Harbor Views

From the Deck and the Dock…Long sights and close ups

Wednesday, April 18, 2012

Dear ,

It's been almost a year since I've written my views on the market in a formal manner---far longer than ever I anticipated a gap to occur. I received a Christmas card which may have described the situation. "My muse", wrote my correspondent, "has gone missing." I think mine, by contrast, bucked me off and galloped away. However, as any number of writers have told me (with apologies to Crosby, Stills and Nash), "There are no easy horses…but you've got to learn to wride."

Of course, I know what happened, what caused the initial freeze. We had a market which through May 2011 had been attempting to incorporate in its prices a recovering economy and then got hit with a case of uncertainties as we went into the summer. The fight over the budget ceiling was bad enough in terms of confidence. But the bigger scare was whether the world's financial system would hold together when European banks could go bankrupt because they held mis-rated bonds.

In case you missed it, there was a precipitous collapse of confidence at the beginning of August 2011 which took the S&P down 20% in about 2½ weeks. And it took a long 2 months of continued uncertainty without a further market fall to persuade investors that indeed the end of the world was not again at hand, that economic conditions in the US were in fact improving, and that stock prices could move back up. (In technical speak, we had a second test of the bottom…and it held.)

I was in such shock at such violent gyrations of the market that it was impossible for me to write anything sensible at the time. And indeed it was pretty easy to be pessimistic because of the inability of the Europeans to agree on how valueless the Greek bonds held throughout their financial system actually were.

The best way I can describe the impact of this to you is to ask you to imagine a ten-room house, with each room maintained by a team from a different (European) nationality. The spokesman for the house is asking for a refinancing, and you, as their banker, have to decide if you want to roll the loan over. They've told you that the house is sound, but you find that one of the rooms, the Greek room, is riddled with termites and is going to fall off the end of the building.

J. Williams Wealth Management, llc.

PO Box 1492, East Dennis MA 02641-0366, USA

+1 508 385 2176

You've been valuing the house at $500,000, and the loan is only $350,000. But if one of the ten rooms falls off, you can't knock the value down by just one-tenth of the house. Maybe you can get away with knocking the house value down to $350,000, the value of the loan. With that the owners are wiped out, but your loan to them is still good, though you might be worried about their cash flow to repay the loan.

What happens, though, when a knowledgeable real estate agent comments that the house is really only worth $150,000, because the termites have infiltrated the next two rooms (Spain and Italy?). Suddenly you are faced with a loan worth less than you laid out…and <u>your</u> net worth is being impacted. You're going to have to write off $200,000.

Worse yet, suppose <u>you</u> had borrowed $300,000 of the $350,000 you put up for the loan. Your $50,000 is gone, and you are going to have to tell the people who lent you the $300,000 that half of it is gone too! (Darned termites).

But most of the people who lent to you have done so mostly with funds which were lent to them. And the news that their holding of your loan now has a reduced value has a similar wipe-out effect on them. Eventually we will reach somebody who doesn't have to write off the total value they have invested in this lending chain, but it could be a far number of links away from that termite ridden house.

Similarly with Greek bonds, a permanent reduction in their value is going to wipe out some of the net worth of the institutions lending to them. But those institutions have been lent funds, so there will be a negative impact on a secondary or even a tertiary lender. All of which causes an investor to want to flee.

And yet, by October of 2011, the forces of rationality(?) had examined enough of the European situation to see that much of the bad news was in the price. In fact the market was probably too far away from fair value and US prices started to rise again. By the end of the year we had had a market which had gone up 9% to a peak, collapsed 20% from that peak, and then recovered 13% to end up virtually where it had started. It left me shaking my head; how could I write sensibly about any such action?

The only comment I could make was one I put in my end of year letter to clients:

> *I find myself more optimistic about 2012 year end prices than I expected to be. There is still a great deal of skepticism in the market about investment conditions, which would lead one to expect lower prices at the end of 2012.* ***But it is unusual for a market to give flat returns two years in a row, and we have had prices <u>down</u> in 2011.*** *(*emphasis added for this letter*)*

I am sure we will have plenty of volatility during the year, requiring greater willingness on my part to change positions. All things considered, 2012 may indeed be the better year that we were hoping for.

