Rahlfs Capital, LLC

Critical Point

Maybe this ain't Happy Days

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We intend to keep our reports to you short and timed only when we have something new to say. With six pages this report may not qualify on either measure, but the markets are changing.

Following the March 2009 bottom in stock prices, our suggested spring and summer rally has extended into fall and winter. In our last written report (*Happy Money,* August 28) we were prepared to consider a year-end rally "possibly to new recovery highs" depending on the nature of the interim declines. The subsequent shallow low-volume dips have been unremarkable, but we posted a Whiteboard on the website precisely 3 months ago on October 21 with a specific outlook. The driving thoughts behind that posting were that changes in central bank policies and international economic fundamentals were likely to cause the dollar to (surprisingly) bottom with a corresponding negative impact on gold, oil, the euro, and stock prices. From a technical timing perspective, two dates were considered: October 21, and February 2010 following the possible aforementioned year-end rally.

The following comments expand on the growing and immediate seriousness of that premise.

Domestic Stocks

Most stocks did not peak on October 21, and it is quickly becoming less likely the market can make it another half dozen trading days to qualify for February.

Sometimes a stock market will peak or bottom at a focused point with highly correlated turns in the component industries and securities, such action reminiscent of the way bull markets in a commodity market often end. More often, a stock market will peak (or bottom) in a gradual process with more diffuse reversals in the underlying component industries. Leading into such gradual reversals, the strongest periods of momentum (the best risk-adjusted earned rates of return) are more likely to be synchronized among industries…then one by one the components flatten, with fewer and fewer industries or securities participating strongly enough to make new highs. This is why breadth and volume often weaken as a market trend grows tired and ultimately reverses direction.

In mathematical terms the point of inflection, where the rate of growth flattens and begins to diminish, precedes the critical point of the function, the maxima or absolute extreme value.

A similar pattern prevailed in the closing months of 2009. For example, while the earned rates of change in many technology and industrial stocks peaked in the August-October timeframe, in many cases prices have continued to drift higher into January. On the other hand, the value of equity in many consumer staples companies peaked on an absolute or rate of change basis from mid-November to the first week of December, with the timing often correlated to the importance of the dollar to the earnings stream of that particular company.

Turning to health care stocks, here the peak momentum was achieved in the timeframe of December through today, presumably as expectations have changed regarding domestic health care reform and Senator-elect Scott Brown (R) winning the Kennedy seat. Communications stocks peaked in December, and utilities were quite diverse with peaks from August to December. Energy companies varied, with peak rates of return ranging from September through today, seemingly based on the importance of refined product vs. domestic natural gas to each company. Likewise, many materials stocks have been strong right into January.

Sustainability is a key word or question for 2010. The economic rebound and rebuilding of inventories continues with some momentum during the first quarter, but stock prices will be quickly discounting future quarters with real questions about the sustainability of government stimulus absent job growth. Price action, sentiment, and some proprietary studies further cause us to think the domestic stock market is poised to reverse direction.

Whether or not today is the pivot point, we see the first quarter of 2010 being the rollover phase, and are prepared for a downtrend during the bulk of this calendar year. It would be wonderful to be wrong.

The US Dollar

In the October 21 website posting, we suggested the foreign exchange value of the dollar would bottom partly because accommodative monetary policies would increasingly vary between the U.S. and some stronger growth developing nations. The dollar bottomed a month later, the absolute price peak in gold was a week after that, oil double topped on October 21 and again the first week of January, the Hang Seng index double topped on October 21 and again in mid-November, several European stock markets peaked in October, and likewise many commodity markets are rolling over in this same timeframe – when measured in the U.S. dollar.

Central banks around the world are removing some of the accommodation, and while less stimulus can be bearish for stocks, it should be bullish for the dollar.

The value of the dollar is important, such was the point of that website posting, and while all of these markets are generally correlated, trend reversals can still be diffuse. It is a complicated transition, and we wouldn't completely rule out certain of these markets attempting to make new recovery highs over the next month or so.

