

# The Alamo Moment

## A Line in the Sand

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This is our first update since the July 7 “Exit...Stage Left” which was timed against a backdrop of high valuation metrics in the U.S. stock market, peculiar global economic data, weakening corporate fundamentals, growing support of far wing views in global politics, and a technical stage for the stock market that was set for a peak.

We compared global investment decision-making at the time to a committee structure in which an organization can make the wrong decision, unanimously, while harboring separate individual doubts (the Abilene Paradox) – and the concern that this presumption of low interest rates and a low cost of capital was impacting every major economy on the planet. Any snap decisions in the opposite direction would create a terribly volatile situation.



This is an update of our graph and “wedge” from the July 7 report on the 5000 stock U.S. Wilshire Index. Our prior observations about rules-based trading, and that such wedge patterns are often “ending patterns and culminate in sharp retracements,” has seemingly played out.

But it leads to two important and prominent questions:

- Is the recent sharp decline in global equity prices over, or
- is this the start of something longer lasting and even more concerning.

Our attempts to answer those questions follow.

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## **Oil, Gold and the U.S. Dollar**

In our commentaries of May and September 2011 we noted that 2011 represented a change or inflection point towards downtrends in most commodities and an increasingly bullish posture towards the US dollar. Deflation. The CRB commodity index peaked in the first quarter of 2011 and, with just a few interruptions, has been in a steady decline ever since making new lows as this is written. Historic declines have occurred in copper, iron ore, cotton, precious metals, grains, and more recently oil/gas.

Not coincidentally as these commodity prices are quoted in dollars, the US Dollar also bottomed in 2011 (though there were some marginally lower levels in 2008), and while the progress was initially slow, the US Dollar truly came to life in 2014 and has continued higher through recent weeks. These two influences of weak commodity prices and a stronger dollar have been incredibly influential upon the financial markets, and economics of major global industries, over recent years.

Another inflection point, in the opposite direction, is quickly approaching in 2016. We have reached a point where an appreciating currency is clearly not in the best interest of the United States. The duration of the subsequent counter-trends will likely be shorter than the trends following 2011, but the significance will nonetheless be powerful in our view because of current sentiments.

*"The biggest investing errors come not from factors that are informational or analytical, but from those that are psychological." Howard Marks, Oaktree Capital Management*

The negative bearish sentiment towards crude oil is overwhelming, and ripe for a turn. The next couple of weeks might be a good time to fill up extra tanks of gasoline. Natural gas may have already bottomed on December 18, and while the bearish fundamentals for crude oil are well-known and seemingly compelling, our analysis is that crude oil, as priced in dollars, is bottoming. Our conversation for now is to expect a subsequent rebound into the mid-40s from the upper 20s currently.

Despite having been bullish on the dollar through 2015, we became more intrigued with the upside potential of gold. Gold, priced in dollars, did not decline as much in 2015 as most other commodities (nor did it decline as much as in previous years from the 2011 peak), but it has not yet appreciated in dollar value. The negative deflationary impacts on gold have continued to outweigh the growing positive impacts of global currency instabilities. Again, this is true only in dollar terms, gold has been an attractive holding in many other currencies. We are more bullish on gold for 2016, and lonely at that.

Our risk in all of this discussion is that we may be a bit early. We don't think the final top tick for the US Dollar has quite yet been reached, but we are convinced the ingredients are coming together quickly for a subsequent turn lower, and we think those factors will have profound impacts on certain commodities and segments of the financial markets in coming months. It is time to begin thinking differently about some of the trends that have been in place since 2011. These are not consensus thoughts.

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## **Interest Rates**

One of the better performing assets in 2015 was none other than the simple high-quality tax-free municipal bond. One of the worst performing assets in 2015 was none other than a low-quality corporate bond ... high-yield or junk bonds.

Avoiding one in favor of the other was beneficial. The expected widening of quality spreads has continued as previously discussed. Those expectations, and attempts to acquire quality securities at opportune times, have generally produced favorable comparisons in your fixed income portfolios over recent years. Having said that, the value of junk bonds have very roughly tracked the CRB commodity index since 2011, so with any commodity rebound one might envision some rebound in junk bonds, but we will remain committed to quality.

*"Most investors are primarily oriented toward return, how much they can make, and pay little attention to risk, how much they can lose." Seth Klarman, Baupost Group*

The graph on page 4 of our last commentary “Exit Stage Left” seems reasonably well-timed in retrospect, as income securities have performed much better than equity securities since then. We are comfortable with our asset allocation decisions. However, at this point with the performance pendulum having swung in favor of income securities largely due to recent drops in stocks, we have reached one of those decisive moments in time with respect to:

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## Stocks

Since our comments of May and September 2014, and July 2015, we proposed a case of high valuation in the U.S. stock market, which coupled with investor sentiment measures, was reminiscent of such periods as 2007, 2000, 1987, the late 60s, and so on.

Stocks just snapped in January, similar to last September, which seems consistent with our earlier thoughts. However, at this writing, it does feel like one of those Alamo moments, a moment in time where a line is drawn in the sand. If stocks can hold near these levels, the prospect of a sharp retracement rally is high. Sentiment is quite negative, stocks are very oversold, and a technical case for a near-term bottom in stocks is quite feasible. One supposes that if the market does not hold near these levels, this crash of sorts could continue, but it is just very surprising that a uniformity of bearish sentiment from many professionals and brokerage firms seems to have developed in an instant. Our short-term views of some inflection points in other markets contribute to why we think that something else may happen, and we also expect more consistent messaging from the Federal Reserve. In fact, despite remaining concerned about equity valuations longer term, if a meaningful rebound can develop from these levels we can be patient with blue chip stock holdings.

Corporate earnings for the S&P 500 are declining. Corporate revenues have been declining. Outside of the larger capitalization stocks, the average stock or smaller capitalization companies have been declining since the spring of last year. Many, many stocks have experienced bear markets already. The massive build in global debt remains troubling, so we tend towards “Quality” above all things. Balance sheets are important.

Dependent on individual considerations, we remain positioned with above average cash levels in most portfolios, we mentioned utility stocks in July, and our lonely early thoughts on gold are known.

Still, our sense of this market is that if we can hold near these levels, investors who are short US stocks, or have hedged, may want to remove some of that bet at this time. We may find support for US stocks very near these levels, with a welcome rebound in oil prices.

It's an interesting moment for crude oil and multinational stocks, and perhaps soon for the US dollar and many commodities. We look forward to elaborating on these thoughts in our individual meetings and conversations, but the drumbeats of the various markets have picked up considerably and we will expect to update our comments more frequently as well.

-Brian

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