April 16, 2010

2010 First Quarter Review

What a huge difference a year makes. The first quarter of last year brought a near financial panic and a generational low in stock prices. The first quarter of this year brought a continuation of the recovery in both the economy and the stock market that has proceeded almost uninterrupted from the lows of one year ago. Except for a brief and shallow dip from mid-January to early February, this quarter continued the advance. The Dow Jones Industrial Average rose 4.1% while the S&P 500 rose 4.87%. Bonds were mixed with corporate bonds gaining slightly while the Barclay's Treasury Bond Index fell by 1.5%. Gold prices gained 2%, fluctuating around $1,120 dollars per ounce, while crude oil climbed 6% to over $80 per barrel. Inflation has remained largely in check, and short term interest rates continue to hover close to zero, at a fraction of 1%.

It appears as though we are seeing the economic "boomlet" that we mentioned in recent quarterly letters that we should expect as a result of the massive amount of stimulus money that has been pumped into the economy. Corporations have pared down costs and inventories so much that small increases in business activity can translate into a quick rebound in profits. This operational leverage has begun to translate into healthy increases in profitability for many companies. The stock market has reacted accordingly, with a seemingly inexorable rise from the lows reached just over a year ago. The question, as always, is "Where do we go from here?"

The optimistic case for stocks includes the fact that business cycles last an average of 48 months. The recession ended about nine months ago, so we could be in for a protracted period of economic growth (IF the recovery proves to be self-sustaining). The market as a whole is not extremely expensive based on common metrics of earnings and cash flow, trading at about 14 to 15 times earnings. Corporate cash levels are at record highs (It is the government that is outspending its income). Many companies are "lean and mean" and operational leverage could translate into healthy growth in earnings.

The anomaly in the recent market rally is that there has not been large "buy-in" to this market by retail investors. It appears to have been fueled largely by institutional investors who cannot afford to take the safety of cash with such low returns. Even then, many institutional investors are frustrated by being under-invested in this move. We talked last quarter about how "hated" this rally has been. As always, if stocks rise, you want to have owned more, and if they drop, you want to have owned less. It reminds me of Mark Twain's investment advice to "buy stocks that go up. If they don't go up, don't buy'em." The average retail investor has been withdrawing money from stocks and buying bond funds during this whole rally until recently. If the average investor "comes out of the bomb shelter" and starts moving money from bonds and money markets back into stocks again, the buying could produce a healthy move higher.

However, we've had a very nice rally and should be prepared for a reasonable pullback in the near future. Stocks are not terribly over-valued at current prices, but they are no longer in "cheap" territory as a whole. Long advances of this kind with only minor declines are rare. Measures of complacency are high, and confidence born of market advances can easily turn into over-confidence. Consequently, the market is probably vulnerable to a "correction" at any time. The dangers ahead for the markets include such non-traditional headwinds as rising bond rates, rising taxes, increased regulation, higher oil prices, growing federal government deficits, elevated unemployment and a constrained consumer. On the longer term, the creation of money by the U.S. government to fund our deficits may eventually produce a weaker dollar and higher inflation. Timing, as always, is critical on this issue too; and investors seem to be saying that they think those consequences are far enough down the road to party now and worry later.

April 15th "Tax Day" has just past and, since you probably just paid an uncomfortable amount of money to the U.S. Treasury, you might be interested to know a bit about where that money goes. According the Tax Foundation, 56 cents of every dollar you pay in taxes goes to "entitlement" payments for social security, medicare, etc. That is, 56 cents goes straight to somebody else. 20 cents goes for defense, and 10 cents will soon go just to pay the interest on the federal borrowings to fund the deficit. The problem is that the deficit is growing, going from 6% to a projected 12% of GDP in the near future. If rates rise, U.S. bonds will drop in value and federal interest expense on its debt will increase. As you can see, a combination of rising debt *and* rising interest rates is a double whammy for the government budget. Fortunately, unlike Greece and other countries, the U.S. can just print money to cover those expenses. The problem is that such a strategy could very well lead to a debasing of the currency. That is why, as time goes on, we may want to increase our exposure to investments that do well with rising inflation.

Rising real estate values and employment are often cited in the financial press as being key to a recovery, but they are both likely to recover after the stock market has already moved. We should realize that they, especially employment, are lagging indicators and are not good forecasters of market advances. We should also not forget the potential for another "sovereign" debt crisis. Greece provided the most recent scare as one of the "PIIGS" countries (Portugal, Iceland, Ireland, Greece, and Spain) came close to defaulting. During my investing career, I have witnessed various crises originating in South America, Mexico, Russia, Southeast Asia, to name a few. Each one was a problem that didn't matter…until it did. Whatever the reason, when we get our inevitable "correction" in stock prices we should be prepared to continue our strategy of adding to our positions in a combination of high quality, income producing, precious metal, energy, and "small cap" deep-value stocks that are leveraged to an economic rebound. Because of the outlook for government budget deficits at both the national and state levels, we should avoid U.S. and municipal bonds for the near future.

Please take a moment to review the enclosed statements at your convenience and let us know if you have any questions. If you need any further information to file your taxes, we can get it to you or your accountant quickly if you just give us a call.

Sincerely,

Claude Carmichael CFA