July 2, 2012

Greetings,

One of the reasons that we got off to such a great start to the year was because market psychology improved. As we saw in the first quarter, with a market that has such a low valuation; it doesn't take that much of an improvement in market psychology to make a big move up. Market psychology moves the market in the very short run. It changes quickly and it is almost impossible to predict when it will change. One of the reasons for the recent correction is that market psychology took a turn for the worse. During the correction, the 10-year Treasury bond hit the lowest yield (1.46%) in its history. I believe that even some of the most pessimistic people will acknowledge that as bad as things are now, things aren't nearly as bad as they were in late 2008 (just after Lehman went under) or in late 2001 just after the 9/11 attack. The problem is that the stock and bond markets are behaving as if we are back in 2001 or 2008. While we are not in a brutal bear market like we were in those years, the valuation of the stock market right now is much cheaper than it was in those years while bonds are more expensive now. Jim Paulson of Wells Capital Management was recently interviewed on CNBC. I have seen him many times over the years and he is a bright man. He noted that individual investors are chasing overly expensive bonds in a similar fashion as they chased astronomically priced internet stocks in the late 1990's that had no earnings. He also said that all these people who are chasing bonds are doing it more for performance than for income and they are going to get hurt badly just like people who got hurt badly just over 10 years ago. While not to be too literal, I will just add that while the bond chasers will get hurt, they won't get hurt as badly as the people who lost anywhere between 50-90% of their investments in internet and highly priced tech. stocks.

A client recently sent me a column to read from the NY Times. The subject matter was similar to what Mr. Paulson talked about on CNBC, but since the tone of the column was so dire (as are most of the columns in the NYT having to do with the stock market), the opinion of the writer was vastly different than Mr. Paulson's. The general view of the columnist was that he was pointing out how the general public has given up on stocks in favor of bonds and for good reason. My own view of the column was that much of what was written was silly. I felt it was silly because the view of the columnist reflected the herd mentality. Over time, the herd is wrong and I am surprised that a NYT columnist isn't smart enough to realize this. The columnist pointed out the obvious fact about how poorly equities have performed over the recent decade relative to bonds. The writer also pointed out how people continue to flee poor performing equities to strong performing bonds "and for good reason". The "for good reason" part of the column in particular galled me. If a columnist for any publication wants to fan the flames and remind people how poorly investors have done in equities over the last 11 years, what the heck, that is the nature of the beast. One of the things that Mr. Paulson pointed out in his CNBC interview is that historically, over a 40-50 year period, you make money in any asset class by buying it cheap and selling an asset class that is expensive. The NYT columnist was advocating selling a cheap asset class (equities) because so many people in the past have been burnt by the stock market. He failed to point out that one of the reasons the public got burnt was because they followed the same herd mentality 12-13 years ago by purchasing equities at high prices and selling fixed income at low prices. If anything, all things being equal, if an asset class (whether it be equities, bonds, real estate or a commodity) has done poorly in the past, the chances are going forward it will do better than it did in the past. Unless you have a time frame of a few weeks or possibly several months, chasing performance and buying an expensive asset class is a recipe for disaster.

I acknowledge that there was a relevant part of that column. What was relevant was the fact that individual investors have lost confidence in the stock market. This is something that can not be ignored; something that I have been aware and concerned about. I even brought this concern up to several of my mutual fund managers during the past year. What I found disappointing was that two of my fund managers didn't even address my question in their response. As important as fundamentals and valuations of individual company's are, you simply can't ignore the fact that the retail/individual investor has lost total faith in the stock market. Even though company fundamentals are outstanding and valuations compelling, unless confidence is restored to the market, then stocks will continue to stay cheap. Once again, it is all about your time frame. Let's face the facts. With all the headline risk, there is a real probability that the broad market will be flat over the next 3-6 months. As I like to remind my clients, we don't own "the market". While I detest making short term predictions, since I know that we own higher quality stocks (and mutual funds that own high quality stocks) that mostly are at cheaper prices than "'the market", we should be able to make some money even in the short term. Given how low bond yields are, even a low to middle single digit return will outperform fixed income. I will also state that because of all the fear in the market now, there is a possibility that over the next 3-6 months, the value of our investments will be lower than it is now. If you can't tolerate having your investments being worth less than it is now for 3-6 months, then please by all means contact me now because that is something that we should discuss. We do have a nice cash position (along with some nice dividend paying stocks that will hold up ok in a down turn) but it is only large enough to take advantage of buying opportunities, not enough to shield you from temporary losses.

