

## Mistake Out

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Two unrelated things happened in 1955. One was the birth of the future co-founder of the company that would develop the Microsoft Word software which I'm using to type this. Second, an innovative structure was being built in downtown Dallas by the Texas Bank & Trust Company.

It was an elaborate drive-in motor bank and parking garage that would be the first "autobank" in the country, providing drive-thru convenience for banking transactions on several floors of the facility. The bank's Chairman was Mr. W.W. Overton, Jr. and amidst all the activities of the time it is understandable that not much attention was focused on the doings of his executive secretary, Ms. Bette Nesmith.

Bette was quite the typist, but there was no "delete key" on her typewriter, there was no Microsoft Word. In fact, this was about two and a half years before Jack Kilby (one of the more interesting men I've had the pleasure to work with) would invent the microchip that led to the development of such things.

Instead, Bette was working on an electric typewriter, and the electric part was considered quite an improvement except for one little problem. The ribbons on those new electric typewriters made typing errors more difficult to erase with a normal eraser.

Bette was an enterprising woman. By 1955 she had developed on her own a mixture of quick-dry tempera paint and other ingredients that gave us the ability to apply a thin cover layer over blemishes and typing errors. By the time that fancy motorbank was finished, Bette was beginning to sell her product to others with the help of son Michael. She soon formed her own company, and another American success story was launched.

Bette's business flourished, her son Michael became a guitarist for *The Monkees* with hits like *I'm a Believer*, and she later sold her business to Gillette... a product we all know as Liquid Paper.

People loved it, a great product that made business presentations and letters look clean, pristine, and professional long before Microsoft Word. By the way, her original name for the product was ***Mistake Out***.

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## **U.S. Economic Policy**

Desperate measures have been pursued to stabilize the economy, combat credit deflation, and reverse the deleveraging phase of this credit cycle. Short term interest rates are close to zero, and efforts have been made to reduce long term rates through a monetary policy process we all know as “quantitative easing”. Nothing new here.

We’ve referred to this stimulus, both fiscal and monetary, as Happy Money in past commentaries. I wish we’d previously thought of the term Liquid Paper, or better yet, Mistake Out.

It is an effort to delay or counter the effects of deleveraging and newfound austerity from so many consumers and businesses. Government entities have borrowed and effectively printed money in a grand attempt to paper over or delay the economic impact of reduced buying power from our workforce. It’s not entirely different from the banking industry’s “extend and pretend” practice of modifying their loans on distressed real estate properties. Perhaps the phrase “extend and hope” might be fairer.<sup>1</sup>

I think we had also previously referred to this as one colossal science project. In terms of QE, the US practiced this from 1932 to 1936, and Japan tried similar measures 20 years ago ... unsuccessfully I might add. It is the policy equivalent of Bette’s Liquid Paper, designed to make things look better and hide the mistakes. Mistake Out.

We’ve stated before that the core problems in the economy are not cash management or liquidity issues. Instead, there is good evidence of core secular challenges related first, to the ongoing structural unemployment in the US, leading secondly to the spectacular build up of credit and the deflationary impact of this subsequent deleveraging. We’ve spoken at length about this second theme, the credit cycle, because of its direct influence on financial markets. It might be interesting to share more conversation about the first influence, but separately perhaps, as it does not relate to our immediate task of investing quite as directly.<sup>2</sup>

As our Congress struggles to address the root problems, a case can be made that the wrong government entity is by default having to fight this economic battle. The primary branches of government appear unfocused to the core problems, so Dr. Bernanke continues to be our lone warrior. His weapons are geared to liquidity and rate issues however, at a time when liquid paper is not our primary need. There is plenty of money available; we mentioned the “liquidity trap” in our last commentary.

The culmination or peaking of the QE policy is set to occur this next month. Some say interest rates will now start to rise. However, we conclude the general strategy of continuing to paper over problems and maintain very low real interest rates is here to stay. Perhaps not a consensus view.

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## **Interest Rates and Investment Cashflow**

So, I’m wondering, if the economy is not benefitting in a robust way from lower interest rates, and employers (and thus prospective employees) are not benefitting in a robust way from lower interest rates, and the growing segment of our population that is retired and living off a lifetime of savings is not benefitting from lower interest rates.... who is?

If I owed someone a lot of money, I’d sure like the interest rate to stay as low as possible. If one thinks the federal deficit looks bad now, we don’t want to consider the consequences if interest rates were to rise dramatically. One might even try to finance a large part of the operation with the cheapest and shortest term paper, and just continue rolling it over with new issuances to cover the previous ones. Frankly, maintaining nominal interest rates below the rate of nominal GDP growth is a very likely path from a government faced with this situation.

