

Macro

September 3, 2011

Brian W. Rahlfs, CFA

This is our third commentary of 2011. Our first anticipated a timeframe when it could be wiser to play the market as a “Loser’s Game” rather than a “Winner’s Game” and further noted that the burden of any continued uptrend was shifting from Wall Street to Main Street.

Then at the end of May a primary theme was, despite an end to QE2 in June, we expected U.S. policy to continue to “liquid paper” over our problems and that “very low real interest rates (were) here to stay.” On August 9 the Federal Reserve released an almost unprecedented statement that exceptionally low short-term interest rates would be maintained for at least the next two years. (Coincidentally, a bulk of the U.S. federal debt rolls over and must be refinanced during this same timeframe.)

One connecting issue, which we mentioned, between those two reports is the rare issue of what is sometimes termed a “liquidity trap.” In our conversations, the liquidity trap is a predicament where lowering interest rates or increasing liquidity does not meaningfully stimulate business activity. Sound familiar? Rather than boosting employment or capital equipment, participants increase savings. In our eyes, this ineffectiveness of monetary policy is most likely to occur during the deleveraging phase of a credit cycle, something we’ve been talking about for much too long now...but the reason is simple. If one is trying to reduce one’s debts, or the effect of a reduction in credit on aggregate demand overwhelms any increase in liquidity, then participants are not going to take out a new loan regardless of the interest rate. Their objective is to remain solvent, to be conservative, to increase savings rather than borrowings, and to expand business only when top-line sales growth will truly justify it – to not make mistakes in a Loser’s Game. One borrows money when greed and confidence exceed fear or ambiguity...and then, and only then, based on the interest rate cost of the money. The ineffectiveness of monetary policy on Main Street, as opposed to Wall Street, is symptomatic of the deleveraging phase of a credit cycle.

It has taken some time for this to play out, but there were valid reasons to think that the rally during the latter months of 2010 might turn out to be a fairy tale, and the giant issues mentioned in the commentaries of a year ago remain present factors arguing for a most challenging environment as we move into 2012. Main Street has not yet taken the baton from Wall Street, and as Wall Street loses patience, the timeframe over which these risks are recognized and re-priced can accelerate.

There are some other facets of this we'd like to outline this weekend.

Investment strategists, and the processes of a management firm, tend to specialize according to style. Some call themselves "value" investors, comfortable buying companies down on their luck with stock prices ignored or beaten to presumably cheap levels, anticipating some nice reversion back to the mean. Others focus on companies demonstrating strong earnings growth, anticipating the strong to get stronger. I'm certain the permutations or combinations of metrics and factors used to analyze the stock market will forever amaze me, yet somewhere there is humor that given 64 ways to analyze a market, the market can only move 2 ways, up or down.

Some basic philosophy of any investment process is unavoidable and extends to the most mechanical or purely technical trading systems. Does one buy on weakness, or does one sell? Buy on strength, or sell into strength?

Investment strategists may also differ according to whether they employ "top-down" models or "bottoms-up" models. In a top-down approach, one analyzes the overall macroeconomic factors in the world determining the impacts on the various economies, markets, and industries in an effort to identify reasonable investments. With a bottoms-up approach, one essentially analyzes the microeconomic factors impacting specific companies and industries with less regard for any efforts to anticipate the macro picture.

This is important at the moment because the two approaches are in many ways at odds today, and in some respects it largely defines the current investment debate.

We read the comments of many analysts and strategists, and the most frequent perspective of those who are bullish on the stock market is a bottoms-up approach. The price-to-earnings ratios and efficiency of individual companies appear attractive in isolation, and as usual I've see many beautiful earnings projections from industry analysts -- the suggestion being to buy on weakness.

The perspective of a top-down macroeconomic strategist might be different as one can imagine, with the suggestion being to sell into any strength. In the question of whether to pay more attention to microeconomics or macroeconomics at the moment, we have felt the macroeconomic factors are so significant, so consequential, that our preference is for **macro**.

Our second use of the term **macro** this weekend relates to our long-running discussion of the credit cycle. In some respects, there is an argument for conversation purposes to think of the initial phases of the deleveraging in 2007 to have been a rolling over of a microeconomic credit cycle...relating to the individual balance sheets of consumers and companies in terms of their credit cards, mortgages, other debt loads, and newfound comfort and affection for cash balances. That process has not yet played out, and you know that we consider it a secular deflationary influence on the prices of high-ticket items typically financed with credit.

Debts continue to build almost exponentially with respect to certain governments however, we know who we're talking about, and the arguments between fiscal stimulus vs. fiscal austerity, liberal spending vs. tea-party spending limits, are on a crescendo around the world. If for conversational purposes we refer to this as a macroeconomic credit cycle, then we've discussed in a number of client meetings a fairly obvious factor. Many of us have been able to avoid or even benefit from the microeconomic credit cycle by positioning ourselves to avoid balance sheet problems and own the right type of assets. However, the potential ramifications of an unwinding macroeconomic credit cycle are larger, more far-reaching, tend to impact all participants, and are more difficult to isolate oneself from.

