
All Skate

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This commentary is to address the equity market situation, and I know, I know, we're probably early. Sometimes we issue reports after having taken actions in the portfolios, and sometimes we issue reports prior to taking action...a sort of mental preparation or roadmap for you. We would not want to be accused of attempting to "call a bottom" here, as a number of attempts have been made by others:

The October 10 Art Hogan Bottom around 7700
The October 17 Warren Buffett Bottom around 8700
The February 3-13 Charles Nenner Bottom around 7900
The March 3 Doug Kass Bottom around 6800

Rather, this is to suggest a buy zone is being reached which offers interesting upside potential with downside risks that are no longer unusual for equity investments. We have remained underweighted in equities for a reasonably lengthy period of time. Longer term issues still exist, but on an intermediate basis it is time to begin considering changing our tactic.

Concept

Significant cash holdings remain at the edge of the rink. It is now rare to read of upside projections or targets by stock market strategists, and it is now common to see downside targets, many in the 5000s. Those may be correct, but with the DJIA just above 6500, it is simply an 8-10% decline to drop into the upper 5000s. Not insignificant, but 8-10% declines are a normal risk anytime one invests in stocks, it simply comes with the territory. This past month we've spoken of the Great '8-9 Bust being in the 8th or 9th inning, it is now clearly the 9th inning in our view and the game could soon be changing. We've reached a point where it is now more reasonable for the normal investor at the side of the rink to venture back out onto the rink -- carefully at first, as there is always some risk of a fall when skating.

Why the change? It's no secret that the market is oversold, exhausted. Our views on the credit cycle have been discussed so much in recent years, you will be happy to learn that topic will be avoided in this commentary. We've also discussed the political elements of this decline. Anticipating higher taxes and a more negative business environment, the last 12 months have been a terrific time to rotate asset holdings. The political aspects of the past couple months have been somewhat different however.

The opportunities and excitement in the Democratic Party are valid. With control of the executive and legislative branches of federal government, it is understandable that the initial efforts to assist the economy would be painted with tangent political objectives. However, investors remain free to vote, and the prospects for employers in so many industries are believed to be even darker as a result of these tangent objectives, and are quickly reflected in equity values. These initial efforts to “never waste a good crisis” may instead be followed by more on-target economic objectives, and some resurfacing of Paul Volcker, Lawrence Summers, and Treasury deputies for an over-worked Geithner. The Obama teleprompter will become less of a pulpit and more of a voice to help both employee and employer. Certainly a more centrist approach, which ultimately proved so successful for Clinton, would be helpful. I’m told one architect of that eventual Clinton posture, Dick Morris, actually suggested in a book written and published in the first half of 2008 that as the odds of Obama’s election increased, the faster the markets would drop, with sharp declines around the time of the election. Not bad, and certainly within our theme that there are some political elements involved in the ’08-9 trends. In any event, we do anticipate that government actions will be interpreted in a friendlier fashion than was the case thus far this year.

The new Term Asset-Backed Securities Loan Facility (TALF) should have a significant intermediate-term benefit to the non-bank lending sector, and while fiscal stimulus plans may have questionable long-term affects, the short-term impact can in fact be positive as well. These are good things for an incredibly oversold market moving into the summer of ’09. Capital spending may not increase dramatically, but some rebound in consumer spending patterns is expected this summer.

The concept of “All Skate” stems from two perspectives. So many “normal investors” are largely on the sideline, watching the nation’s equity values being priced by professional short-term traders who remain in the rink. Our suggestion is to announce over the speaker that we’ve reached a zone where some of those on the sidelines may want to carefully venture back out.

There is a second perspective however. It’s not unlikely that, at some point in this rebound process, a large supply of sideline cash may provide a mini-rush back into stocks. As scary as the current situation is, in the back of some minds is the thought that when this market starts to turn around, they’re going to be presented with the buy of a lifetime. Imagine buying stocks in 1932. Should a rebound seem to be gaining momentum and demonstrating some staying power, the thought that the buying opportunity of a lifetime may be missed could provide a different perspective on “All Skate.”

Context

Our comments in this report will not be unexpected to you. We’ve anticipated a more significant bottom developing in this timeframe in client conversations and in fact, the January 21 report.

In the January 21 commentary, we suggested there was a high probability that the market would take out the November bottom of 7500 and move to new lows. Now, at 6500, we see 5-15% downside and 25-40% upside in virtually every sector of the market.

Interestingly, because this Great ‘8-9 Bust has been so sharp, rebounds of 25-40% or more can take place while remaining in the context of a continuing sloppy economic environment that might extend for many quarters. In our October 24 report, we suggested that the then forthcoming bottom and rebound would be for short-term trades only. Now however, equity values and investor sentiment are so washed out that a more significant rebound is a clear possibility.

If we may be so bold to attempt a more specific expectation of how this might play out... we do not think all stocks are going to bottom out and rebound at the same time obviously. We think some stocks are bottoming now, this week. Other sectors may not bottom for a number of weeks out, and indeed the same may be true for the overall market averages. However, we do think that from here, the nature

of the declines will be less focused, more diffuse, sloppier, and with a broader mix of crosscurrents of both negative and somewhat positive news. If so, this can lead to market rebounds that are a bit more significant than simply a sharp quick short-covering rally.

In any event, we don't intend to chase a rally. Our intent is to now accumulate certain stocks in this weakness. Some clients have expressed great concern for committing any additional capital into the equity markets. We understand that, and will be respectful of your concerns, and particularly within the context of your objectives and tolerance for risk as each portfolio is tailored, bespoke.

Taxes

We've answered a number of questions about taxes recently. This is a separate topic, although certainly somewhat relevant to the current environment. Our thoughts tend to correlate taxes with prices, inflation, and investment decisions. Monetary policy is certainly tied to inflation expectations, but fiscal tax policies probably play some minor roles as well. Tax increases tend to get incorporated into the cost structure of products, and thus may increase prices, regardless of the type of tax. Taxes on the wealthy employers and capital investment providers may thus have negative impacts on middle America employees and purchasers of business products and services.

Returns on capital are at the bottom of the income statement, after tax. Capital budgeting decisions, business investment by employers, are essentially determined by the projected returns on capital. That return on capital that a business requires to pursue an enterprise is determined by risk/reward behavior of human beings, not government.

Government can affect the costs however... taxes in all forms whether income taxes, excise taxes, fees, sales taxes and so on. To all costs, the required return on capital desired by the business entrepreneur is added, and the result is the price for the product, or through competition such might be a long-term equilibrium price. If the product is successful, the consumer pays the price.

So the end-product-consumer looks at the price and decides whether the product is worthwhile, and the production-resource-employer looks at the price minus the costs and decides whether the resulting return is worth the risk. Government taxes in all forms are in the middle, a cost, which either raises the price of successful products, or drives the resource-employer to end businesses which are now less beneficial to the shareholders. The key is that taxes and government costs are going higher, at all levels. At state and local levels, the same is true, and the deficits of some states and municipalities may even continue to mushroom to the point that odd combinations or consolidations are discussed for efficiency purposes.

"All Skate" may not mean that one rushes out to buy the stock market on March 10th, but we've entered an interesting zone. We encourage your questions and thoughts and always look forward to our individual discussions with you.

-Brian

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