
Thick or Thin?

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Thick or thin? Trick or treat? It's the wrong time of year for this idiomatic phrase, but though we accept the equity market rebound this spring as a treat, one must now consider whether it is just a trick.

Stock Markets

In the March 9th report titled "All Skate" we said we did not want to be accused of attempting to call a bottom. I'd like to take that back now if I may do so with a smile. In any event, having reached a buy zone which offered interesting upside potential, it was an appropriate time to change tactics. We noted that we saw 25-40% upside in virtually every sector of the market. We've also mentioned, in past reports and meetings, the idea that this spring/summer rally in the DJIA could extend into the 9,000-10,000 range.

With the market now up 35-43% from the March 9 lows depending on the index used, and within conversational reach of DJIA 9000 or 1000 for the S&P500 (stretching a little early here), we sense at these levels it is now timely to more strongly question whether the ice we will be skating on this summer is thick or thin.

First, to quickly revisit the premise for "All Skate":

Change is here, and more changes are coming. This was known, discounted over time, and the foundation for a market bottom was formed from that psychological depression within the community of capital providers and business employers. One metric or manifestation of that psychology was the hugely significant balance of cash holdings that remained at the edge of the skating rink, unwilling to venture out. Our premise was that we had reached a point of exhaustion, and a level of price valuation relative to normalized earnings power, from which rational investors could begin to again venture back into risky assets, as is now reflected in this subsequent 40% rally. As a further comment at that time, we suggested "*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.*" So while the initial premise has been fulfilled in this 40% rally, perhaps largely from professional investors, it's not clear that the second rush from the general public has occurred.

And it's not clear that a second rush will occur, though it's an important part of now assessing whether we are skating on thin ice. While only a conjecture on our part, based on experience it would be no

surprise if a market drop were to occur first, sandwiched between this first psychological rebound and a future mini-rush back into stocks by the general public later this summer. If so, again based on experience, that would typically correlate with more generally improving economic statistics and so we make a few comments on the course of economic statistics this summer.

First, as noted previously:

Market economies weave any number of cycles, both short and long. The “normal” business cycle rotating every few years between periods of good economic growth and recession is essentially an earnings and sales/inventory cycle which is income statement oriented. There may be a longer term cycle as well, however, defined by the inclination and capacity to take on debt and extend credit -- which is balance sheet oriented. Income statement cycles are shorter in term, are based on cyclical interruptions in demand, and have the capacity to cause inflation during the upcycle. Balance sheet cycles are longer in term, derive from the general propensity to finance and supply economic infrastructure, and have the capacity to cause deflation during any downcycle.

With a cyclical rebound in sentiment, and unprecedented global government actions of both monetary and fiscal stimulus, some short-term improvement in economic metrics would be logical (regardless of the longer term ramifications and unintended consequences). A mild consumer bounce back is occurring as one facet of aggregate economic demand, but it will be moderated by a newfound propensity to save and more conservative spending patterns. On the supply side, much of the declines in GDP are a result of slashing inventories, which often rebound quickly. In this instance however, don't expect companies to finance an accumulation of inventory without hard orders anytime soon. Not happening. Rebounds in shipping, significant inventory replenishment, and business capital investment are for future news stories. In this battle, supply will wait on consumers until it can see the whites of their eyes.

Still, the evidence suggests that the rate-of-change bottom of the immediate sales/inventory economic cycle is behind us. We felt there was some evidence of this in February which factored into our thinking in the March 9th commentary. As this plays out, there will be normal short-term business cycle reasons for the public to join this little stock market party and it will likely be late in the game.

