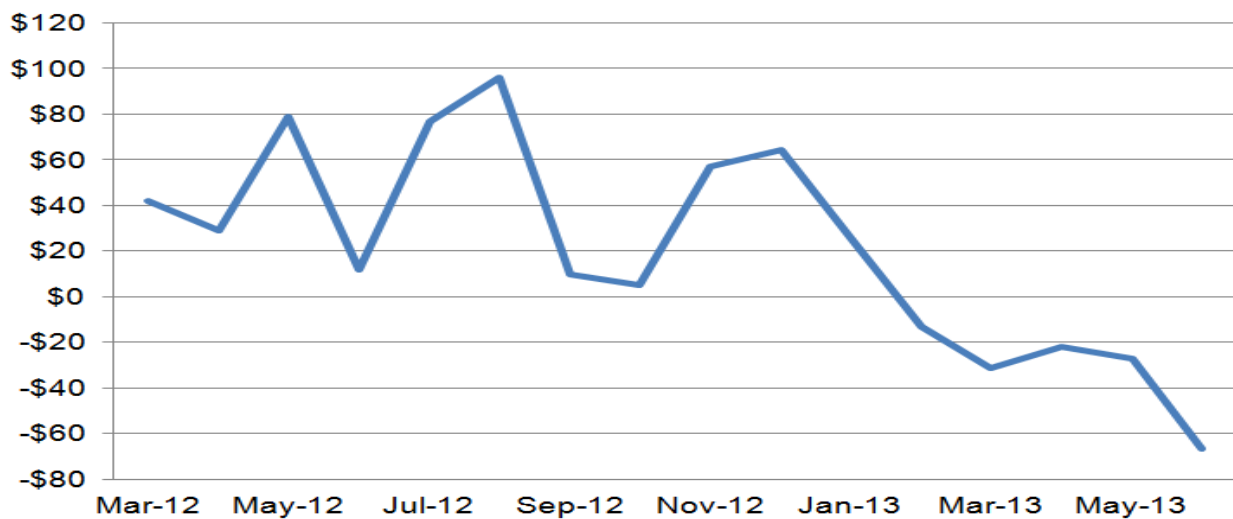


**Market Insight:
Rising Rates Threaten Stock Rally**

Interest Rates are a key ingredient in determining all financial asset prices. Since the Fed embarked on its massive quantitative easing (bond buying) program, rates have fallen dramatically. Falling rates have been the primary fuel facilitating rising asset prices of bonds, real estate, and equity prices. Falling rates also made the US dollar cheap, which in turned encouraged foreign holders of US dollars to buy US assets. Now, with the Fed planning to reduce its bond-buying program (possibly in September), rates have risen dramatically, doubling in just two months. Higher rates are challenging investors to re-evaluate the prices of all financial assets and in particular their holdings of US assets.

The tide has changed: Foreign demand for U.S. assets is a big determinant of interest rates: The U.S. Treasury measures foreign purchases of U.S. financial assets through the Treasury International Capital (TIC) report and shows how the flow of money into US assets has reversed. (See chart below) Last summer when fears of a European liquidity crisis fed a flight to quality, nearly \$90 billion poured into US financial assets, in particular US Treasury Bonds, pushing interest rates of the ten-year yield down to a record low 1.4%. As the liquidity crisis subsided in Europe, the flow of money into the US slowed.

Net Foreign Purchases of US Assets (\$billion)



Initially, the decline in purchases had no effect on rates, because it was offset by yet another round of QE initiated by the Fed in January of this year. At that time, the Fed pledged to increase their purchases to \$85 billion a month. Now, as the Fed threatens to end asset purchases (QE) the tide has shifted dramatically. Foreign investors are bailing and have become net sellers. The most recent data for June shows net outflows of -\$85.4 billion, putting significant pressure on bond prices (lower) and rates higher.

How high can rates go? The chart below shows the US 10yr Treasury Rate since March of 2010 when rates were as high as 4%. Then, with the Fed's QE program and global liquidity scare, rates fell, reaching a low of 1.4% during summer of 2012. Since then, rates have hovered in that low range until late May of this year when Bernanke hinted the end of QE was coming. Now that both foreign selling and the hint of reduced QE is on the table, **rates could easily rise further to 3-3.25% and push 30yr mortgage rates over 5%.**



What is the impact of Rising Rates? The chart below shows the change in the US10yr Treasury yield (blue Bars) versus the change in S&P500 (Brown Line) since 2011. In sum, **the US 10yr Treasury yield is now nearly at the same level (2.89%) as it was in July 2011 but the S&P500 is 20% higher today.**



Tightening without Tightening: The interesting point here is that rates have *risen without the Fed actually doing anything*. In fact, *it has been purely the mention of possible shift in Fed policy that has caused a major shift in investors' flow of funds*, sending a shock wave through the bond market and now maybe threatening all other financial assets as well. How much higher can rates rise without derailing the housing market, the US recovery, and the stock market? Of course no one knows, including the Fed.

Signs of Strength: There are signs of economic strength that justify both a rise in stock prices and a withdrawal in QE. In fact, recent data shows the US economy is gaining traction. Housing initially took a dip in June but seems to be recovering, as the supply of both new and existing homes for sale is very low. Employment is slowly improving and consumers' balance sheets are much healthier. At the same time, Europe just posted its first positive GDP number for the 2nd quarter and is no longer a drain on global growth. Off setting that however is a dramatic slowing in Asia. Thus, the global economic picture continues to be subdued, but positive. It will take time to see how much, if at all, the recent rise in rates bites into economic growth. In the mean time, until more clarity is given from the Fed, (which is unlikely to come before its next FOMC meeting in September), the markets will likely struggle. Low rates were the fuel for the rally, and now the gas gauge is on empty.

Investment Strategy: Risk positions were pared modestly over the last two months thru raising Cash and re-allocating much of the Bond exposure to Floating Rate Notes.

As always, please contact me with any questions or concerns.

Kind Regards,
Barbara

Barbara HS Huff
CEO & President
New Albany Investment Management
614-216-6139 ~ www.newalbanyinvestment.com