I believe it possible that this will occupy more of our prospective conversations.

Our final thought on **macros** is in terms of computer science and the use of quicker automated sequences used to execute program instructions. It seems appropriate to nod one's head in the direction of the computers as the bulk of common stock trading these days appears to be by and between the computers!

Despite a bearish perspective approaching 2012, we were hoping for a bit more strength in the U.S. stock market rally from mid-June to mid-July. The subsequent breakdown in late July into early August was almost historic in terms of the uniform across-the-board sharpness and I will admit it had an almost indiscriminant computerized feel to it. We'll not dispute the idea that the U.S. stock market is joining the European indices in rolling over with concerns to the macroeconomic picture, but the character of that decline is quite interesting and we treat it as an indication of future possibilities. A market analyst needs to be equally observant of the historical and the contemporary.

We end with some specific comments on individual markets. Because of the apropos differences between individual portfolios, I rarely mention specific stocks, but for some reason did so in May. Terra Nitrogen (TNH), Abbott Labs (ABT), and Bristol Myers (BMY) have all outperformed the market in terms of price in addition to providing superior yield. Intel (INTC) has precisely matched the market's performance since then, but also provides a superior yield. We will not mention specific stocks now, but do have a specific outlook, if it matters, for the overall US stock market. That script would call for one more sharp downdraft over coming days to then be followed by a more comprehensive rebound and partial retracement of the July-September decline. How long and extensive that rebound might be is a prospective conversation, but are prepared to then anticipate further weakness into 2012.

We continue to be bearish towards the European stock markets, and yet are still willing to think of many Asian stock markets as being in a secular uptrend. This thought has been discussed for some time, and not always with success, but we do have more favorable **macro** views of locales such as Taiwan and Singapore and so on. In fact, this may be one of the starkest differences in our outlook for the various markets, that being the difference in our view of Europe vs. Asia.

The commodity markets are changing, noting in May that the following 12 months would be quite different than the preceding. This is a macro influence with real implications for investment. Though we have liked energy, we will not ignore the prospect of this comment being true in terms of oil and gas as well, and that represents some change in our thinking...to acknowledge the levels of economic activity.

As suggested, the grains have moved on to new highs in corn and soybeans, no doubt helping the advance in TNH, though we will remember that no stalk grows to the sky. Having discussed the prospect of the bull market in coffee prices continuing to new highs, that has not happened quite yet but it has certainly moved in that direction and it has been a fascinating market to track for several years now. It still seems a very real possibility that the highs in the fat cattle market have been seen for the year, though feeders did rally to a new high following our May 27 notes.

We remain bearish on the euro currency, most commodities, and have been quiet on gold. Our focus on gold has increasingly been on the global cast of characters involved rather than the economics. That may seem odd, but sometimes it is helpful to think of who owns an asset and why and how. In our view it takes a special tolerance to be involved in that physical market (though some gold stocks were added to some portfolios a bit earlier in the year).

Still, we've thought that the US dollar is bottoming, suggesting a "balanced" perspective on the dollar and that the bottom could take some time to develop. The dollar index has been moving sideways now for over four months, and frankly, if it's going to develop a trend to the upside, the time has arrived. The reasons behind that are the same as discussed in prior comments and conversations, but for investment purposes will just stick with a "balanced" view, as I smile...meaning we may well be wrong!

We've not scrutinized all of the performance data for August yet, but we are expecting a reasonably nice report in terms of year-to-date activity. We will update you in the manner you like, as well as the overall firm's performance on the website later in the month.

We'll look forward to a time when the most difficult task at hand is simply to analyze the microeconomics of an industry or valuation of an individual company. But there are times when the forest is more important than the trees, the tide is more important than the boat, and the macro picture overwhelms the micro. This remains one of those times in our view. We appreciate your feedback of questions, disagreement, or conversation.

-Brian

All rights reserved. User assumes entire risk of any use of this information and is advised against such use. Content represents partial insight into our current thinking relative to management of client holdings, and is subject to immediate and frequent change. The website version of this report is subject to disclaimer and notices found at www.RahifsCapital.com and may differ from custom versions of this report prepared for specific clients. It is possible this analyst or related entities may hold investments which like these opinions are subject to change without notice, with effort to avoid any conflict of interest. This is not an offer or solicitation to buy or sell. This report is a general update intended for the individual families and entities we work with, is not prepared for use by unknown users of unknown jurisdiction, and could not possibly represent custom or actionable advice on any matter.