If and when that happens, expect a commentary from us revisiting why the September 19th report was titled Phase Three and not Strike Three. The quick answer is that a long drawn-out period will be required to rehabilitate balance sheets sufficiently to support a lasting recovery in real dollar terms. US government officials will stop at nothing to fight this longer balance sheet/credit cycle – there is no cost too high because the stakes are perceived to be so high. Declining demands for credit, and supply of credit, overwhelm the currently large monetary stimulus and have a deflationary influence ... but the virus of inflation is lying in wait. We've thought that gold and currencies would give us another buying opportunity prior to that virus more fully taking hold, though the strength of that argument gets questioned on some days. A further virus is developing with a federally-controlled banking and credit industry, health care industry, insurance industry, auto industry, and much increased regulatory requirements in most segments of the US economy. These factors are more likely to reduce the price you would pay for a business enterprise than increase the valuation.

Stepping back for a broader multi-year international view – most of the global equity markets we review have maintained high correlations throughout the Great '08-9 Bust, however there are some real indications that this pattern will change. The economic fundamentals and market technical pictures for Europe and the Americas (excluding Brazil) are such that one must keep open the possibility of another assault to bear market lows over the next couple years. We can get into the specific details of our work in person, but the analysis leads in a different direction however for Taiwan, India, Australia, and – with less conviction – for China, Singapore, Hong Kong, Japan. Taiwan, and increasingly India and Australia as well, should provide relative strength over a multi-year period. Investments in Taiwan did not fare better than the U.S. last year, but we are comfortable with this developing theme.

In sum, we will admit to being more uncertain now about the status of the equity markets. We try to be resolute in our updates to you and avoid a watered-down innocuous letter dated each month or quarter. Still, there are a few statements we can make with comfort:

We've had a nice spring rally in stocks but the going will get rougher from here with deeper pullbacks expected. It is now easier to take profits on purchases made in March and April, and more difficult to acquire new holdings at the moment. A larger portion of the cash reserves available to the general public will be used as a personal finance safety net in the future, but sufficient reserves exist to finance another summer rally, albeit perhaps beginning from lower levels. The environment for specific foreign economies appears brighter than in the US and Europe. There are viruses lurking. The ice is not thick.

Bond Markets

To the extent that money market reserves held in portfolios were intended for investment in stocks, we made investments in recent months to take advantage of the recent stock market rally. To the extent that such money market reserves were intended for investment in bonds, we've moved slowly thinking that interest rates on high-quality securities could rise and this is happening. This effort was complicated by the premise that credit spreads could narrow somewhat at the same time, and this is happening. We have been able to hit some sweet spots however, and are very focused on acquiring interest-bearing securities at opportune times. You may see some results of this in your May and forthcoming June statements.

We've had fun discussing from time to time an "end-of-decade bubble" phenomena... the Nifty Fifty large-cap stocks in 1969, precious metals in 1979, Japan in 1989, Nasdaq technology stocks in 1999-2000. Perhaps 2009 does not line up quite as nicely thus far, but a number of markets set extreme price points in recent quarters and this is true of US Treasury securities. Thus far, the actual high point of valuations for US Treasury securities occurred in December 2008 and represented a poor time to purchase quality income securities, especially securities of long duration. Interest rates have improved somewhat since then, and securities of moderate duration acquired today are at least more attractive than was true earlier in the year I suppose. There remains a lot of money on the sidelines which will be eager to commit to any increases in "secure" interest rates. Still, yields on Treasury securities have been so low, it's worthwhile to treat them as an end-of-decade bubble and proceed with caution. The longer the maturity, the truer that statement probably is.

Most portfolios are focused on tax-free bonds with separate dynamics, and going forward perhaps more global government securities, and it's been easier to make reasonable investments there.

In terms of lower credit quality securities of corporations, the implications of subordinating the senior debt of auto industry bond holders to the interests of labor unions is something which, subject to the judicial branch, we'd like to comment upon at a later date. If they did this to an auto company, what might they do if it was an oil company or pharmaceutical provider? Capitalism relies on enforceable trust, property rights, contract law, and a prerequisite understanding of capital structure rights and responsibilities whether funding a promising business or reorganizing a failing business. This is another area of change which should influence our valuation of assets.

We've had good results in the portfolios,
and remain focused on managing your holdings through thick and thin...

-Brian

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