Few economists were optimistic about the prospects for the US dollar in the 4^{th} quarter of 2009. The debt problems of sovereign nations such as Dubai or Greece, weaker European economies, a growing middle-America fiscal prudence movement, further problems in capital markets, and frankly questions about the euro, can all contribute to some strength in the US currency. On the euro and European Union, we've commented before that this manufactured union remains an untested experiment. Frankly, the EU probably expanded too quickly, and more problems are ahead as further stresses argue for divergent policy by member countries.

To be clear about this idea of a rally in the dollar, and a drop in the price of gold and the tangent impacts upon other markets, this is something that concerns us here in anticipation of much of 2010.

Investing for inflation -- with exposure to certain equity markets, real assets, oil, gold, certain other commodities and the like -- will be more appropriate in later years rather than now.

Oil and Commodities

We received a question last week about oil prices and commodities, given our view on the dollar. A rise in the price of crude oil had been one of our major themes since 2002. We felt oil would act as a store of value against a decline in the dollar (our second major theme at the time). Further, we were impressed with the work of Princeton Professor Kenneth Deffeyes in 2001, and others, on the developing scarcity of supply relative to demand.

Today, a near-term rise in the dollar would keep a lid on oil prices, and world oil demand in this weak economic recovery is not robust. In 2010, it's not outrageous to think that there could be some downward pressure on oil prices, with any potential for upward spikes existing only because of geopolitical events rather than demand or currency reasons. Natural gas being a domestic market is impacted by very different factors and may have more upside than oil absent geopolitical problems.

In future years we can revisit both the supply/demand and currency impacts on oil. Indeed, our interest in other commodities will also be partly currency-driven and partly based on relative resource scarcity. I would not say that we are fans of a "Simon-Ehrlich" or "Simmons-Tierney" type wager, but there are structural reasons to think a number of commodities could experience supply problems in future years. Such discussion is premature, as we continue to be focused on near-term deflation and the process of unwinding the debts of that multigenerational credit cycle peak in 2007. For 2010, excess capacity and less than robust demand pressure near term prices.

Inflation vs. Deflation

Thirty years ago the US endured stagflation – a stagnant economy combined with inflation. Today, the "stag" part of a stagnant economic outlook seems likely, and the question is whether the "flation" part will be deflation or inflation.

In 2006 our report suggested we would see, among other things, a deflation in asset prices fueled by the tremendous expansion of financial credit (i.e. real estate), and a further inflation in asset prices fueled by a declining value of fiat money (i.e. commodities). We wrote "China and India, and the delicate financial position of the US at both federal and household levels, are at the root of many of these changes." As a long term theme, this process or cycle is not yet complete, and as spoken at that time, with so many divergent influences it is almost silly to generalize about what the single rate of inflation is. There isn't one. There are many, and they are different, depending upon which item, asset, or context is referenced.

Our outlook remains for deflationary forces in the near-term as we continue to remove debt from our balance sheets, and for inflationary forces out in future years. A steep yield curve is the manifestation of these concerns, as further discussed below.

Interest Rates and Cash Flow Investments

A few weeks ago, someone called me and said: "Is it just me, or did investing in bonds and CDs used to seem a lot more straightforward than it does now?" We smiled in recalling an old country song about some fine people just simply being "in the wrong place at the wrong time."

Lately it does seem with such investments it's more important to know where not to be, rather than where to be. The preceding discussions on the dollar and inflation are important to interest rates. Under most analyses, the risks appear to increase in the "out years" of the yield curve. Thus, there have been and will continue to be two different fixed income markets in terms of maturity and risk. The longer maturity securities behave quite independent of short maturity securities, and this steep yield curve may well continue for some time.

This steep yield curve and uncertainty has significant implications on "time value of money" calculations: commercial real estate cap rates, corporate capital budgeting decisions, value stocks vs. growth stocks, and income vs. capital gains. Promises to pay a certain sum of currency far off into the future may be discounted heavily. Can the promise be trusted? What will the value of that particular currency be? What will the economy or that country look like even in terms of sovereign risk?

