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Greetings,

There is no sanity to the stock market at this point in time. There is little or no thought. There is no intellect. There is no fundamental analysis. Each day, before the market opens, all eyes are on what is going on in Europe. The European markets open five hours before the domestic market does. By the time I start watching the pre market activity (usually around 7:00AM) the DOW futures are either up or down 100 points. If there are bad things going on in Europe, the domestic market has the DOW down over 100 points. If there is some good news out of Europe, then the DOW more often than not goes up 100 points or more. When there is no news, the market has tended to go up. Over the last three months, it has been a rare occasion that the DOW hasn't been either up or down 100 points each day.

The emotions over the macro economic environment have totally and completely taken over any focus on individual security fundamentals. I am not going to dismiss the poor economic environment. While I recognize how bad this economy is, an intelligent person has to realize that while the macro environment is important, it isn't the only thing to focus on. Stock market valuations matter. They may not matter too many people at this point in time because so many people are overcome with fear because of the poor economy. The average PE multiple (PE is the price to earnings ratio which is a common valuation method) for the S&P 500 over the last 30 years is 18. In early 2000, right before the tech. bubble burst, the PE of the S&P 500 was 30. Today, the PE of the S&P 500 is 12. Those numbers are facts, not my opinion. I should also point out that historically, stocks are cheap when interest rates are high and expensive when interest rates are low. Interest rates are near zero now. Equities are cheap.

I have a pretty good memory, to put it mildly. I remember early 2000 like it was yesterday. Just like today when very few people care that stocks are cheap, very few people (other than myself and a few of my mutual fund managers) cared at that point in time that stocks were expensive. People were happy because they were making money owning over priced companies. Quality companies were selling at PE's of 50, or more. Lower quality companies with minimal earnings but high growth prospects were selling at PE's of 100 or more. Market sentiment then was strong. Market sentiment now couldn't be much worse. Even before 9/11 and the subsequent recession, things ended badly for those who were happy owning those over priced stocks.

At this point in time, with all the cash that I still have (as a result of my timely selling in July) available for us, I am finding companies to buy that I never thought that I would be able to own. It isn't because I have all of a sudden discovered these companies. It is because I never thought they would be this cheap! I am finding companies with single digit PE's (30-35% cheaper than the market multiple) 4-5% dividend yields (over twice the dividend yield of the broad market) and growth rates in the low teens which is higher than the markets growth rate. As long as you have a time frame longer than a few months, we will make a lot of money owning these high quality, cheap companies. I should also point out that the dividend yield of the S&P 500 is higher than the 10 year Treasury bond. This is almost unheard of. Bonds are very expensive. Jeremy Graham, a professor at the Wharton business school, just a couple of days ago pointed out that the last time that equities were this cheap relative to Treasury bonds for a prolonged period of time was in the early 1950's. He then pointed out that the equity markets then had a strong 20 year run.

Those who say that equities aren't really cheap say they aren't because you can't rely upon future earnings. I find that an interesting point. I don't agree with it but it is interesting. First of all, publicly traded large cap corporations are in great shape. During the last recession they cleaned up their balance sheets. Five years ago, many companies were fat. Now, they are lean. They hold a record amount of cash as a % of assets. Many companies are increasing stock buybacks or increasing dividends. Some companies will not make their earnings estimates. Some companies will exceed the "analysts" estimates. 70% of companies in the S&P 500 over the last two years have exceeded the estimates. As recently as two weeks ago, both Oracle and Nike reported strong earnings that exceeded expectations. Neither company gave poor guidance. Stock selection over the next year will be paramount to ensure good performance. Dividends will also be important. Not all dividend paying stocks are alike. The dividend paying stocks that should do well are the companies with low valuations and earnings growth of at least 10% per year.

Other than perhaps during election season, I watched more news (on more than one news station) during the debt ceiling mud slinging than I can remember. At that time, I told my wife that our country has reached it lowest point since Watergate. Yes, I do remember Watergate. While corporate America is in fantastic shape, it is not hiring. For business people to hire there has to be some confidence that you will generate enough revenue to pay the salary of the additional worker plus something left over. With the total dysfunctional state of affairs of the incompetent politicians who are literally running this country into the ground, who in their right minds would want to hire anyone? Congress has a 12% approval rating. Someone (I am not 100% sure who, it might have been John Boehner, the speaker of the House) recently asked who those 12% are that approve of the job that Congress is doing. The President has an anti business administration. When I first read about the new "jobs bill", I raised my eyebrows and said to myself, on the surface it didn't look too bad. Then a couple of days later, I read how it is going to be funded. In front of the T.V cameras, the President said it will be funded by raising taxes on the millionaires and billionaires. This is simply not factually correct. Sure, their taxes will go up but so will taxes on single people making over $ 200,000 a year and married people making over $ 250,000 per year beginning in 2013. This is in addition to the tax hikes that will be a result of the expiration of the Bush tax cuts. Basically, these people will be looking at two tax hikes simultaneously. There will be an increase in tax rates and a reduction of their itemized deductions.

