

# Breaking Point

Seven Giants

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Our stock market outlook for 2010 has been described in some client meetings this year as being Grumpy, Dopey, Happy, Sneezzy, Choppy, Sloppy, and Down. This is our third commentary of the year. The first was written with the Dow Jones Industrial Average at 10,390 on January 21, the second was written in May with the index at 10,380, and as we began working on this report yesterday the index closed at that same level of 10,378. If not Bashful and Sleepy, we've certainly had Choppy and Sloppy, and our concern is growing that we may have Down.

It's a scenario we've been prepared for. Part of our concern with second quarter earnings and economic stats was based on the statistical quirk of comparisons against the horrible metrics during the first half of 2009. This was noted in the June 3<sup>rd</sup> Whiteboard posted on the website. The market did rally in July with the release of second quarter earnings reports. Our May report cautioned against acting upon headline news, and indeed we feel one's conclusion about the economic picture changes the deeper one analyzes recent reports.

There are reasons to think this July rally may turn out to have been a fairy tale. We've mentioned a number of factors previously, and will add a few more today. In any event, for many months the stock market has acted as if it is waiting for some catalyst to catapult it in one direction or another. We've had to get past Q2 earnings reports, but there is evidence that *Breaking Point* has arrived.

It was not that many months ago when investors were trying to evaluate how the economy would respond to a slow reversal of the government stimulus and Federal Reserve support provided in late 2008 and 2009. This perspective has now shifted to an acknowledgement that the Federal Reserve must continue to extend its balance sheet to support the economy.

Such realization that economic progress or even sustainability still truly remains dependent upon unprecedented government support may break us out of a fairy tale into a starker reality. However, it also leads us down a path of beginning to wonder ... Is money enough? These are bullets we've fired before. We've experienced quantitative easing by the Federal Reserve, we've issued debt to pay for pet stimulus projects, our government has funded acquisitions of key entities; we've used up a lot of money!

Is this going to require something more powerful than money?

...and what is more powerful than money?

Trust. Confidence. Security. The word *credit* itself is derived from the Latin word *credere*...to believe, confide or entrust.

In commenting quickly on seven critical issues that just won't go away, we note that these are not dwarfs, they are giants.

1. Political trust continues to deteriorate with respect to confidence in Congress and government leaders at the federal and even state and municipal levels. There is a polarizing confusion with respect to such basic policy decisions as to increase or reduce taxes, to cut or increase government spending, or to centralize or decentralize functions. Some of this polarization is partisan politics, and some is the result of focusing on a different timeframe. In this environment, a short-term cyclical focus can lead to quite different answers than addressing long-term structural policy questions. This unfortunately leads to an increased risk that policy mistakes will be made. Questions of the credibility of spoken words relative to actions also produce further uncertainty in both the public and private sector.
2. Business trust continues to deteriorate. It has impacts on a variety of fronts, from brand loyalty to political pressure and regulatory burdens. These trends are representative of the mood of the country, and even globally. It contributes to an eggshell environment not beneficial to long-term decisions of strategy, employment, major capital budgeting, and prospective investment.
3. Income security is increasingly uncertain for an ever growing segment of the population with continuing unemployment and underemployment. Wage and employment issues act like a force of gravity or friction on virtually every other measure of the consumer economy. This trend is persistently eroding confidence in an economic recovery.
4. Consumer credit continues to decline. This is unusual, and in terms of degree is unique to my knowledge in modern history. Consumer credit peaked in 2008 as discussed at the time, and has continued to decline steadily for two years. It is in some respects a measure of long term rather than short term consumer confidence. This tsunami of a credit cycle impacts perhaps two-thirds of the US economy and is the metric illustrating a reluctance to acquire homes, appliances, autos, and so on. The demand for credit is price elastic in normal times (lower rates encourage borrowing) but the demand for credit is price inelastic in this cycle (lower rates are not encouraging borrowing but are reducing the income of many investors). This harms the effectiveness of some Federal Reserve policies. Confidence is more important than price.
5. An analysis of today's economy requires greater understanding of the longer term secular or structural sustainability vs. the shorter term cyclical swings of inventory or productivity. We may elaborate on this with a Whiteboard posting later this month, but it is a perspective which seems to explain much of what is being reported from companies and governments. The longer term secular cycle correlates with the credit cycle, consumer demand, employment decisions, and top line revenue and sales. The shorter term cycle correlates with swings in inventory levels, productivity, cost-cutting, and quarterly earnings among other things. Overlaying those two perspectives is important to understanding this complicated environment.
6. The removal of credit from the system because of new found conservatism on the part of consumers, companies, and in some corners of the earth, governments, can be deflationary. We see no evidence that this cycle of credit liquidation is changing on a secular basis. Yes, there are cyclical pockets of inflation...unique supply/demand circumstances with a particular commodity, health care costs, tax costs will be rising, and our Gulf seafood! We've commented many times in recent quarters that the "inflation" picture is complex, divergent, and unlike past cycles. If it happens, outright deflation is an incredible complication to economic policy decisions and demands unique and talented responses from our policy leaders...a risk.
7. Interestingly, in view of such challenges to public trust, security, and social confidence, the majority of buy-side investors and sell-side strategists have remained bullish. That posture has not been rewarded thus far in 2010. It is a delicate balance which is vulnerable to a catalyst.