There will be more sovereign debt events such as Dubai, and it is a reminder of the Phase III process we described in 2007. Deficits as a percent of GDP in most developed nations have soared in a very short time, and the delicate financial position of many economies is more exposed. We remain overleveraged and the job of fixed income investors is to identify where they don't want to be standing during this unwinding process.

The extraordinary action of central bank purchases of government securities likely propped up the prices of those securities and reduced interest rates. As central banks stop buying such securities, it is interesting to see the impact on interest rates. Because so many governments have increased their deficit spending, and thus are competing for their required and growing funding needs, it is conceivable that increased competition produces much higher interest rates demanded on sovereign debt in the future. So we have a problem with the long end of the yield curve.

We expect central banks to remain highly accommodative in the primary areas of bank risk, that certainly including the US and the UK. Over time, as federal stimulus schemes are removed and the liquidity recedes, we will see who is standing on rock and who is standing on sand. We need to be on rock.

As always, the return of your principal is more important than the return on it. Despite our economic outlook and the market gyrations, we've maintained for several years that high-quality tax-free intermediate securities would maintain value. That strategy has been comforting to clients. We expect negative events in the general municipal bond markets over coming quarters, serious state and local government problems, and such preparations have already been addressed in portfolios. As you know, we've identified particular segments of the tax-free bond market which should continue to be a haven and provide appropriate returns in this environment. Taxation will become a much larger issue over time, indeed my fears on marginal tax rates for the wealthy are something I can't even put into print right now. Likewise, questions of currency exposure will be addressed for future periods.

Politics and Organized Robbery

"In the absence of justice, what is sovereignty but organized robbery?"
Saint Augustine

We'd still like to comment more fully on the apparent irreverence for contract law, and the ironies of actions and decisions made over the past few years by our political leaders. However, that project has almost literally turned into a book in need of serious editing so we will save that project for a future day or glass of wine. Still, the suggestion that select members of the banking industry will be sent a bill to pay for the presumably bad investments which the government made in insurance, automobile companies and government sponsored enterprises like Fannie Mae -- I've not yet found anyone who can explain that one.

Well, it's been said that the foxes have a sincere interest in prolonging the lives of the poultry. An election is coming on November 2, and in view of the Scott Brown election and new questions about health care reform, may we say the foxes are quickly dusting off previous plans for previous villains. In the October 21 website posting, we mentioned the likelihood of a second round of populism in terms of the federal government vs. capital markets firms. The first round was in late January and February of

2009. It did not go well. Round two has taken a bit longer to develop than we thought, but it is clear that the U.S. government intends to take punitive actions against major banks. Why is this important?

Investing in the banks today is no place for chickens. The IMF and others estimate that banks may collectively still have $1 trillion in losses yet to be realized on their balance sheets. I'm not sure how we'd even know, but some stability of financial institutions has been quite important to the rebound in global markets. This stability is partly based on the planned ability for financial institutions to earn profits from a steep yield curve, but is also more generally based on the presumed embracement and support for the industry in view of the second sentence of this paragraph. If in fact there remains insufficient capital on the part of banks to properly absorb the potential losses which have been deferred, the marketplace has been comforted by the belief that a government can uphold and sustain the critical institutions.

Prepare to be less comforted. Market or economic weakness could exacerbate a series of questions in such a continued crisis, and it is a virus which can feed on itself.

I have only one scenario where such government attacks on the banks can be perceived to be bullish. Would the government appear to be taking punitive actions against the banks if they thought the industry remained vulnerable? Would we have gone through everything we've gone through, and then reverse policy too quickly and risk a repeat? No, so in someone's mind, either the economy must be performing quite well now, and the risks of future losses are quite low, or the political points to be gained in the short-term outweigh any negative impacts longer-term. Perhaps it is good that, for the moment, the Federal Reserve is free of political influence.

That's one scenario, and it's not likely to be the way the market interprets this news. It is difficult to place much of our equity investments in the banks. As you know, sometimes we try to be the fox, but often we act like chickens.

