

August 2009: The Rally Continues...

The market rally that began in early March resumed its upward path in July – with U.S. equities now having rebounded 50% since the lows earlier this year. In our opinion, this market move is largely a result of liquidity returning to the market and a resumption of risk appetite. The general mindset has shifted from “a fear of losing money” to “a fear of missing out on a big rally.” Cash interest rates hovering near 0% have contributed to the upswing as no one wants to hold onto cash, a depreciating asset – and there is a momentum factor at play. The fundamental picture, however, is a bit cloudier given anemic lending activity, rising fiscal deficits and the government’s ongoing involvement in the financial markets.

In the month of July, earnings reports came in significantly better than what was expected. In fact, “positive surprises” outnumbered “negative surprises” by a wide margin, and some companies gave more upbeat forecasts than anticipated. The 2nd quarter GDP report released Friday was also rosier than the consensus and may signal that the economy has already bottomed.

News in the housing sector has improved as well. The Case-Shiller Index is indicating a clear slowdown of price declines, and housing inventory has been reduced from 11 months to 9 months (nationally). These both suggest that the housing market has begun the process of clearing itself. Moreover, the Housing Affordability Index hit *all-time* highs earlier this year (the higher the index, the more affordable house prices are relative to income).

The collapse of residential real estate prices was the driving force of the banking crisis and recession – but excessive leverage was the root cause. Many institutions are still hamstrung by deteriorating collateral values and have either been reluctant (or unable) to make new loans. Obviously, any signs of housing market stabilization are indeed great news because a stable real-estate market is necessary to end the credit crunch. In addition, given current interest rates, a bank’s ability to borrow at virtually zero and re-lend funds north of 5% will surely help. With such healthy net interest margins, it should not take long to restore health to balance sheets, especially when asset values are going up.

All in all, indicators seem to suggest the economic contraction may be ending and rising asset prices confirm this. We have no idea how much higher asset prices will go, but the cyclical bull market in global equities should continue. We have not lost sight of the fact, however, that even with the recent rally the S&P500 is still down by more than 35% from its all time highs in 2007 – and that we are back to levels that are consistent with a recession. We also remain concerned about the rise of populism and continued government intervention in the U.S. and therefore are not unmitigated bulls.

One example of rising populism is the CFTC’s (Commodity Futures Trading Commission) recent blaming of “speculators” for the run-up in oil prices last year to \$147/bbl and their promises to solve the problem by imposing position limits, and various other tweaks, on certain intermediaries involved in oil futures. To initiate new regulation to try to engineer lower prices is completely misguided

because the *problem* is that oil prices are beyond *any* regulator control – except for perhaps the geological regulator (scarcity) and the amount of paper currency floating around the world.

Why weren't regulators outraged when oil moved from \$147/bbl to \$33/bbl last fall if they are anti-speculation? A lot of people also lost money from being on the wrong side of the down-move. "Speculators" like the Harvard Endowment and the California Public Employees Retirement System were heavily involved in owning oil futures (through intermediaries) and their constituents (pensioners and future students) took big markdowns on their portfolio as a result of the decline. The managers merely wanted to hedge their portfolios against the effect of future higher energy prices that had occurred because of a very real supply/demand imbalance.

A common argument is that society only benefits when oil prices move down, but it depends on which society and which players you're talking about. Higher energy prices greatly benefit Canada and Mexico because energy production is a large part of their economies. On the flip side, declining oil prices nearly bankrupted United Airlines last fall because it hedged its forward purchases at oil prices in the triple digits at a time of declining load factors.

Ironically, the State of California has recently been making noise about resuming off-shore drilling as a way to work out of its effective insolvency. Should we now be rooting for higher oil prices to save the Golden State from itself?

The fact is that investors/speculators play an essential role in futures markets by providing liquidity and price discovery to hedgers. Also, speculators mostly confine themselves to front-month contracts and not out-month contracts (more than 6 months) on the futures curve. What this means is that oil prices along the curve are a function of market perceptions of supply/demand fundamentals at future delivery dates. For example, oil priced for delivery in 2010 is trading at \$78 or more than 10% above the spot price, so hard-money hedgers (like airlines and shippers) are buying out in the future because they're concerned about being solvent when the economy recovers. Curtailing position limits won't do *a thing* with respect to keeping prices down – doing so merely plays well in the media because it misdirects public outcry away from a politically unpopular reality of tight global supplies.

We believe policies should be designed to address the true sources of economic headwinds (e.g., too much leverage, limited oil supplies, too much tort cost in the economy, a lack of transparency in financial markets, etc.) instead of the symptoms, and that the U.S. will face significant challenges until this occurs. Remember, however, that we don't just seek opportunities in the U.S. markets and that certain investments can be profitable even in challenging times. As investment managers we need to identify and understand the issues facing the U.S. *and* the world; our focus is to design portfolios that capitalize on opportunities around the world and to account for very real risks – as opposed to hoping that they will go away.

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