The Federal Reserve exerts control on the short end of the yield curve, and so long as that is the case, there are some reasonable academic arguments that the slope of the yield curve can

increase only so much. In other words, there's probably a limit to how high Treasury rates can go, even in longer maturities, so long as short rates remain close to zero. (That's another concept which probably deserves a separate conversation.) So, if our expectations for unexciting GDP growth continue, and short-term rates remain well below that rate, and there is some reasonable limit on the steepness of the yield curve, then we may be faced with a more prolonged period of low interest rates on quality paper.

Now, a retired person of some means, and living in part or whole on the interest income cashflow being generated from their portfolio, is probably thinking the past few years have played out a little different than they were expecting. These low interest rates have had a serious negative impact on the spending and economic health of so many investors.

As beneficial as this may be to the world's largest debtor, the benefit is at the expense of a great many retired people and savers. In effect, this very low level of interest rates has acted as a huge "tax" on a large segment of our population, and yes, that in itself has an impact on economic activity. It is a transfer of wealth from conservative savers to an undisciplined government.

This led to a hobby which has surpassed baseball as "America's pastime" called... the hunt for yield. It's a fun game only if you are easily entertained or increasingly frustrated by the cashflow from your savings. Often the game is demonstrated by the willingness of retired people to trade in stocks to collect a dividend or quick pop, and then jump out of the position to move on. It doesn't take much to beat the rate on a bank certificate of deposit, so individuals who had always viewed themselves as conservative long term investors now rank as short term traders and speculators with the best of them. This can work, until it doesn't.

If this is true of retired investors, it's true of the professionals, and the low cost of capital can at times raise some near term level of speculation in commodity, currency, real property, and equity markets. These efforts to inflate asset values, collateral – as discussed on other pages, are deliberate (keeping in mind that this is a short-term effect, not long term). But real estate is tainted, commodities and currencies are best left to the professionals, and this leads us to the stock market.

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## **Business Equity Values**

Most analysts seem united that the stock market has benefitted from lower interest rates, from QE, from increased speculative interest, and the decline in the dollar. I suppose that is true, more liquidity seems to have moved into the capital markets than capital equipment. Lower costs of capital on Wall Street have not produced the expected improvements in Main Street lending and activity. In many cases it's a question of collateral because asset deflation or drops in real property values stop that flow of credit, and it's one of the reasons our Federal Reserve endeavors to produce some asset inflation.

Much of this was discussed in our last commentary, and we felt it was time for the burden, of maintaining an uptrend, to shift from Wall Street traders to Main Street employers. We felt at the end of January it was time to see meaningful improvements in economic and employment metrics, and in lieu of such improvements, wondered if "February 2011 (was) a time to be careful to avoid mistakes or a time to 'go for it'?"

The economy does not seem to have materially improved this year, though it certainly still could. Since February, the market has experienced deeper pullbacks and a less consistent pattern, yet we have not made any serious effort to raise cash or reduce exposure to stocks just yet. That position is, as you know, always subject to decisive change.

Over that time period, our attempts to purchase during weakness have included Terra Nitrogen, Abbott Labs, Intel, Bristol Myers, Singapore, Brazil, and others; in some cases adding to positions but always in context of your individual asset array. The health care sector seemed primed for a

rebound, we still like the long term story of the stronger nations and growing economies, and agriculture still strikes us as an attractive industry generally. So, we continue to find some individual companies that appear attractive.

Now, with respect to Asia, China, and the opportunities there, that is a theme and we think the needle still points north there. Some of the structural issues we touch upon in the second footnote to this piece ... those are issues which China will be facing in many respects, and there could be some real challenges along the way. While we think those problems are not forefront issues at the moment, it requires a watchful eye. We were accurate in our assessments of those issues in the US market a few years back, but China is not in our backyard.

In terms of the technical condition of the market, some of the signs we look for at completion of a trend are not yet present, and indeed some of our indicators argue strongly for another move up this summer. I know in some circles technical analysis is a tool that is frowned upon. Our view on that is if a market moves from point A to point B, the fundamental economics may dictate where point B is, but technical and behavioral conditions likely determine how the market will first travel and when it will arrive.

The structure of the uptrend in many sectors (not all) remains unbroken in spite of recent declines. While the technical picture of the stock market argues for another move up this summer, our top-down macro picture does not necessarily agree, but we continue our nervous participation for now. There is a real argument in this environment for positioning one's assets with the most competitive and conservatively financed corporations, particularly if able to demonstrate some sustainable pricing power. I'm not talking about the next quarter. Companies operating with more leverage or cyclical margins require a much stronger story to justify an investment.