Pointing Fingers

I hope you will not think we are inflating ourselves to say that in several respects we saw the credit crisis coming. We make many mistakes certainly, but we did write a number of reports in advance describing that cycle as it developed. My point is this. At that time, in terms of causes, not once did we mention Wall Street bonuses, not once did we mention tricky mortgage brokers, not once did we really point a finger at the providers of capital or credit. What did we mention?

Us. The demanders of credit.

The cause of the credit crisis is that people, real people who vote and pay taxes and are employed around the world, borrowed more money than they should have. They borrowed on their personal credit cards, they borrowed to buy a larger home, they borrowed to buy cars, whatever. Some of them were employed by corporations and handled increased debt loads in the business. Some of them were employees whose job description was to make credit cards more attractive and available. Some of them were employed by the government and spent more money which had to be raised by ever higher debt loads in the city, state or federal government. Regular people, all of us. Some of us work for the government and designed legislative programs intended to make loans available to people who normally would not qualify. So to make sure we point the fingers in the right direction, we all need to line up for the mirror. It was a pervasive sentiment and inclination towards the benefits of credit indicative of a peaking multigenerational credit cycle. You had to be over the age of 70 or a dedicated student of economic history to have a chance of noticing what was even happening.

Business activity slows somewhat, fuel prices go up, medical costs rise, tuition costs rise, consumer inflation was probably higher than reported at the time (*Something Will Happen*, June 2007), foreign economies become very competitive, and we began to see budgets tighten. Questions start to surface about whether the debt loads can be serviced, the economy slows further, layoffs build, and those who borrowed too much began to understand why you shouldn't borrow too much.

If all these real people with real loan payments properly pay the interest and principal they agreed to pay, there is no credit crisis.

We described the painful unwinding as a Strike One, Strike Two, Phase Three sort of process. Apparently I should have mentioned the compensation contracts of senior employees at capital markets firms as well, but it didn't seem relevant or pertinent to my analysis of the credit cycle. Some changes are probably overdue with respect to Wall Street bonuses, but was that a cause of the credit crisis that I somehow missed? Is it possible that the finger pointing and proposed legislative reactions to the credit crisis are misplaced and will therefore not provide any meaningful solution?

So when one hears rhetoric along the lines of -- *We're going to make sure you taxpayers get back every dime you spent saving the auto indust, er, I mean financial industry* -- I can't help but wonder how many of the people cheering are the same people who borrowed more money than they could pay back to the financial industry in the first place.

Though this political rhetoric does sour me, we are pleased to see that the behavior of private citizens with respect to debt is now much more disciplined. Indeed, it is the government which now lacks such discipline. It will not surprise you to hear that I am disappointed in the state of our union, in Republicans, in Democrats, in the legislative branch, in the executive branch. More importantly, I may not be the only one, and that's a negative for both the economy and the financial markets. Round one did not go well early last year. I wish I knew where round two is headed.

As we reflect on the past several years and the performance of your portfolios, we are again reminded how fortunate we've been to dodge the bulk of the problems, and stand here in good shape today. In 2009, our performance can generally be attributed to appropriate changes in tactical asset allocation, more so than stock-picking per-se. In past years the reverse could sometimes be said, but somehow we have glided along fairly nicely. In this process, I am privy to many frank conversations today which, because of some of the things discussed in this report, are focused as much on maintaining value as on building value. I am not alone in thinking that we are at something of a crossroads or critical point in this rebound. There are significant families in this country that have decided they need to make some big decisions and asset shifts as they adapt to this world.

I was a pretty big fan of Richie, Potsie, Ralph, and of course the charismatic Fonzie who was originally a minor character and quickly became the hugely popular figurehead of the show. It represented a classic and fanciful view of life some 50 years ago. The US stock market returned 53% in 1954, 32% in 1955, 43% in 1958, and the 1950s were a very profitable decade built on sound balance sheets. From the lows of 2009, the US stock market jumped over 60% in the remainder of the year, and we are wondering if Happy Days are here again. We'll get through this, but I recommend being nimble.

-Brian