

# Questions

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The DJIA closed at 10,390 on the date of our previous commentary January 21. On Friday it closed at 10,380 yet much has happened in the past 100 days. We felt we had reached critical levels. While the market has been almost 600 points lower, it has also been some 900 points higher, and back again.

The large drop in the afternoon of Thursday May 6 is understandably a concern. Our first response that afternoon was, like everyone, to craft some technical noneconomic explanation for such a "mysterious plunge." There are important questions about what happened that afternoon, and some answers will be developed, but the market has been declining since late last month for legitimate reasons. Indeed, anyone reading our report from January 21 will know that the money some investors lost recently is money we weren't sure they were going to earn in the first place!

As these comments are written, the market is rallying this morning on news that the European Union has had to take extraordinary actions to avert a growing crisis of confidence in sovereign government debts. With all this volatility, perhaps the timing is right to reconsider some previous comments and outlook... though this time with a twist. We'd like to think our discussions typically provide some specific plans or the occasional lucky answer. Today we offer questions.

## **Actions or Words**

We start with what will seem an odd detour, an odd question. Do investors, collectively, react to news? Or do investors – people – create the news and reporters then react to craft the headlines? It's an interesting question, but what's the point? I am reminded of a quote attributed to Eleanor Roosevelt: *"Great minds discuss ideas; Average minds discuss events; Small minds discuss people."*

If one might draw a tangent from that, if actions are more important than words, then in analyzing markets an understanding of the base thoughts and ideas is timelier than witnessing the actions, let alone reading the headlines. If so, market movements today are often based on headlines which will be crafted in the future rather than headlines we read today.

This may seem obvious, but somewhere in this is the explanation of why the financial markets can be so frustrating or mysterious to people, and result in some fairly humorous attempts at explaining why the market is rising or falling. In our experience it's a primary reason people say "I don't understand the stock market," or point fingers in the wrong direction in presuming cause and effect.

In the same way, are the actions more revealing than the well-chosen words of a company executive or an elected government official? Which analysis might provide more insight, or be most timely today?

Thoughts and ideas, actions and events, or words and people?

It's a difficult perspective to maintain. We are careful with headlines and news media. Even today.

## **Perception or Reality**

A second odd question: Which is more powerful, perception or reality?

In matters of investment finance, it's actually a good question. Some of you will recall that we had a somewhat unusual view of the collapse of Enron 8 or 9 years ago. Enron had become a trading firm. It is now a fundamental tenet that the impatient and greedy executives at Enron designed a ploy or scheme for purposes unique to that company, including mysterious off-balance sheet partnerships. Indeed, the company's financial reports were a black box making it virtually impossible to determine the full nature and quality of the reported earnings.

May I suggest that such a reality applies to many companies with often healthy valuations and quite satisfied shareholders? You may be able to think of a few right now. However, if for any reason the perception develops that the customers run a risk of doing business with a trading firm, game over. Does the risk need to be real, or is it sufficient that the risk simply be widely proposed? Call it a crisis of confidence, call it reputational risk, call it counterparty risk, such a firm can go under whether it be from rumor, media frenzy, or fact (particularly if the balance sheet is supported by financings of short terms). On the other hand, for such firms that enjoy their reputation and the confidence of their counterparties, the music continues to play.

Former CEO Jimmy Cayne of Bear Stearns claims their collapse in 2008 was caused by mysterious rumors in the marketplace and a self-fulfilling prophecy. In the face of questions about quality, liquid assets can become illiquid. Once it became poisonous to do business with Bear, the game was over.

Because so often in investment finance the reality of an evolving situation can be a mystery, might it be perception or reality which often defines valuation? I have another question. Can this crisis of confidence only apply to companies?

## **Mysterious Plunge or Developing Fears**

With that preface, we comment on the May 6 "mysterious plunge."

Truly, if large sellers had to specify minimum acceptable prices in limit orders rather than use market orders, some of the odd price moves in individual stocks would not have occurred. Congress will spend considerable time debating that tree. Very little would have changed in the forest.

