

### **April 2010: An Interesting Development**

The 1<sup>st</sup> quarter witnessed a nice rally in U.S. stocks, but those investors who are positioned globally and more defensively (like us) have given up some relative performance so far this year to the S&P. Is the cautious positioning misguided? We feel it is not for the reasons described below.

There has been much complacency of late that the U.S. is back to business as usual, that asset prices are back to levels where they belong, and that we're in the midst of a long overdue cyclical recovery. Given the amount of stimulus put through the system, it is no surprise we experienced some sort of rebound, but we're cautious on how far it goes and how it impacts financial markets. Of course we want to be optimistic, but we also have to look clearly at a tricky environment and mixed data, and rely on our training and experience as long-time investors of capital.

Some of the indicators that give us pause and get very little press are flashing warning signals. For example, the recent rally has occurred on very low volume, which may be a sign that the rally is on weak legs. In addition, the crude goods component of PPI, which was one of the 1<sup>st</sup> to flash inflation warnings in the 70s, is flashing those same warnings now.

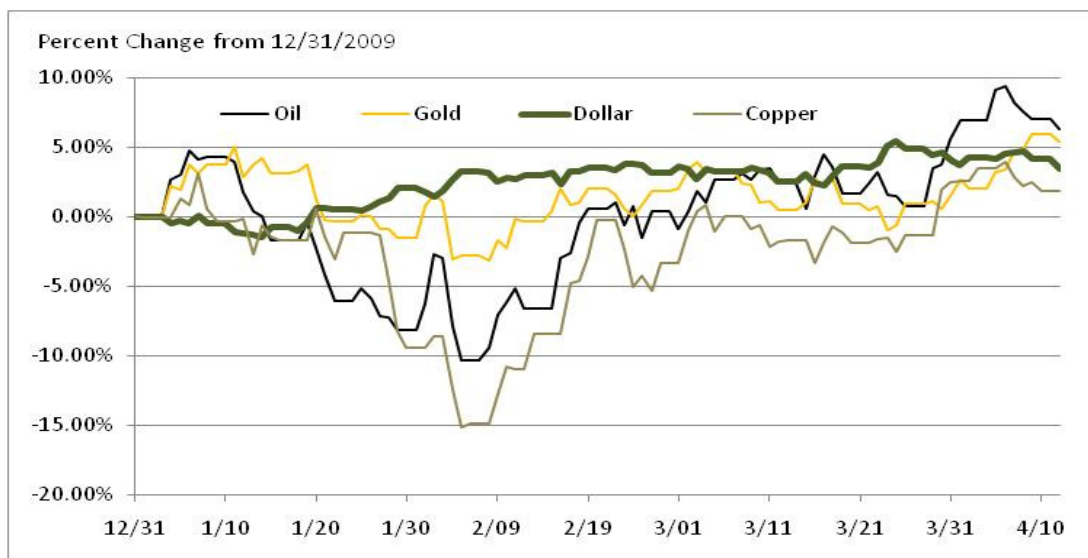
In the 1<sup>st</sup> quarter, the S&P500 was the top performer of most global equities indices. Within the S&P, the best performing sectors were airlines, biotech, casinos and retail stocks—areas where we have little or no exposure. Additionally, in the 1<sup>st</sup> quarter the dollar rallied strongly vs. other major currencies. These factors caused our portfolio to lag the S&P, but we don't believe a change in strategy is warranted at this time. Rather, we will continue to monitor developments and keep our options open.

In the last 3 years, it has been the *modus operandi* in financial markets for riskier assets (stocks, commodities, junk bonds, etc.) to rally when the dollar weakens and vice versa. This evolved due to Fed policy of holding rates super-low, which makes the U.S. dollar a funding currency, where global investors borrow dollars for very little cost and invest them up the risk curve. In order to keep asset prices up, the Fed holds rates low because of the high levels of debt in the United States.

If there is a liquidity squeeze (like the one we saw in 2008 that came about because of excesses on Wall Street), we see broad-based selling of all risk-assets, a tactical shift to U.S. Treasuries, and a rush for dollars to pay back the loans used to lever up—hence, the dollar rallies strongly. That is why we have seen an almost perfect inverse correlation between the dollar and risky (non-fixed income) assets for such a long time.

Interestingly, the rally in stocks, commodities and other risky assets in the 1<sup>st</sup> quarter came during a time when the dollar strengthened, a notable departure from the usual market action of the last 3 years. We believe this is because global liquidity flowed to the U.S. due to the front page story of what's happening in the EU with Greece and the attempted resolution of its debt crisis/fiscal situation. So at the moment, from a global perspective, the U.S. dollar has become regarded as the least worst of the all major currencies and as a result, dollar-based assets like S&P stocks have been strong on a relative basis. More interesting is that gold rallied strongly as well.

That gold and other commodities should rise amidst dollar strength befuddles many market observers. It challenges the widely-held belief that the only reason commodities rallied was that the dollar had weakened vs. other currencies. According to dogma; gold, base metals and crude oil are not supposed to rise when the dollar is strong. Could it be that scarcities and the high cost of producing and delivering commodities are starting to become evident in the rising prices of commodities? Time will tell.



Many pundits and politicians point to excessive speculation among market participants as the reason why crude oil ran up, or why gold now trades at over \$1,150. But if that were the case, why would the best-performing commodities now be scrap steel and metallurgical coal—both commodities for which there are no futures markets, and whose prices are only driven by actual industrial demand?

What gives?

It goes back to a theme we discussed a few issues back, which is the movement and importance of liquidity, i.e., where investors (who are flush and/or have access to cheap credit) stand ready to make bids and put money to work.