Those people whose taxes are going up, twice, are the business owners who the President is imploring to do the hiring. Some of the business owners can afford to pay more taxes some can not. Affordability isn't the point. The point is that while large companies are doing very well, the small and medium size business owners are not, at least not in this economy. If you don't believe me, please just ask a small business owner who you may know how things are going for him or her. 70% of jobs are created by small businesses.

That is a fact, not my opinion. As I wrote in my last investment letter, the banks (which were bailed out with taxpayer money) aren't lending to small businesses. The small business owners are people with emotions. When I was a practicing CPA, I dealt with these people all the time. I know how they think and how they feel. If anyone thinks that a small business owner is going to be in the frame of mind to want to hire someone in this lousy economy while at the same time having a tax hike staring him (or her) in the face in the near future, then they are sorely mistaken. What I find even more galling is that with the huge Republican majority in the House, the President (who is a brilliant man) must have known that any "jobs bill" funded by tax increases would be dead on arrival. I am confident that if this "jobs bill" were funded by spending cuts in other areas (ending the wars, anyone? anyone??), then it would have already been passed. Now, get this, subsequent to the writing of this letter originally, Harry Reid (the Senate Majority leader) proposed to scrap the original funding plan and instead will increase the tax on all people making $ 1 million by 5%, effective January 1, 2012. The original plan was to have taxes go up in 2013. While this funding plan is more "fair" than the original and I am confident that people making more than $ 1 million can afford to pay more in taxes, given the political situation, this will never pass. I am a pragmatic person and I would think that the objective would be a bi partisan plan to put people back to work. The Republican dominated House already said that this won't even come up for a vote and there will be a threat of a filibuster in the Senate so it won't be voted on in the Senate. Again, this is politics as usual.

What I find personally so discouraging is that over the last 30 years, people who ran this country who were at opposite ends of the spectrum were somehow able to put their differences aside to get things done to benefit the country. In 2011, both sides just want to get elected, no matter what the price to the country. Back to my great memory. In the early 1980's, Tip O'Neil was a leading Democrat as the speaker of the House. Tip O'Neil wasn't any more of a moderate than President Obama or even Nancy Pelosi or Barney Frank. President Reagan was a noted conservative and wasn't any more a moderate than John Boehner or Eric Cantor. Somehow both sides worked together to get things done. As I recall, the economy was strong for much of the 1980's. Bill Bradley (the former NY Knick for you basketball fans) was a Democratic Senator from New Jersey in the 1980's and much of the 1990's. He worked with the Reagan administration on tax reform. In the mid 1990's, the same people who can't stand the tea party and the Republicans couldn't stand Newt Gingrich and the Republican leadership. The same people who dislike President Obama felt the same way about President Clinton. They probably don't dislike him as much now but at the time they did, that is for sure. Again, somehow Newt Gingrich and his Republicans were able to find some common ground and work with President Clinton. They accomplished some good things and guess what? They even balanced the budget with some real spending cuts! The economy and the stock market both did great for six years.

Not long ago, I saw Alan Simpson (the former Senator from Wyoming) interviewed on CNN. He said that when he was in the Senate, the caucuses would get together and at least make an effort to do some good for the country. He said that when the caucuses get together now, all they talk about now is how to screw the other side. He then said that neither side has a vision past the election cycle.

I don't want to go to much more into the economy mostly because we all pretty much know how bad things are. I don't think that the economy will go into a recession although I can't rule out the possibility of it happening. If a recession occurs, it will be because of a combination of politics and people talking themselves into a recession like a self fulfilling prophecy. At this point in time, the economic data points to a lethargic, slow growth economy. Historically, before a recession occurs there are three consecutive months of heavy job losses. While there is tepid job growth, there is a difference between this and heavy job losses which was the case in late 2008 and early 2009. I also notice that crude oil prices have stabilized. While crude oil prices are 30% (or so) off the spring highs, if a recession was imminent, then there would be total demand destruction for oil and crude oil would be at least 30% lower than it is now.

Please feel free to either email me or call me if you have any questions.

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