



MARKET UPDATE
August 31, 2010

OUR VIEW



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A Left-Brain Moment

As many readers of these occasional notes appreciate (in some cases far better than the writer), neurologists have made extraordinary strides in understanding the physiology and behavioral attributes of the human brain. Using functional MRI technology, researchers can now monitor and track the unique blood flow patterns of each person's brain and with reasonable accuracy predict how an individual might respond to a given stimulus. Most are aware that from this analysis it has also emerged that functionally the brain is divided into two parts, the right, or emotional side, and left or logical side. Further research by psychologists and behavioral economists has determined that not surprisingly in times of stress, emotion (the right side) almost always trumps logic (the left side). Beyond this, those attempting to map the genome have uncovered genetic markers in an individual's DNA profile which can seemingly predict one's propensity to avoid or take risk.

No doubt, future findings in these disciplines will add to our understanding of how the human brain drives us to act as we do. But today, for investors the primary lesson from all this is that when it comes to our wealth, the urge to take flight in times of extreme stress often overpowers what might be a more rational assessment of the probabilities.

That Nagging, Frustrating Feeling

The crisis in confidence for investors persists; with current circumstances promising no let-up. The media, incessantly clamoring for attention, reinforces our visceral response to each new event with its usual lack of perspective or context. Our political class, displaying limited knowledge of economic essentials, provides little incentive for business executives and consumers to do anything but "wait and see." Recently, the discussion has returned to whether we are in fact faced with the next phase of a predicted (by some) "double-dip" recession. This has been accompanied by renewed concern, voiced by some sound-bite economists, that the beginning of a deflationary spiral is at hand.

Elsewhere, global economic rebalancing proceeds apace and our competitive advantage continues to erode. Combined Gross Domestic Product of Emerging Countries (China is now the world's second largest economy as measured by GDP) exceeds 50% of the world's total output of goods and services. As a reserve currency, the U.S. dollar, although still dominant, is losing its importance; some are predicting its value will decline as much as 8-10% against the Chinese renminbi in the next 12 months. Because of recent legislative and regulatory enactments, U.S. business owners/managers are reluctant to hire, as it is not possible to calculate the "all-in" payroll and benefit costs of a new employee. Not surprisingly, the unemployment rate seems stuck at just under 10%. We are confronted daily with the prospect of terrorist attacks while unwinding one war, prosecuting another, and anxious about a possible future conflict in the Middle East. The list goes on. Emotionally, the background for investors couldn't be bleaker.



The survivalist mentality and dreary forecasts so prevalent in the late 1970s have returned.

The Hindenburg Omen

Today the dark side prevails. We are confronted with the revival of the survivalist mentality and dreary forecasts so prevalent in the late 1970s. Attention to a pontification labeled the “Hindenburg Omen” serves to illustrate the latest media distortion; a headline-grabbing doomsday theory propounded by an obscure worthy enjoying his 15 minutes in the spotlight. The author, one senses, embarrassed by the buzz generated by his newly-uncovered “crash signal,” suggests the financial markets’ stars are aligned at the moment, so as to ensure a cataclysmic collapse this month. He predicts that U.S. equities will plummet to 4,000 on the Dow (in 1999 it was predicted the Dow Jones Industrial Index would peak at 36,000); everyone should convert financial paper to precious metals and move back to the farm.

The Other Side of the Dark Side

Reasonably free markets, given time, tend to arbitrage away knowledge differentials, as well as misaligned asset class and individual security valuations. Currently, in the minds of investors there exists a gap between the perception that the U.S. economy is underperforming and vulnerable and the reality that corporate earnings and balance sheets are surprisingly robust. By the end of this year, domestic corporate profits will have nearly returned to their historic peak levels of 2007. This will have been achieved with 7 million fewer employed in the American workforce! During the 2008-2009 economic decline, businesses aggressively trimmed operating costs, added labor-saving capital equipment, and are today capturing higher margins on each additional dollar of revenue or increase in sales. The productivity of the average worker and investor capital (i.e., corporate resources), has grown materially during the past three years; perhaps an unintended consequence of the cascade of policy errors originating in our nation’s capital.

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The glaring inefficiencies and general incompetence in the public sector when compared with what individuals and businesses have endured these past few years are becoming evident. The Federal payroll has expanded dramatically while California alone lost 1.2 million private sector jobs during the past three years, but its state worker payroll remains at pre-2008 levels. The average Federal employee today enjoys a total annual compensation package of \$123,000 per year, while the average private sector worker’s comparable payroll cost is \$64,000. Realization of how these imbalances have crept into the government/private sector equation will hopefully begin to resonate with the voter. If the political playing field levels somewhat in November, the psychological backdrop for the markets could improve, at which time investors may find that:

- Globally, equities are priced at a very reasonable 11x 2011 projected earnings per share (vs. 34x in 1999);
- Inflationary expectations may replace deflationary concerns;
- Interest rates may be rising and long-dated bond prices declining;



- The cascading flow of investor funds out of stocks into bond funds of these past three years may subside, if not reverse;
- The extraordinary amounts of cash on the sidelines today, both in investor savings accounts and corporate balance sheet reserves, will begin to seek higher returns in an environment of increased willingness to take risk again; and
- We will begin to accept that co-existence with the extremist terrorism threat is part of the “new normal,” and perhaps no worse than during the Cold War era of the 1970s and 1980s when thousands of Russian nuclear missiles were aimed at the U.S., and “mutually assured destruction” (MAD) was the Damocles sword of our time.

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Core Assumptions and Recent Portfolio Fine-Tuning

World-wide, during the past three years the investment markets have absorbed a seemingly never-ending stream of bad news and depressing projections. Stock valuations have declined accordingly. The underlying structure of the global capital markets has morphed into a technology-driven, computer-to-computer, high-frequency trading algorithm, nanosecond speculative arena. Investors can't be blamed if these developments have led to a sense of disconnectedness from the original concept that long term investment of one's personal capital is the foundation for a financially secure retirement. This structural evolution in our financial markets will continue to be a work in progress, but at least a partial return to first principals along the way cannot be ruled out and would seem a reasonable expectation.

Although useful in a balanced portfolio in appropriate proportions, maintaining the purchasing power of one's investment capital cannot be reached through a fixed income securities (i.e., bond) portfolio. Today, in many instances stock dividend yields (2.2% on the S&P 500 Index) nearly equal average short-term bond coupon interest rates. 5-Year U.S. Treasury bonds yield an anemic 1.3% and for a buyer today hold little prospect of improving. The average U.S. company's earnings yield (i.e., a company's price-earnings ratio expressed as a percentage of its stock price) is 8.5%. The possibility of future sovereign bond credit rating downgrades (including our government's) cannot be ignored. For the most part, U.S. corporate balance sheets are healthier than those of many political entities.

After reassessing all the present cross-currents, our core belief remains that globally diversified equities should comprise the bulk of an individual's investable wealth. At the moment, given the investment environment, such an assertion probably rings a bit hollow. One might be tempted to say “. . . but it's different this time.” It is, and always will be, different. In today's circumstances, or whatever new combination of events conspires to regenerate this ever-recurring sense of unease, the tendency will usually be to seek cover. But it is at just such times when a left-brained assessment of the probabilities would appear in order. Excessive caution today could be a costly long-term strategy.

Should you have any questions or comments, please let me know.

Best


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