

Happy Money

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Some of the best investment ideas often grow from a puzzle of rather fragile judgments.

When they work, the fragility of those judgments strengthens over time; and in the case of very high returns, from one extreme to the other.

...from one extreme to the other?

The conditions of early March have largely reversed. At that time, sentiment towards U.S. equities was extraordinarily lopsided and uniformly bearish, for good reasons, yet valuations had reached intriguing levels. Amongst consumer metrics there were selective signs of stabilization already in December and January, by late February a number of leading economic indicators were declining at a moderating rate, and Asia was demonstrating relative strength free of the political concerns in the United States.

Today, the relaxed sentiment is comfortably bullish, Asia recently demonstrated relative weakness in comparison to the U.S. market, and a healthy blend of economic indicators have now moved from ice cold to something closer to room temperature. Very little is hot, and these mixed fundamentals are unlikely to get hot even if "cash for clunkers" is followed by goodies for go-karts, dinero for dishwashers, and happy monies for health insurance.

We described a "spring/summer rally" in a number of client commentaries and website postings this year. I do think we've seen something of an "All Skate" moment with a building of confidence and sideline cash moving back into the market. I'm not entirely convinced we've yet seen a culmination of that movement, but certainly the summer is ending on our spring/summer rally and in some respects we've moved from one extreme to the other.

...happily inspired by the uninspiring?

This exciting March-(September?) stock market rally, perhaps the strongest in 70 or 80 years, is accompanied by uninspiring or mixed economic news. It's been said that the recession has ended, often by the same people who didn't see it coming in the first place.

Well, sometimes the bounce depends on how high you were when you dropped the ball. We had a pretty big drop, the bounce in the stock market seems to be correlated, and perhaps the same will be true for some economic measurements. Still, this rally may be ending just about the time that more positive short-term economic news is announced.

In this cycle GDP increases may lag somewhat until depleted inventories beg to be replenished. We referred to this in the June report -- that new supply would wait on consumers until it can see the whites of their eyes. The stock market dropped after that June report, a decline of about 900 points sandwiched between the first psychological rebound of March-May and the sharp rally of July-August. Investors are just so thankful that total financial annihilation was avoided, extreme happiness is expressed even when unexceptional economic news is announced. For now, we are grateful and inspired by even the uninspiring.

So now that we are here, where do we go?

...where to from here?

We stand in the middle of one colossal science project.

Can governments always sufficiently manipulate economies to counterbalance business cycles and control swings in economic activity? Our thesis of recent years was that the current cycle was debt-driven and as much a function of the balance sheet as opposed to a typical sales/inventory income statement cycle. Further, the size of the mountain that needs to be moved is overwhelming...all discussed at length and we will not repeat it here. The science project question: Is it possible that a force as large as the U.S. government itself may have met a counterforce or burden too large to fight with traditional stimulus measures and stabilization efforts, and/or have met that burden at a time when such counteractions make that cure as bad as the disease?

In effect, we are throwing more happy money on top of happy money to spend ourselves back into prosperity when the size of the problem, and the nature of the cycle, are materially different from most other economic cycles. We've gone from Happy Meals to Big Macs, and some people weren't even sure the Happy Meals were healthy for us.

If not, then despite the anticipated and current deflation, there are real questions about whether longer-term US growth will comfortably exceed long-run US inflation. As mentioned earlier in the year, this hurdle may seem easier for countries such as Australia, Taiwan, Brazil, India, and others.

These are difficult questions. The number of pertinent variables has exploded beyond our desire to document here the number of scenarios we've studied. If interested in further comment, we look forward to full discussions about this with you, but I want to summarize here our best tactical thesis, and we are addressing only US equities at this time.

We believe odds favor sharper drops in stock prices as early as this next week and extending over a timeframe roughly corresponding with the Congressional sessions of September 8-October 30. We are prepared to consider a subsequent year-end rally, possibly to new recovery highs, again depending on the nature of the sell-off. Markets tend to tip their hand prior to significant moves, and the next decline or 5%+ correction in US equities will tell us much about its health and stamina.

This tactical path is then softened or hardened according to the longer-term investment strategy being pursued in your portfolio and -- considering the almost unprecedented volatility of the last two years -- our tactical thoughts will remain flexible and subject to active adjustments. Performance data through July is now available as well, and we look forward to reviewing those results with you.

-Brian

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