

Quarterly Investment Outlook

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Headlines Take the Market on a Wild Ride

Stocks staged a strong finish to the first quarter that was followed by a better than expected earnings season that pushed the market to its high for the year in late April. The elation was short-lived as headlines heralding doom and gloom bombarded investors. This was the catalyst for an overdue market consolidation that not only erased the Q1 gains but raised fears in some quarters that this correction might prove to be something else: The beginning of a new bear market. We don't see it that way for a number of reasons. While the headlines present challenges and raise anxiety levels, we see substantive progress being made toward remediation of the financial system and equity market structures that will produce a real (sustainable) recovery of the US economy. And what's good for the US economy is good for the global economy and the markets.

The Big Picture

Let's take a look at where we've been and where we are today. Eighteen months ago, the markets spiraled down to levels not seen since the 90's as the financial system teetered at the brink of destruction. Jim Stack of InvesTech Research recently pointed out that the end of 2009 marked the close of the worst decade in stock market history (-9.1%). That factoid dovetails nicely with our belief that a 20-year bull market ended in early 2000 and was replaced by a bear market that ended in March of 2009. Many experts think the Bull Market ended in 2007. To the contrary, we believe the grand expansion we enjoyed from 2003 to 2007 was an illusion built on a foundation of questionable political initiatives and imprudent monetary policy, aided by inept regulation, and abetted by consumers and investors who believed the real estate and stock markets only go in one direction: Up. Rather than viewing 2007 as the end of a bull market, we saw it as the year in which the collective "we" were presented with the bill for all the future income we spent propping up the housing and stock markets in order to avoid the bear market that truly began in 2000. In doing that, we turned a run-of-the-mill recession into the Great Recession and almost broke the Financial System in the process. That's in the past and while we see a brighter future it is one that is not without risks and challenges that will demand some prudent policy responses from central banks and government. That makes us nervous.

In our letter that accompanied first quarter statements we expressed our pleasure and surprise that exceptionally good earnings news had spooked the bad news bears while taking stock indexes to new 12-month highs. We should have knocked wood. Since then, we've seen no shortage of headlines for bears to feed on in the interim between earnings seasons. The correction that began in late April continues and has now taken stocks back down to November 2009 levels. A number of analysts believe this downturn hints of the next bear market. It could be, but we don't think so. Despite the angst that is delivered with the newspaper each morning, we see what we call a "Recovery Bull Market" solidly in place and continuing into the end of the year. While we are the first to agree that perceptions can drive the stock market in the short-term, we strongly subscribe to the tenet that earnings will drive valuations in the intermediate term and we see healthy earnings gains well into next year.

Headlines Rule the Markets

We are being alerted to impending doom every day. Where do we start? The sovereign debt crisis in the Euro zone and the US? The May 6 Flash Crash of 1000 points? The Korean and Gaza Strip conflicts? Iran's nuclear aspirations? BP's folly in the Gulf? The strangling of institutional investors and markets by over-regulation? Bigger government, higher taxes, and gargantuan deficits? It's exhausting! Little wonder then that the markets have been roiled of late. The din is so overwhelming that the Iraq-Afghan wars and their cost in lives and capital have now been ushered to the back pages along with Bernie Madoff and Toyota. We're confident that a year from now most of the above will be similarly relegated. We're guessing that a number of Euro-zone countries, including the UK, will have skirted default by restructuring their debt and implementing austerity measures. We expect California, New York, and a few other US states to do the same. China and the

US are likely to partner in taming North Korea's leadership through back-channels. Tensions surrounding the Gaza strip will have eased similarly and the BP-funded stimulus program for the Gulf Coast will be a plus for the US economy. Today's headlines will give way to others that are equally foreboding since there is always something for investors to worry about.

Some issues relating to regulation and fiscal policy may be with us for some time. Hopefully, we'll find we don't need the Big Banks and high frequency traders to have orderly and efficient markets. We'd also like to see uniform trading rules implemented across all exchanges and networks so as to avoid a repeat of May's Flash Crash. In short, we see the need for a *re-regulation* of the banks, brokers, and markets that would take us back to the pre-1999 regulatory landscape but with some enhancements to increase transparency. Our fear is that Congress, in its zeal to absolve themselves of any culpability for the Crash of '09, *over-regulates* at the risk of impairing the economy and its markets. Unfortunately, bigger government and higher taxes can't be addressed quickly. They will be a significant headwind to private sector growth but we've been down that path before and we're hopeful change will occur over time. The only headline we fear is that of an event that alters long-term human and investor behavior. Until then, we expect markets to create and correct misallocations of capital, labor, and resources in an orderly manner and on an ascending path.

Looking Beyond to the Next Cycle

The bull market advance from March of '09 was similar to those that followed the major index lows of 1929 and 1975. One preceded the second-worse decade in market history (1930-1939) while the other set the stage for the long-term Bull Market that began in '82 and ended in 2000. Both advances initially offered the promise of a return to good times after stocks dramatically overshot on the downside. However, the difference between the two examples was defined by the policy actions that followed. The 1930's brought about an expansion of government that required much higher taxes that worked to the detriment of the private sector. In the decade following 1975, taxes were already high (14%-70% brackets) but remain *unchanged* through 1980. Growth was modest by historical standards but sufficient to fuel the Rebuilding phase of the Bull Market that spanned 1975-1980. This low-growth period saw stimulus added and withdrawn as interest rates see-sawed wildly. The Fed became hawkish toward inflation before taxes were significantly reduced in 1981 (11%-50%). They remained there until being cut again in '87-'88. Not by coincidence, the 1981 tax cuts marked the beginning of the next phase of the secular (long-term) Bull Market we enjoyed for the next 20 years.

At the market lows last year the media trumpeted the end of capitalism as we know it. Guess what, that didn't happen. At the time, we heard a wise commentator say: "The world can only end once and this isn't it". He was right. Today, we once again have a fully functioning Financial System and see nothing on the horizon that hints of a similar meltdown. That could change next year if federal and state fiscal policy-makers repeat the mistakes of the 30's rather than heed the lessons of the late 70's. As of today, we see sustainable economic recovery in our future. We base this on our belief that a couple of underlying themes remain in place: The Industrialization of the Emerging Markets and Developing Economies continues unabated; A tangible resurgence of the US Economy is underway. Both of these should help sustain an increase in capital spending (CAPEX) and personal consumption on a global scale that will translate to improved corporate earnings.

Today investors find themselves fretting over a drop of a little more than 10% off April's high while forgetting we're still roughly 56% above last year's end-of-the-world low in the S & P 500. We think corrections are healthy in the long run and suggest investors think of them as bubble-proofing the market. The end of this Recovery Bull Market is likely to lose steam in 2011. We then could see a major correction or short-lived bear market leading to a low-growth Rebuilding phase of the secular Bull Market similar to what we saw in 1975-1980. In this phase we will see interest rates and bond yields normalize at levels higher than today as the economy regains traction and inflationary pressures build.

If policy-makers play their cards right and resist the temptation to raise taxes and over-regulate, our hope is that this second phase could be abbreviated and ultimately evolve into a Momentum-Driven Bull Market with the economy expanding at a healthy rate while inciting only moderate inflation. This is where most retail investors come out of hiding, convinced that it's safe to return to the stock market. This also breeds potential for a bubble emerging ala the late 90's in technology and the 2000's in housing where frothy valuations begin to disconnect from fundamentals. We'll worry about that later. For now, we see the markets remaining skittish during those periods between earnings seasons. We believe earnings will support a higher stock market valuation over the next several quarters while mixed economic data paints a picture of a global economy regaining its footing after being knocked down, but not out.