And now we've had a "straight-up" market for the last 3 months. Speak it not, but we've actually had 6 months of rising prices---and nobody believed it! In fact, price action in the month of March began to smack of desperation as it seemed fund managers were needing to get fully invested before the end of the quarter.

And pushing against that was the selling of individuals who wanted to move funds from the volatility of the stock market into the "safety" of the bond market. The curious piece here is the policy position of the Federal Reserve. By keeping interest rates low, so that there is a greater incentive to spend than to save, I can only infer that their view is that if someone did want to save, they would be forced to do so in "riskier" assets of the stock market.

And while we're at it, thinking of unintended consequences, as you watch the debates on higher taxes, think about the question for people who are older than 65 and are no longer in steady employment. If taxes on dividends are raised, and raised sharply, doesn't that reduce the income we have to live on? Or is this a case of letting us eat our seed-corn; we draw down our capital to fund living expenses and hope we die before we run out? I wonder when the AARP is going to point out that plain-living, good ordinary middle-class old people are going to be hurt by higher taxes on dividends. (They sure can't live on current interest rates!)

OK, I'll get off my soapbox. Let's deal with what we should incorporate into prices now. What we know is:

-There is some sort of economic recovery going on in the US

- When there is an economic recovery, there is greater demand for transport fuels.
- When there is an economic recovery, interest rates eventually rise.
- Usually an economic recovery is started by/accompanied by a rise in housing starts. (This is the "forgotten" sector in this market and may still constitute the greatest value opportunity, even though some stocks like Home Depot, a building supply stock, and Lennar, a home builder, have moved sharply from very depressed levels).

-There is a presidential campaign which will doubtless include some incredible vitriol as well as some extreme comments about taxes (increased taxes drains funds from the markets, both stock and bonds)

-There are mandated fiscal changes at the beginning of 2013 which could change all the discussion about budget deficits

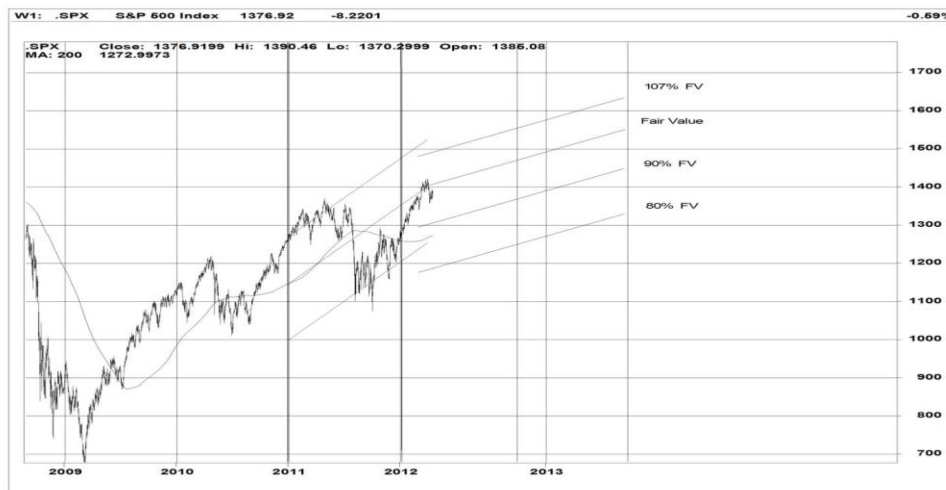
- Sequestration begins to take funds out of the major spending areas of government control---defense and Medicare
- More importantly, the Bush tax cuts expire <u>for everyone</u>. Like it or not, the government revenues increase more if collected from millions of (middle income) families than from thousands of ("rich") families.
- Social security taxes return to previous levels, boosting government revenues from the 50% of American families who do not pay income taxes.

-There appears to be an increasing recession in Europe. (The trick will be to identify when it is attractive to get back in to that market)

-China appears to be less aggressive in the commodity markets. Indeed there may be an economic slowdown in China that enthusiasts had not counted on, with ripple effects across much of Asia and Australia.

Confused? All these different flows remind me of sailing in Cape Cod Bay, with a northwesterly blow pushing against west flowing tides, all resulting a nasty, choppy, uncomfortable ride. Better to keep the sails up for stability, and turn on the motor to move the boat along.

