September 10, 2009

It is worth saying again . . .

"Markets generally go up when business is bad, deteriorating, or not significantly improving." While I cannot take credit for this quotation, it is an extremely valuable nugget of wisdom. It came from a long-time friend and client who also happens to be a very bright thinker and a very adept student of the stock market. Following this advice is difficult because it flies in the face of our natural instincts. When we watch the evening news describe the increasingly sorry state of our economy, fear begins to arise. Logic would seem to dictate that we should act on this emotion, sell our stocks, and put the money in a hole. It is exactly the wrong thing to do.

The accuracy of our opening statement can be proven if one takes the time and effort to study the history of economic cycles and the corresponding movements of the markets. It is really quite amazing. In retrospect, some of the most distressing periods in history turned out to be the best time to invest:

1. 1932 - unemployment rate hits 25% (within 2 months of major market bottom)
2. 1941 - attack on Pearl Harbor (within 4 months of major market bottom)
3. 1974 - nation in turmoil; Nixon resigns (within 2 months of major market bottom)

The contra argument also appears to be probably as valid. When business is booming and headlines are euphoric, caution flags should be flashing. Witness 1999 and early 2000 when technology and dot-com companies were the rage and the stock market was roaring. "Warren Buffet's caution is irrational," claimed one alleged expert, "He is old-fashioned, and simply out of touch with the modern economy." Then in late February and March, for no apparent reason, the market began its unpleasant and protracted tumble. Five years later, in the fall of 2005, virtually the same kind of price expansion and top occurred in the housing market. With optimism abounding, real estate sales faltered, virtually ground to a halt, and values began to evaporate.

Anyone who studies past economic cycles learns that almost all asset classes have their boom and bust rotations. Occasionally an ordinary upward movement gets out of hand and there are explosive bubbles in price. They are always caused by excessive debt combined with extreme optimism, and they invariably come to a bad end. People become so blinded by the prospect of increasing prosperity; they throw caution to the wind. Then suddenly, and for no apparent reason, the upward move is over and prices start to fall. The ensuing decline usually takes several years, perhaps a decade or more, before normal markets again resume.

We are four years from the peak prices in housing, and nine years down the road from the S&P high of 1552 in the stock market. Even though this level was slightly exceeded in 2007, we quickly fell again to much lower levels. This year, in a recessionary environment, the Standard & Poor is actually up a little over 12%. We are still a long way from the highs, and from this point it would take an increase of over 50% to just to get back to the levels attained nine years ago.

What causes stocks to unexpectedly begin turning the corner amidst a continuing swirl of negative news? We believe there are a couple of important reasons. Most investors exit the market as they gradually become convinced we are in very difficult economic straights. They have already taken their beating, and their remaining holdings are small. In other words, stocks are at low levels and most people have already done the majority of their selling. New buying will meet only small resistance, and prices rise more easily. Secondly, many companies which are still earning money have dropped to levels not seen in years and may offer serious values.

We have seen a strong rebound since March, especially in stocks, such as financial companies, which had been driven down to extreme levels. While this is a positive sign, we are not convinced we are out of the woods. We would not be surprised to see a decline between now and the end of the year engendering renewed apprehension. Don't be overly alarmed should this occur. That is what markets do.

There are many economists who continue to predict deflation, due to the contraction in productivity and employment. We do not agree. With the vast amount of money being spent by our government (I should say printed and spent), we believe the Dollar will remain under pressure. We expect to see increasing inflation with a commensurate rise in interest rates. This should also manifest itself in the price of gold. We believe gold will continue to climb over the next few months, perhaps even more rapidly, advancing to all time highs. We are not far from that now.

Last week, while doing some banking, I happened to ask the teller what they were paying on certificates of deposit. She said, "Oh, we have a special rate on the 2 year CD. It pays 1.75%." I replied, "That is special!" Ask yourself a question with respect to your own investments. Taking risks into account, where will you be better served over the next five years? Don't be <u>influenced by crowd mentality</u>. A successful old trader I knew once said, "What is obvious to the majority is obviously wrong."

Sincerely,

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