A little knowledge is a very dangerous thing. That is why I detest the type of columns that do very little other than to stoke the emotions of the masses. What is imperative to understand and what that column (and many others) didn't address is the risk versus reward of fixed income verses equities! With fixed income so expensive, there is zero upside. Unless you expect to hold everything that you have until maturity, there is a huge and I mean huge amount of downside risk in holding bonds and bond funds (which have no maturity dates, only a net asset value), which is where all the money is flowing now. With equities, there is huge upside and some downside risk in the short term. If your time frame is at least 2 years, at these levels the downside risk is minimal. The return that we had in the first quarter is a perfect example of how well we can do once things turn around for the better. While our long-term record isn't what we would like it to be, since the bull market began just over three years ago, we have done very well.

I did watch and listen to Ben Bernanke (the head of the Federal Reserve) speak to both Houses of Congress recently. He made it clear that he will do whatever he can to keep both short and long term interest rates low for at least the next two years. Some people call this "the Bernanke put" since the ultra low interest rates will limit just how low the market can go. I am in the camp that believes that one of the reasons the market has limited downside risk (beyond six months) is because there is so much liquidity. What I have found irritating over the years is how so few members of Congress have asked him about the adverse affect of low interest rates on senior citizens. I recall someone asked him the question a couple of years ago and then again just a couple of weeks ago. His response this time was similar to last time in that while he is aware that low interest rates are having an adverse affect on senior citizens, he said that it is necessary to keep interest rates low "to help the greater good" of the American public. I suppose if historically low interest rates were truly "helping the greater good", I could possibly stomach the fact that senior citizens are hurting badly. I would have loved to hear exactly in detail how "the greater good" of the American public is benefiting from these low interest rates. He did give a brief, textbook explanation of how low interest rates encourage and make it easier for businesses to expand and purchase capital equipment. He then further explained that these purchases of equipment would lead to job creation. In theory, Mr. Bernanke is correct. The problem which Mr. Bernanke refuses to recognize is that we live in reality, not in a world of theories. In the real world, the banks simply are not lending to small and medium sized businesses so the low interest rates are not helping the people that they were supposed to help. Just two weeks ago, there was a front page story in the Wall Street Journal about the great credit divide. The article explained how this great credit divide shows the largest disparity between what the wealthy individuals and multi national corporations are borrowing and how the rest of the country (middle class individuals and small businesses) has limited access to credit. The hedge funds certainly are benefiting from low interest rates. The banks are also benefiting. Jim Cramer of CNBC has said that even a banker can make money borrowing at less than 1%. Just think, if you want a guaranteed return without the risk that the bond market entails, these same banks that caused the financial crises and which now won't lend (other than to the wealthy) will be happy to give you a CD for 2 years with a 1 ½% rate of return, before taxes that is.

So, even with all these low interest rates for the last 4 years, the economy continues to sputter along. The labor market is appearing to be getting worse instead of better, believe it or not. I felt like I was hit in the gut when only 69,000 jobs were created last May. I expected a bad number but not that bad. The unemployment rate clicked up to 8.2%. The only reason that the rate is not higher is because so many people have left the work force and according to the Department of Labor, these people don't count as being unemployed. This number also doesn't count part time workers who would like to be working full time, the underemployed and independent contractors who would prefer to be working with benefits as employees. Meanwhile, first quarter GDP was just revised down to a 1.9% annual growth rate. I expected the domestic economy to grow in the 2.5% to 3.0% range this year which while not good, is not terrible. It looks like the economy now will grow at best at a 2.5% rate this year but most likely, in the 2-2.5% range.

If you have any questions or if there is anything that you would like to discuss, please either email me or give me a call.