Acknowledging a bias to the upside in the near term, as the year progresses this climate leads us in the direction of cashflow, in the direction of dividends, towards value stocks more so than growth stocks, towards quality balance sheets, and towards the boring.

Again, our view is of a growing disconnect between the trends on Wall Street and the trends on Main Street. Four years ago in the summer of 2007, we saw a similar situation develop and authored a report titled "Something Will Happen." Something did.

So the near term prospects are one thing, but we will be very alert to see how this progresses into 2012.

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## Currency

We would not be surprised if the U.S. dollar has bottomed for the year, although a quick reversal is unlikely. A more labored backing and filling type of price action is more likely, but the trend in the dollar appears to be changing as we head into the last half of the year.

The frequent notion that the US currency will continue to spiral lower as a result of irresponsible U.S. fiscal and monetary policy is colorful and powerful. It may even be accurate. However, our view is tempered by the perspective that currency values are simply expressions of ratios between instruments of exchange, and over time the advantages accruing to major country ABC become disadvantages to major country XYZ. Perhaps we believe too much in the power of cycles, but market forces tend to react and then counteract these imbalances. We've observed with respect to currencies that these swings can take much longer to develop, but nonetheless a weak currency in the US translates to a very strong currency in Brazil or Japan or Europe and forces build to counteract these swings.

Specifically, the European Union looks worse than the United States, and the currencies involved don't get much bigger than this. Consider a European sovereign debt crisis, or a Japanese sovereign debt crisis for that matter. Consider some positions against the dollar being reversed

based on their belief of the impact of QE ending. Consider a break of commodity inflation in the emerging markets and subsequent reversal of the carry trade against the US dollar. And considering some things down the road I'd rather not mention right now, a move away from risk and back into the US dollar is not some far-fetched idea.

If investors are not positioned for a rising US dollar, they should be neutral with respect to the dollar, and traders might be better served to look for opportunities to go long.

Still, we do for now offset that view with some residual attraction to a selection of assets or countries which counter the core problems facing the US...certain Asian economies, Brazil, select energy assets as a store of value, Canada, and so on, always subject to constant review. For now, we simply have a more balanced view with respect to currency.

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## Commodities

The formation of this firm, and slight career shift, in 2002 was based on several factors. One investment consideration was our belief in a thematic change that would be best capitalized upon as an independent. Those themes were based on

- a prospective weakening of the US dollar after many years of strength through 2001,
- prospective strengthening of energy prices after a decade of weak / steady prices,
- and a climate where raw materials as an asset class could outperform financial assets.

In past years we tended to comment more frequently on the various commodity markets, although that can be challenging since these commentaries are written on an irregular basis. We do not operate a hedge fund or commodity pool, but perform private research and activity in the commodity markets, and frankly have loved analyzing the commodities before even having a drivers' license. I suppose that last comment should embarrass me. In any event, the two most interesting themes of the past decade have been the dramatic unfolding of a generational credit cycle, and the historic explosion of bull markets in so many of the major commodity markets.

I say that...to say this.

I've seen much conversation about the impact of QE on consumer inflation, or the impact of grain prices or grocery meats or cotton or oil prices. I do not find a material correlation, and I know that is a controversial comment.

Importantly, I don't disagree that QE ignited some speculation in certain commodity markets, but in terms of direction we've felt that each of these cyclical commodity moves are well explained by fundamental supply and demand factors unique to each of the markets. In other words, our analysis of the trend in those markets has been based on the supply/demand picture without regard for QE. Now one could argue about amplitudes, and I might lose that argument, but not direction.

Back to the comment on consumer inflation, we continue to be impressed with the high price elasticity of demand for consumer products. Companies raising prices to pass through commodity price increases in an effort to fully maintain margins are facing this issue we believe. It's a question of how much of the increase in commodity prices can be passed through to consumers, and it's a question of how much longer some of these cyclical increases in commodity prices can last.

Because of the deflationary impacts of deleveraging from the credit cycle, and we commented on this earlier in the year, Bernanke "has been in a position to flood the economy with incredible levels of liquidity while smiling at the loud fears of inflation for over two years." So one can imagine how thrilled he's been to see floods here, droughts there, and China everywhere. (Having said that, we keep in mind that some degree of asset inflation – inflation for debt collateral - is not all bad from their perspective.)

Increasingly it appears that many of the major commodity markets have peaked or will soon do so. We still have a friendly bias towards energy. Natural gas looks nervous in the near term but should have good prospects over coming years. And while we've not run out of oil, we've run out of cheap oil. It's an industry that remains worthy of selective investment.

