

# Vertigo

## Teetering vs Tottering

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When I looked back at the cashier, I noticed she had a polite but worried look on her face. She glanced at us, and then the machine. It was a late night and my oldest son wanted some dessert after enjoying a nice family meal on our recent vacation to Vancouver. We found a McDonald's, stepped inside, and immediately noticed two odd touch screen stands positioned near the front door. We all gathered around the stand, confident this crew of semi-intelligent Rahlfs family members could figure out how to order John's chocolate shake from a kiosk. When successful, we all smiled and turned around towards the cashier with words like "cool" and "wow." (We are easily entertained.) Soon, John grabbed his shake and, as we all left the restaurant, turned to me and said "Did you see the look on the cashier's face?"

"Yeah, she was quiet – and she looked worried."

Technology and productivity lead to income inequality for some, more on that in a moment.

Our last commentary in mid-January was written at an alarming and volatile moment in the markets. The S&P 500 was declining sharply (down over 10% in 12 trading days), many stocks were in bear market downtrends, oil prices had plunged into the upper 20s, and the theme of deflation was apparent.

With tepid courage, we suggested for stocks that "the prospect of a sharp retracement rally is high...and a technical case for a near-term bottom in stocks is quite feasible." Although that bottom was retested in mid-February, stocks have managed to rally 10-12% since then, largely reversing the previous drop.

With greater courage, it was suggested that crude oil "is bottoming...expect a subsequent rebound into the mid-40s from the upper 20s currently" – and while that bottom was also retested in mid-February, we have seen over a 50% increase in a short time with oil above \$40 as this is written.

And with more stubbornness than courage, a view was reiterated to be "more bullish on gold for 2016, and lonely at that" than we were in 2015. Acknowledging that even broken clocks are eventually correct, the primary gold stock index has jumped 60% in that short time and gold is arguably the best performing asset class thus far in 2016.

Significant changes over just several weeks. With moves like that, despite feeling a bit dizzy at the moment, this appears to be a proper time to revisit those thoughts.

## **Oil**

The \$14 move from \$28 to \$42 was easier than another \$14 move from \$42 to \$56, and instead we are inclined to think oil prices again decline over coming weeks. A seesaw. The strong rally over the last several weeks has been more about technical market factors or short-covering than fundamental supply/demand changes or new buying. The core issues impacting the oil industry remain unsolved for now, and with the market having largely achieved our target range in the 40s, we think it could be vulnerable and particularly with any further questions about global economic growth.

## **Gold**

Typically when a long depressed commodity experiences a sharp rally off of an apparently meaningful bottom (in this case moving from \$1046 to \$1287), a significant countermove develops, and here it would suggest gold likely retraces back under \$1200. So, we may see some interruption in the recent sharp uptrend in gold prices, but there should still be at least one more rally in the next several months.

## **Stocks**

Our mid-January suggestion was that those with short or hedged positions “may want to remove some of that bet.” Now, with the reversal of the last 9 weeks, we view this as a more logical moment to revisit that strategy for those with long-short investment objectives. Prices above 2050 on the S&P or perhaps 17,600 on the DJIA provide that opportunity. For others with equity exposure, it is a time to be careful of increasing risk investments – the upside is simply not what it was in mid-January.

We have several thoughts in this regard. In the United States, current quarter economic growth is at a level that is within the standard error of GDP reports. In other words, the growth rate is within the size of typical future revisions to the data, meaning we could already be flirting with recession. Or not. What we know is that I don't know and you don't know. We do know many industries and countries continue to struggle with measurable recessions, and actual corporate earnings reflect this. Multi-quarter sequential declines in sales revenue and earnings reports continue in this environment.

So, the rally in stocks over the past few weeks is demonstrating weak participation, and economic data is seesawing from cool to lukewarm all over the globe. This environment quite simply limits the upside in our view. There are other factors and considerations, some long term, some short term, which may also limit the upside for now.

### *Both. Maybe*

One of the issues the financial markets must resolve is that the cost of capital (economic risk and return) is diverging from the cost of money (central bank/government planning). One easy measurement of this is in the high-yield/junk bond market. Several years ago we referred to this environment of aggressive monetary policy as a science project, an experiment. Well, sometimes the guinea pigs and the monkeys watch the scientists and get nervous. We felt in January that a move to more consistent messaging from the Federal Reserve would stabilize equity prices, but our opinion of that is changing based on some Fed Governor comments of the last few days. Nervousness is returning, and the value of the US Dollar could strengthen some. This is a slight change, as a weaker Dollar was a common thread in many of the views in our last commentary. So, it seems if stocks rally accompanied by any strength in an economic news release, then the Fed will speak of raising rates ... and if stocks weaken or an economic news release is lackluster, then the Fed will speak of maintaining low rates. Being data-dependent is ok, but confusion influences valuation. A confused mind either says no, or discounts an opinion of valuation.

The dizzy question is will central bank policies teeter or totter, and does this weaken valuation?

### *The Extremes*

We think politics may also increasingly influence valuation. How do political parties work together, or even cooperate with themselves today? Increasingly, they don't. We've mentioned the growth of extreme political views in prior comments, particularly in Europe. These trends help to identify the backdrop environment in which investments are valued. Societies frustrated with stagnant economic progress seek someone to blame. The splitting of the dominant political parties in the United States fit this social theme as well: constitutional protectionists,

social populists, isolationism, historic changes to political parties. Adjusting valuation metrics for regulation, tax, tariff and fiscal uncertainties is almost humorous after years of federal inactivity (which left central banks in charge of economic policy and monetary experimentation) – but some downward adjustment to P/E valuations seems prudent in 2016. Once such factors are known, earnings estimates are adjusted; when such factors are uncertain, P/E valuations are adjusted.

We now wonder: are more voters in the middle, or at the extremes?

Very Carefully

Somewhat related to this, we have spent a fair amount of time with a further question about valuing enterprises, about P/E ratios, in this decade as compared with previous periods. Valuing businesses for many multiples of current earnings is a function of interest rates, credit assessments, tax policies, growth potential, and so on ... but also the predictability or reliability or expected variance of such factors. Extending Moore's Law of escalating capabilities to technology, robotics, agriculture, medicine, communications – to so many industries – is stunning. How do we value businesses when the speed of technological advance is increasing at such a rate that entire business models can be impacted very quickly? Auto manufacturers, product distribution, media, taxis, distributed manufacturing, trucking, travel agencies, global delivery services ... and yes, fast food restaurant cashiers. Industry changes are not new, obviously, it is simply a management challenge, but there is some sense that the speed of such change is remarkably distinct and notable today. The drumbeat of technological change is accelerating. How does one make value judgments in this environment?

How do porcupines mate?

If our views from late 2014 through 2015 describe a market teetering towards a breakdown, the recent rebound has us back to tottering. The teeter-totter oscillation continues between prices above 17,500 on the DJIA to prices below 16,500 over the last 2+ years. The seesaw is back over 17,500. For now, we want to emphasize a limited upside ... longer term we have more concerns about the downside but will save that conversation for our meetings. So, we use the terms vertigo or tottering at the moment, and we will see if it is just a wobble, or a full stagger.

-Brian

This document was updated for accuracy and suggested clarifications on March 25,  
with minor information missing in the original posting.

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