Where the liquidity comes from—whether it's created by the government out of thin air and transmitted through the big banks, or if it's earned by the profitability and value-adding activities of legitimate businesses that provide valuable things to real people—doesn't seem to matter for

speculators who fixate on the short-term. But over the longer-term, we feel it does matter and should inform the prudent positioning of marketable securities portfolios.

It is true that liquidity—no matter the source—usually makes its way towards improving final demand and can provide economic growth. Astute investors, projecting forward that there should be a pickup in global demand, are taking positions in assets that will benefit from its pickup. But it is also true that governments can withdraw liquidity or provide incentives and disincentives to try to manipulate where liquidity goes through capital controls, tariffs, tax policy and other forms of statutory or regulatory measures. So therefore, the market action has been a bit tentative.

The fact that \$8 trillion of new government commitments, hand-outs, and guarantees were required to fuel the recent cyclical rally does matter to us from a structural perspective. The Fed is doing a lot to juice risk-taking, but where that juice goes (whether it continues to flow to U.S. stocks) is unpredictable. Rational investors will protect themselves and hedge their portfolio's purchasing power risk in an environment where the government is trying to engineer social outcomes through financial markets.

Alan Greenspan and Ben Bernanke ran record monetary stimulus during their tenure and G.W. Bush ran the most expansive fiscal policy since at least LBJ. This, however, did not lead to permanent wealth creation for most people or desired long-term outcomes in financial markets. We are getting even more stimulus now.

During the 2000s, at the time of record stimulus, U.S. real income and living standards declined because there was a massive transfer of wealth to foreigners and the income and wealth that did remain in the U.S. became exceedingly concentrated. While people at the top of the Wall Street food chain levered up their organizations to accumulate vacation homes, private jets and Renoirs, the average American levered up consumption via credit and home equity withdrawals. We all know how that ended.

Now we have the media, pundits and economists regurgitating the same platitudes that were routinely put out before the crisis: *The government data and ISM surveys show that people don't understand how well the economy is doing. Stocks are undervalued. The stock market is forecasting an economic boom. We are having a jobless recovery.*

Yes, the economy has improved, but it has improved because of record government and Fed intervention. Income remains stagnant even though transfer payments and food stamp usage have soared. The U.S. is having another party on credit, but this time the party is on the U.S.'s credit card and the Fed balance sheet instead of foreign savings. Another difference is that consumers are now tapped out. Instead of using their homes as ATMs to support unearned consumption, consumers now employ strategic mortgage defaults so they can continue to consume above their means. This and abundant tax rebates and refunds have produced a good bounce in retail sales.

Also, we can't forget that the past quarter is the easiest economic growth comparison since the thirties because the 1<sup>st</sup> quarter of 2009 was the nadir of the crisis. And the next quarter is forecast to be the peak of economic activity this year. State sales taxes remain soft even though retail sales look strong. Economists try to ignore this and the weakness in withheld income taxes.

March's withheld income taxes jumped about \$8.5B y/y, but probably mostly on Wall Street bonuses.

There is even more concentration of wealth than what occurred during the great stock bubble of 1999 and the real estate mania of several years ago. In the middle '00s, the top 25 hedge fund managers averaged \$450 million of income per year. In 2009, the top 25 hedge fund managers averaged \$1 billion in remuneration, and the *Harvard Business Review* says U.S. CEOs now make 300 times an average employee. In 1978 it was 35:1. We don't believe this is a bullish situation for an economy that is driven 70% by consumption.

It is indeed a relief that the worst appears to be over in financial markets, but we now have to deal with the fallout of the government trying to game outcomes. Just because we've had a strong rebound from the bottom doesn't mean it isn't still a very tricky environment. What that environment will look like is difficult to project. What we *do* know is that we are still getting a privatization of gains and socialization of losses that we saw in the original response to the 2008 crisis.

As former Federal Reserve Bank of St. Louis President William Poole recently observed, central banks played favorites when providing aid as part of efforts to stem the financial crisis. "The Fed," he noted, "did not provide assistance to all on an equal basis but tilted the playing field. Why should the Fed have had a program to buy commercial paper from large corporations and no program to help small businesses starved for funds?" The Fed's program to purchase \$1.25 trillion in mortgage-backed securities issued by government-sponsored enterprises probably contributed to the demise of the market for *non-government* mortgage-backed securities and will, Poole claims, "complicate monetary policy in the years ahead...Much more research is necessary to determine whether the Fed made the right choices; clearly, I have my doubts." Poole was president of the St. Louis Fed from 1998 until retiring from the post in March 2008, the month that Bear Stearns collapsed. Poole expressed concern about "an appalling lack of economic literacy in Congress" and said that neither the House nor Senate versions of legislation to overhaul financial regulation address the most important shortcomings. Banks, he feels, should be required to hold more long-term bonds, and tax deductions for interest should be eliminated.

In terms of strategy, we still believe that caution is in order in a very uncertain time in financial markets. It may be that the S&P will continue to rally as global investors assess various workout plans within the EU and as pension managers throw caution to the wind in an effort to restore solvency to their highly stressed pension plans. We cannot know this for sure. One thing that we are fairly certain of is that it would be imprudent to wholeheartedly chase S&P returns because there are so many reasons to be skeptical that the current rally will persist over the long-term.

Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that any specific investment will be suitable for an existing or prospective client's investment portfolio. Therefore, no existing or prospective client should assume that future performance of any specific investment or investment strategy (including the investments or investment strategies recommended herein) will be profitable or equal any historical performance levels. Certain portions of our newsletter may contain discussions of recommendations as of a specific prior date. Due to various factors, including changing market conditions, such discussions may no longer be reflective of current positions or recommendations. Information included herein should not be construed as the receipt of, or a substitute for, personalized individual advice. A copy of our current written disclosure statement discussing our business operations, services, and fees is available upon written request.