Substantially all of the trading that day was real, not mysterious, and the market was already trending lower before again briefly hitting the February lows on Thursday afternoon.

- Ignore the most volatile 30 minutes of that afternoon if you like, one perception is that procedures in the algorithms for electronic trading were to blame.
- Former headlines on troubled debt levels of sovereign governments lacking an independent currency, such as Greece, can be ignored if you like, with the news today of a solution!?
- One might ignore a perception that the United Kingdom represents as large a sovereign debt threat to global markets as one would ever fear to address, and indeed a fear to address that problem was painfully evident in these ill-defined campaigns of would-be prime ministers.
- One should not ignore the dominant perception that percentage changes in many economic statistics and earnings metrics look impressive compared to prior depressed levels of activity. Would the neglected reality of how those earnings and economic statistics look over a multiyear period lead to a different conclusion? As noted before, there are real questions about sustainability and trend. Such comparisons become even more difficult later this year.
- The expected hostility toward capital markets firms led to some very interesting shareholder letters penned by Goldman's Blankfein and JPMorgan's Dimon since our last report. The populist perceptions and anger may manifest itself in some equally interesting regulations in the 2010 Financial Reform legislation. Is there any fear that Congress will get this right?

That list could be longer. There will be a lot of words spoken and written about the mysterious plunge, but regardless of the answers developed, many serious questions will remain.

## **Strong or Weak Macroeconomics**

The economic rebounds measured against the lows of a year ago are very constructive. Still, whether analyzing underemployment in the United States or social instabilities in Europe, fiscal spending in major economies or commercial real estate in the US, the size and scale of the economic challenges remain significant.

For some of these reasons, you know that a dominant part of our outlook in recent months has been for a strong US dollar relative to many currencies, and in particular for the euro to be weak to the point that basic questions about this EU currency experiment would surface. This had become a fantastic and important trend change since the 4<sup>th</sup> quarter of 2009, very dramatic, and may now have even moved too much and too quickly without some sort of correction or pause in the process. There is some evidence of that today, though we still expect further strength in the dollar and further weakness in the euro despite today's news. When some significant pause in this trend looks likely, we can try to provide some update through the Whiteboard section of the Web site.

The market is rallying nicely this morning, after this weekend's announcement by the European Union and IMF to support unstable euro zone countries with new loans. Still, we expect the market to remain nervous. This is the TARP program for the EU, as our "phase three" process of the credit cycle continues. Can a debt problem be solved with more debt?

The stock rally of March 2010 was also a bit reminiscent of the September 2007 rally. I can provide you with additional detail on that, but it would not be accurate to say we are thinking on the same scale now. Too many questions. We do not think the outlook for the market is as easy to answer now as it was then. We are not particularly bullish, nor wildly bearish, but it will be volatile and the defensive attitude we've endorsed for 2010 seems appropriate. Again, some domestic industries in the market continue to look good, and certain Asian markets also look promising over an intermediate term.

One of the similarities between now and the summer of 2007 is the market valuation of high yield bonds. Just as sentiment toward the stock market had become uniformly bullish this year, the difference in yields between high yield "junk" bonds and stronger investment grade bonds became very narrow by April. It's a naturally cyclic process, has moved from one extreme to the other, and you may not be surprised we expect these credit spreads to widen again as the year progresses – to the detriment of high yield junk bonds. If wrong, we will have been too conservative with your fixed income investments, and will accept that criticism.

## **Conclusion**

We think today there are relevant questions about perception and sentiment vs. reality, relevant questions about the actions vs. words of decision makers, relevant questions about the stunning and unbelievable mysteries of a volatile market (tongue partly in cheek), and relevant questions about the macroeconomic picture.

We don't always have the answers. Maybe sometimes it's just as helpful to know the right questions, and we can debate some possibilities in our conversations.

I will say in terms of tactics, we are not prepared to anticipate or rely upon anything more than the sloppy outlook described in our January 21 comments. Until we get some more answers.

-Brian

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