Rockin' and Rollin' with Fonzie and Ponzi

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On the day of our Friday October 24 report titled "Get Ready," the DJIA closed at 8379. The index closed at 8176 the following Monday. Today, it closed at 8228. Knowing nothing more, one would assume that the past 3 months have been a most boring period of financial history.

Recent Market Moves

In fact, at the time of the October 24 report the stock market had just dropped 25% in a month and declined over 40% in the past 12 months. A boring stability was the last thing investors were expecting -- and truly, stability would not be an accurate description. Since then, the market has rocked and rolled with a high above 9600 in early November, a low of 7500 on November 20, and been above 9000 on several occasions in early December and early January.

What was the basis for the suggestion in October that the market could rebound? Some fundamental factors driving this stock market decline have been well-discussed in advance and included:

a.) a "strike one" realization that mortgages and credit quality were weaker than advertised;

b.) a "strike two" recognition that mortgage finance was a symptom to a deeper problem of overconsumption -- consumers struggling with debt and impacting the broader economy;

c.) a "phase three" loss of confidence in the broader levels of debt, derivatives, and counter-party risks at the most senior levels of commerce, banks and governments;

d.) all overlayed with a discounting in the valuation of business enterprises and sales of capital assets in the 2008 tax year in preparation for a more anti-corporate and negative tax environment.

The thought behind "Get Ready" was that this latter factor was being more fully discounted and recognized in October and would climax with the actual election amid probable single party control of both the executive administration and legislative branches of federal government. The resulting oversold market could then rebound with inflection from a deeply negative psychology. Our comment was that such a rebound must be treated as a rally within an ongoing bear market, and that any trades would be for tactical and small-cycle moves rather than strategic long-secular investments.

Current Prospects for US Stocks

While a very tense and powerful downtrend did end in November, and the market has rebounded somewhat in search of a more stable equilibrium, the rallies during this timeframe have not been very impressive. The character of the market in recent weeks suggests that these post-election efforts to snap back are largely behind us now. Some continued consolidation, or search for equilibrium, is possible in this 8000-9000 zone, but then, given the weak character of these rallies, one must assign a very high probability that the market will soon explore prices below 7500. From there, a more significant rally can take place.

The resulting picture is that more rockin' and rollin' are ahead of us. In fact, the swings in search of equilibrium in recent weeks (from 7500 to above 9000) are likely to be even wider (from lower than 7500 to much higher than 9000). Why might that be?

In reviewing the list of fundamental factors on page 1, consider that the essential idea behind our October report "Get Ready" was that the negative psychology from only one of those factors could be reversed during the post-election timeframe… that being the Obama factor.

Should the market explore levels below 7500, a more significant rally from those levels can develop from a reversal in the negative psychology from more than one of those factors. We are getting ahead of ourselves here, but our thoughts specifically are that this spring could find us greeting headlines that read along the lines of:

Stability Returns to Many Real Estate Markets
Mortgage Finance Improves
GDP Contraction Less Severe Than Expected

We don't expect these headlines in the near-term, and we are getting ahead of ourselves in this discussion, but these thoughts give some flavor to why the swings in search of equilibrium can expand. For now though, our thought for US equities in the first half of 2009 is: Down, then Up.

Political Environment

We run great risk in appearing to trim the historic significance of the inauguration of President Obama. Rather, our reports are simply about understanding or anticipating when reality can be quite different from the common perceptions and expectations.

And the expectations are high.

The inauguration was to be a "rock concert" with as many as 2-3 million people possibly attending, his inaugural address was sure to be placed among the great speeches of history, women have been fainting, and the positive policies of change to unify the country are eagerly anticipated. Forgive me for thinking The Fonz is going to pound the hood and the car starts, confidently pointing with a big smile, then thumbs up, snaps his fingers, and strangers become friends. Granted, the man is cool.

Meanwhile, in fact, early estimates are that the crowd on hand to witness the inauguration may have been half of what was expected by some authorities, the inaugural address was not considered his best effort though certainly effective, the stock market dropped 5% while the oath of office was flubbed, and his message of unity and positive change awaits positive results. President Obama should in time own some of the great speeches ever delivered by a President as oratory is at the core of his political path, and the long history of Presidential politics has often been shaped by the gift of persuasive and poetic rhetoric. In time however, the use of anaphoric repetition or the cadence and meter of oratory will be less appreciated than the substantive results of executive decisions. To my knowledge only two modern-day Presidents, Eisenhower and Kennedy, were able to maintain public approval ratings above 50%. Most Presidents start in the 60-80% range or experience high ratings sometime early on in their first year of the term, and then decline from there. This trend seems even more likely for someone with an initial "rock star" quality. Nothing against President Obama, he knows it just comes with the territory, and it will be quite interesting to watch media treatment of both the executive and legislative branch this spring and compare it 2-3 years out.

For all the upside potential of Fonzie to reverse the negative psychology of recent months, there is the continued downside potential of Bernard Madoff and the Ponzi schemes of others to damage our confidence. Frankly, the sums of money entrusted to Madoff and others, without independent custody and considering the number of warnings about his operation in the past, are staggering. However, let's pause for a moment to consider the definition of a Ponzi scheme as a fraud where the people who put money into the deal are paid "investment returns" from subsequent people putting additional money into the deal.

> It's like borrowing money so that you can pay the interest on previous borrowings.

Why do the credit card balances of so many consumers suddenly come to mind?
Why does refinancing Florida real estate originally purchased on a balloon note come to mind?
Why does the U S Federal debt situation come to mind?

Let's think about that one. The root of this credit cycle is excessive spending financed by borrowings. At the federal government level this deficit spending could be referred to as fiscal stimulus, and one would suppose it to be a potentially effective tool in a normal business cycle recession.

In a generational credit cycle however, are the symptoms being treated with another dose of the poison? Is a lack of "fiscal stimulus" or deficit spending the problem? If not, over time could this new fiscal stimulus economic plan be equivalent to throwing gasoline on a fire started by gasoline?

In time, we will come around to the arguments increasingly heard from analysts bullish on gold and bearish on the US dollar --- inflation. However, for now, cash is king. While our equity performance has been good only on a relative basis, virtually all portfolios have been quite overweighted in cash equivalents and short high-quality income securities. Understandably, some clients have questioned this tactic. It is unusual. The result however has been that many portfolios have actually achieved positive or breakeven to slightly negative results in one of the worst investment years in history. If credit contracts, if the amount of debt outstanding declines, if debt-financed assets are liquidated, the remaining dollars become more valuable, and for now the bull market in cash and dollars remains intact. With investments, it's generally nice to have what other people wish they had. As that trend changes its course, we will then enjoy changing our strategy. For now, if one must use that cash to buy something… buy low.

-Brian

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