A number of the prior bull markets have peaked and those markets will be declining this year, cocoa, sugar, cotton – although we have a bit firmer view of cotton than the others. Coffee has been a developing bull market which we have liked for several years now. Coffee prices have rallied so much over the past few months, that some backing and filling or consolidation on the price charts would be understandable over coming weeks...but this long term bull market remains intact in our view and would not be surprised to see yet higher prices by year-end.

In each of these cases, the bull markets and subsequent bear markets have been tied to fundamental supply/demand issues unique to those markets. We still look for one more nice rally out of the grains this summer. Beyond that, it becomes a bit easier to envision a falling back of prices and consolidation in the grain markets, though we still view the agriculture sector as a strong industry to be involved with. Fat cattle prices look to have peaked for the year unless we get a stock market rally that cattle decide to participate in, though we see the market tighter for feeders, and we've stated our view on corn.

Again, I mention commodity prices because of the presumed influence these prices are having on inflation around the world, the impact that has on the financial markets and currencies, and the observation that the next 12 months is likely to look quite different than the last 12 months. That's important.

One more observation about where we are in the commodity market cycles, you can't help but wonder if Glencore's initial public offering won't in retrospect be seen as another indication of a top. Glencore is the world's largest commodities trading company, based in Switzerland with production facilities around the world, and has always been a rather secretive and privately held firm. Following a historic explosion of bull markets in so many of the major commodity markets, this event, selling part of the company to the public, has smelled "top" to me from the moment it was announced.

A long commentary. By summary, we are rather bearish towards European stock markets, willing to give the US stock market some time to determine if the uptrend can continue, and likewise for Brazil and certain Asian markets. We don't see magnificent increases in interest rates any time soon, though we hope to see at least some near term rise this summer.

We are newly bearish on the euro, balanced towards the dollar, bearish towards the base metals and most of the soft commodities, while select commodities are positioned for a final rally this summer. And we have great confidence that US policy steps will continue to resemble Bette's Liquid Paper.

I don't know whether these tactical thoughts are important however, because a truer measure of investment activity, or any business strategy, is gauged from how one performs when the original plans don't pan out quite as expected. Good sports teams excel at both offense and defense. It's possible to actually win the game even if all those great pro-active ideas on offense aren't working as well as hoped, but only if the defensive plan and actions are working. If only playing offense, you'll lose, yet anyone listening just to our tactical thoughts would think we are only focused on playing offense.

Equity performance figures appear to be off to a good start again this year, we will post aggregate updates to the website soon.

As always, comments and questions are appreciated.

-Brian

<sup>1</sup> As an aside, our interpretation of FASB ASU 2011-2 is that more real estate loans will get written down than extended, and the classification of TDRs, troubled debt restructurings, will grow particularly in commercial realty sectors. Frankly, to be credible the entirety of FASB rulemaking with respect to TDRs needs to be reworked. In any event, with a perception that the economy has stabilized, there may be political tendencies to begin treating bank TDR accounting with greater scrutiny. FYI, these FASB standards and SEC reviews could correlate to increased reporting issues by certain banks in the 3<sup>rd</sup> and 4<sup>th</sup> quarters of 2011. How helpful has it been to our economy for some to live or operate rent-free, and over what timeframe does this change... I can't say. The advantage for one group is a disadvantage for the other.

<sup>2</sup> It can be argued that the US has experienced core economic challenges related to labor policy, education, and structural unemployment on a secular basis. Some level of cyclical unemployment related to normal recessions and industry cycles is a given. However, when you really lean back and think about it, there has been a developing structural challenge to employment in the US for many years. The economic recovery following 2001-2002 did not produce a great recovery in employment, and I suspect there was a large growing element of "underemployment." (The employment challenges in 2009-2012 dwarf the 2002-2008 experience, so this is a secular problem which continues to develop. I actually think the roots of this issue extend back to the 1990s, but this conversation is beyond our purpose here and better left for another discussion.) So, I think it's possible to step back in time and suggest that income challenges and underemployment provided the psychology necessary for the final innings of the credit cycle. The stratification of employable talents and resulting incomes initiated some of the behavior with respect to credit, and ultimately was also responsible for the income challenges and defaults. My children might say, so in other words, many people who did not have great jobs wanted to live like the people who did have great jobs, so they borrowed the money and then couldn't pay it back? Yeah. Did some people make quick money loaning out credit, or gain political influence by encouraging it, without having to worry too much about whether it was paid back? Yeah. Should the amount of credit in an economic system be reasonably related to the income production in that system, and do interest rates serve to balance and allocate the demand and supply of credit? Time to return to page 2.

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