



Economic and Market Commentary
10.4.09

I would like to start this month's article by asking a question we have discussed before:

Will the markets continue to go up?

At the March 9th lows earlier this year, the S&P 500 traded at roughly 12 times expected 2009 earnings. After a massive rally, the same index is currently priced at almost 19 times expected 2009 earnings. Such strong "multiple expansion" signals the market's expectation that the current recessionary environment is giving way to a traditional post-recession recovery. In my view, profits will come back to Wall Street more slowly than the market is foretelling.

Please take a look at the following charts which were part of an excellent article published by Dr. John Hussman late last month. The first chart is a graph of weekly numbers for the S&P for the past several years. The second chart is a similar graph of weekly numbers of the Dow Industrials displaying the infamous stock market crash of 1929.



Please note how eerily similar these charts are. More importantly, notice the incredible rally that precipitated after the initial destruction of capital ---- in both events. In fact, to find a rally as strong as the one we have just

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seen from the March 9th lows in the U.S. financial markets --- you must go all the way back to this chart from 1929. It has been nearly 80 years since the market has rallied so strongly! Now for the disturbing news... Please take a look at the following chart which tells the “rest of the story” from the 1930s:



Not only did the market test the lows set previously, it shattered through those lows and set massively lower lows. Are we on a course to repeat this currently? Only time will tell... Risk of a market pull back seems relatively high. Bill Gross manages the PIMCO Total Return Fund which is the largest bond fund in the country at approximately \$177.5 billion. He is certainly widely regarded as one of the most astute bond fund managers in the country. Last month, his fund reported a massive 19% allocation shift toward longer dated U.S. government debt. Bill was quoted as follows regarding this shift: “This reflects the re-emergence of deflationary fears. The U.S. is at the center of de-levering as opposed to accelerating growth.” My comment: Bill Gross is spot on. And deflation does NOT coincide with a traditional post-recession recovery.

What is deflation?

Simply put ---- when things get cheaper over time, they are experiencing deflation. A better question might be ---- What causes deflation? I believe there are two primary determinants to deflation, as broadly used to define an economic condition:

- 1) Credit contraction: The volume of bank lending activity in this country is decreasing steadily and appears to show no sign of reversing.
- 2) Velocity of money slow down: This is the number of times a dollar is cycled through an economic transaction in a given period of time. For example, if the total money supply for our country was \$100 and it was cycled through transactions 50 times ---- total revenues for the country (another term for Gross Domestic Product) would be \$5,000. If that same money was only cycled 25 times, then GDP would only be \$2,500. This velocity always slows drastically during deflation.

Certainly, both conditions exist today in our economy. Increasing the money supply and deficit spending are currently being used to reverse the above mentioned trends. It is very possible that our government’s efforts could fail and that deflation could disrupt our nascent recovery and re-create stock market conditions similar to those experienced in the Great Depression. Incidentally, the Great Depression was the last time that our country experienced significant deflationary problems. This is particularly bothersome when you realize that the “professionals” in charge have largely never experienced such circumstances. At best, they have studied it in text books from the safety of academia.

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Incidentally, if deflation does in fact persist it seems plausible that next year we will hear strong discussions of Stimulus II. Politically, it will be nearly impossible for both parties to resist the urge to do "something".

Is there anything to support a bullish position on the market?

In fact, I believe there is. Earnings season starts later this week for the third quarter results of 2009. The market hates to be surprised by bad numbers. It generally rewards expectations that are met. It nearly always rewards expectations that are exceeded.

Side note: Isn't this human nature? I liken it to report cards from our children. If they do ok ---- we generally affirm them. (We don't want to turn into "those parents" who are never satisfied and never affirm...) If they surpass our expectations, we go out of our way to reward them. If they fail, ...

The market is likely to "meet expectations" if only due to the fact that we are beginning to compare profitability numbers against last year that were very poor. Such "easy compare" numbers do not necessarily portend economic strength or rebound, but they might still create an emotional response similar to our child bringing home a report card full of "B's".

Other than your standard skepticism, are there any other significant risks?

Great question. External shock risk to the economic system is VERY high. Certainly, there is a possibility that the Obama/Geithner/Bernanke economic strategy might execute a valid recovery which avoids deflationary (and inflationary) pitfalls. However, the entire system is now extremely vulnerable to the proverbial "100 year flood". A terrorist attack, a natural disaster, significantly escalated war in the Middle East (or elsewhere), a pandemic (swine flu or otherwise), ... All of these could pose serious threats to otherwise well laid plans.

Bottom Line: I remain very cautious. I expect the market is topping out and will likely seek to "re-trench". The next several months will be extremely interesting as we watch the markets digest Q3 earnings and deflation fears. Cash is king. Risk management is the order of the day. Stocks are expensive. Bonds are expensive. Alternative investments continue to be the best place to seek reasonable risk/reward opportunity sets.

By next letter, I will have bored you with pictures of our new daughter ---- Keira Jane ---- due October 25th! We can't wait to meet her. As always, it is a privilege to steward your capital and work with and for your families.

Warm Regards,



Jeremy Boynton
Principal

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