My "motor" in the case of the US market, is Morningstar's estimate of Price to Fair Value ratio for the market. The market's price has ranged between 110% of Fair Value on the high side and 80% on the low. And it has spent most of its time between 103% and 95% of Fair Value. All of which allows me to make up a chart which looks like the one below.



The basic message I can draw from this chart is there is still upside in the market. By the end of 2012, basic market forces (driven by earnings) could see prices up another 7% to the 1475-1500 area. But just as easily, if the market were to go nowhere from here for a year, it wouldn't be compellingly undervalued. And if the vitriol becomes too great, we could see a 12% decline from here, to the 1250 area.

"Sell in May and go away" is a market truism that frequently applied during the years I was in London. And might easily be valid this year in the US. This makes it all the more important for me to be selective in what I own and, even more, selective in the prices at which I own it. In fact, my recent strategy for stocks is to put in sell orders at the top ends of their ranges for stocks which seem fully valued (IBM?) and buy orders at the bottom ends of their ranges for stocks which I want to own (Masco).

So while my boat (portfolio) is being sloshed back and forth by the noise from the stump speeches and "debates", I'll be checking to see how far from the Fair Value level the market is. And making adjustments accordingly.

Of course, mine is an all-equity portfolio. There is a bigger question than what we think of the level of the market, and that is what to do about the bond exposure in Jeannie's portfolio. Under normal circumstances I would be nudging up the bond exposure and squeezing down the stock exposure to convert some of the unusual recovery we have had in equities into the "stability" of bonds.

But I am convinced that economic recovery brings rising interest rates…and rising interest rates mean falling bond prices. So why, why do I want to put money into a part of the market where I feel certain to lose money? No, this isn't just an "equity" guy talking his book. I certainly like owning bonds when I can get equity-like returns from them. It's just that I don't see how the Fed can press interest rates lower. And if rates can only go up…bond prices can only go down.

This is not to say that I don't hold bonds in Jeannie's portfolio. The current target is 33%. But I would normally expect it to be closer to 45% at this point in the market cycle. And the bonds she owns tend to be TIPS and the very short-dated iShares Exchange Traded Fund indexed to the Barclays 1-3yr Credit index (CSJ). So I hope I've minimized the susceptibility to price falls.

Ultimately 2012 will probably prove to be a pretty good year for US stock investors. There are plenty of snags that could throw things awry, but they've mostly been identified. And with identification comes a reduction in their ability to have a negative impact. Rotating holdings so that there is still upside opportunity in the portfolio seems to be the best strategy for me at the moment.

As you know, I keep looking for signals on which to act based on what I see in the environment around me. Jeannie and I went to Brittany in western France for a wedding in late August last year. I felt sure I would hear of wringing hands about the impossible state of the Euro and the riskiness of French banks.

Instead we found, like Cape Cod, was the tourist business in full bloom. Even the end of August is still vacation time for France. The open markets which travel from town to town on a regular, weekly schedule were robustly selling food, clothing, and other perishables. There were few posters denouncing the future or praising “soak-the-rich” candidates (those have come this year). And the sea front at Benodet and Ste-Martine was as active as anyone could hope.

As a better test of economic activity, the city of Quimper was just as busy as the towns we were staying in. A shock to me (and a delight to Jeannie) was that Quimper had attracted a Parisian fashion designer who had set up a school of embroidery and needlearts to embellish the fashionable gowns he was producing. France has always been a place where all the action was in the center (Paris), and yet here was a creative talent springing up to match the artisan tradition of this part of France. So clearly any squeeze on economic activity from banking uncertainty, or the impact of a weaker Euro, had not yet hit the periphery when we were there.

There is one footnote to this trip to France. A month later I was at the Annapolis Sailboat Show gazing admiringly at a 21’day sailer. It had long overhangs at bow and stern and was about half as wide as a normal boat. It looked fast just sitting there at the dock. And when I asked about it, the salesman came from Benodet, bringing this “wonderful European product” to compete in American waters. And he was now my new best friend since I was one of the few who recognized that the French had as long a maritime tradition as the British! Clearly somebody in the sales department had been reading “Currency Wars” by James Rickards and thinking that the Euro would not always be a strong currency and a few exports would be very helpful.

I know my promises of another letter have always seen the subsequent letter begin with an apology for lateness. Now that I am back on the horse, maybe we can avoid that!