This choppy balance between Grumpy and Dopey has reached a point that is, in our eyes, ready to break out. Our bias is to the downside. One hopes that it will be to the upside, though this would appear to require policy decisions that seem unlikely at this point.

This leads to a difficult question – which asset class is most attractive... who is the fairest one of all? Should one invest in commodity asset inflation plays, or bonds as a continuing deflation play, or stocks for yield plus presumed growth?

Bonds have generally outperformed stocks this year. Despite the periodic concerns about inflation risks and low interest rates, our position has been that high-quality intermediate tax-free bonds would maintain value. This year, we could have been positioned with longer maturities as well, rather than just intermediate...but clearly such securities have nicely outperformed the equity markets in 2010.

Too boring? Perhaps, though returns this year have compared quite favorably with the benchmarks in most all portfolios. As a further comment on the fixed income securities, our perspective is that the “high-quality” is important. We continue to expect credit spreads to widen to the detriment of lower quality bonds.

Our interest in stocks has waned considerably from a year ago. The most frequent question we are asked now is “if the market drops further this year, how low do you think it might go?” Generally we’ve declined to attempt an answer. There is no “app” for that, but if the market were to break down convincingly to new lows, an interesting pattern would be left on the charts of U.S. stock indices. We are no experts on charting, but a number of people have pointed to a possible head and shoulders formation in 2010. If so, the first shoulder would have timed with our January report *Critical Point*, the second shoulder would correlate with this report *Breaking Point*, with the May report of *Questions* near the head. There remain a lot of questions in our head! ...but a market technician would say that such a pattern on the charts could easily lead to a drop below 9000 on the DJIA. That’s too much of a speculation for me at the moment.

There are reasonable arguments, based on historical measures of valuation, that stocks are relatively attractive. However, it’s possible that the bigger hurdles in front of us today have more to do with mood and perception and confidence and trust, rather than historical valuation measures or the power of money. We touched on some of those issues in our May comments and these issues seem even stronger to us now.

We’ve commented this year as to a *Critical Point*, and now as to a possible *Breaking Point*. Yields on bonds are low, so it is easy to envision a future *point* (at presumably lower prices for stocks) where the question of “who is the fairest one of all?” becomes much easier to answer. That answer will be stocks; we just don’t think we are yet at that *point*.

Having said all of that, the more important analysis is whether your individual portfolio is well designed and performing to your expectations, and on this question we will always ask for your continual feedback.

-Brian

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