

### **March 2010: CNBC Often Misses the Boat**

When watching the financial news, e.g., CNBC, one quickly notices that the vast majority of reporting is skewed toward what might happen over the next few weeks. By contrast, very little reporting covers long-term investment theses. As short-term impulses are driven overwhelmingly by liquidity and emotions, they are interesting to know about...but very little money is made on chasing stuff in such short timeframes as no one can predict liquidity movement or emotional reactions with prescience sufficient to enable consistent excess returns. Over the longer-term, fundamentals are the big return drivers and therefore deserve more coverage and should be a critical component of portfolio construction.

Obermeyer Asset Management has expended much ink on the long-term factors and rationale for the investment portfolios and strategy that we continue to recommend for clients. It cannot be understated what a powerful enticement the Fed's policy of holding rates at zero is for investors to take on risk. It virtually forces cash into riskier assets – at a minimum back into corporate and agency bonds (whose spreads reached record levels during the credit crisis), but liquidity also flows into stocks as well. Momentum then develops as risk-taking demonstrates rewards, inducing more and more investors to jump in.

At the moment, U.S. stocks and commodities have enjoyed a cyclical bull market courtesy of Fed-induced liquidity. Additionally, with the much-publicized problems in the Eurozone, liquidity has flowed out of European stocks, bonds, and the Euro and is making its way into U.S. and Asian markets, equities, fixed income, currencies, and commodities. The results have been generally constructive for U.S. financial markets and provided an environment of low volatility for the last month or so. On the surface, it may appear that risk has waned, but beneath the surface big problems remain.

How long markets stay in this state is anyone's guess. If we *had* to guess, we estimate that relatively benign market conditions will persist through the 2<sup>nd</sup> quarter (absent any shocks or news that could derail liquidity flow). But if any bad news *does* surface or if economic activity begins to deteriorate anew, we would expect that it will merely prolong the zero rate environment and/or prompt another stimulus program.

What many may not consider is that risk exists precisely *because* of the liquidity and stimulus being injected into the economy by the Fed's holding short-term rates at zero, buying the majority of Treasury bonds being issued, and increasing the likelihood of much higher future tax rates. Risk results from the fact that the Fed can't control where all the artificial liquidity goes. The unintended consequence is that it may not go where politicians would like for it to go—namely into real estate and to finance U.S. companies.

The unintended consequence is that commodity prices (which have been underinvested for 30 years and will likely face increased demand given the hundreds of millions of new entrants to the middle class) could easily continue to run a lot higher, especially with the dollar-negative policies of the Federal government. This is a problem for the U.S. because overleveraged consumers can ill-afford a higher cost of living. Additionally, the only significant domestic resource production is in coal, natural gas and agriculture. If commodities do continue to move

higher, it will be great for those countries that conduct a huge amount of exporting ( e.g., Brazil, Canada, Mexico, Australia and the Middle East), but will likely mean much higher future interest rates here in the U.S. Furthermore, if liquidity and capital flows overseas, it will be used to fund our foreign competitors who are making rapid productivity gains, developing their internal markets and social backstops– both of which could negatively affect the jobs picture in the U.S.

Despite the U.S. government’s well-intentioned programs to help prop up the lower and middle classes (at the expense of future taxpayers), any stimulus plan will pale in comparison to the stimulus that was provided by the 65% decline in crude oil – and hence gasoline – prices after the credit squeeze began in 2008. Before the crisis, crude oil expenditures were running about \$1 trillion per annum, but as oil and gas prices came down expenditures decreased to below \$500 billion per annum. This was the real stimulus.

At present, there is a lot of hype in the financial press that because there is so much stored crude oil, prices *have* to go down. Yet this assumption is flawed as crude oil in storage reflects the shape of the futures curve and the cost of storage – not necessarily an oversupplied market that is bearish for prices. It is more relevant to look at longer-dated crude future prices (e.g., 1 year) which are influenced by supply/demand fundamentals; these continue to be bullish.

We continue to be of the view that because of excessive consumption in the U.S. over the last 25 years, the exploding deficit response may stabilize economic activity in the near term, but will only prolong an inevitable and necessary re-balance of an economy oriented towards consumption. Combined with a declining demographic trend (the first baby boomer hit 65 this year), financial markets will continue to be tricky in the longer run until the excessive levels of debt are worked off, either by inflation, or by a long Japanese-style slog. Unfortunately, the safety of cash and bonds may yield the worst results *in real terms* over time and prudent risk taking will be necessary to keep up.

We don’t recommend adding aggressively to general equity exposure at this point because of the crosscurrents we’re talking about here. There will likely not be the kind of sustained global recovery that the stock market broad indices are telling us, without producing terrific pressure on the scarcity aspects of commodities.

As we’ve stated before, the purpose of an investment portfolio is to provide an ability to keep or improve one’s standard of living. It cannot do so without some moments that really test the investor’s patience and mettle because asset prices depend on liquidity in the short-run– and liquidity is fickle. But in the *long-run*, an understanding of the big picture and how political incentives will create unintended consequences will help protect investors from poor outcomes. Because of this, patience will be a key attribute for success.

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