have investors' backs. Risk of loss is fundamental to a healthy system – it forces prudent decision making, which is degraded by moral hazard. If anyone needs evidence of the extent to which this phenomenon has seeped into our financial 'fabric', look no further than the photo below. Taken January 25th, in the midst of a very routine stock market pullback by historical standards, the talking heads on TV were debating the need for the Fed to 'save the stock market'.

How could we have gotten to the point where such a routine market event elicits this kind of question? We've come to this point because the Fed is over-reaching by any historical precedent or mandate - and it is simply not healthy. Chairwoman Yellen's recent 'super-dovish' comments (a 'dove' is an economic advisor espousing maintenance of low interest rates) continue to reinforce this concept among market participants. Ben Hunt, Chief Risk Officer at Salient Partners and one who writes often about the Fed's misguided direction recently stated:

> *Fed communication policies are intentionally designed to push and cajole us to pay up for financial risk in our investments, in exactly the same way that an insurance company's communication policies are intentionally designed to push and cajole us to pay up for financial risk in our cars and homes. The Fed uses Janet Yellen and forward guidance; Nationwide uses Peyton Manning and a catchy jingle. From a game theory perspective, it's the same thing. As a consequence, stock-picking has never been more difficult, requiring investors and advisors to change the meaning and role of actively managed strategies in any investment portfolio.*[4]

In looking at the investment landscape over the next decade and the potential associated risks of this over-arching Fed presence, it will be vitally important to analyze and treat our investments in publicly traded companies as if they were private. What does this mean? While the investment world focuses intently on stock 'price' action and 'trading' as the mechanism to create returns, we want to look instead to the asset itself to produce the return. The stock market is the vehicle by which we obtain ownership in great companies, and through that ownership we capitalize on durable and rising streams of distributed profits (dividends), not unlike what a private business owner does. An owner of a private enterprise does not look to continually trade in an out of their business based on what someone will pay for it at any given moment, but instead looks to grow and run it sustainably, providing owners with profits it can distribute. The added benefit is that if durable, high and rising cash dividend payments by quality companies are produced in a portfolio, more of the investment return is realized 'up-front', and less is required at the back end (as sales for capital gains) to produce the same total return. By virtue of focusing on the cash payments in the form of dividends we can eliminate some level of risk through the consistent and incremental capture of return. Maintaining a fervent focus on identifying quality companies able to continue producing attractive and durable dividend income will remain our paramount goal, as these will be critical attributes in an age where the Fed, and risks they may inadvertently create, remain omnipresent.

The Federal Reserve needs to get serious about slowly but systematically beginning to raise interest rates, and they need to do it despite normal withdrawal symptoms the patient will experience. By doing so, they can start

the process of reducing the potential side effects of distorted decision making that fosters asset bubbles, future inflation, and moral hazard 'dependence'.

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It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. Wall Street Journal, March 30, 2016.
2. Christian Broda, Stanley Druckenmiller, Wall Street Journal, April 15, 2015.
3. Market Watch, November 11, 2014.
4. W. Ben Hunt, Ph.D., Epsilon Theory, April 6, 2016

Statistical and analytical data provided by Thomson Reuters Datastream, Eikon & Baseline.

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940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com