October 5, 2010

2010 Third Quarter Review

"All aboard the QE2!"

Until lately, the Cunard Lines RMS Queen Elizabeth 2 ocean liner was what came to mind when anyone mentioned "QE2." Alas, the original QE2 is no longer plying the seas of the North Atlantic in majestic grace. It is docked in Dubai and awaiting its fate as a floating hotel or scrap. That's not a bad metaphor for the economy as we approach the November 2nd meeting of the Federal Reserve Board. The name, however, now stands for "quantitative easing, part 2." Quantitative easing is, for the layman, printing money. However, printed money is a very small sliver of the money supply nowadays. Nevertheless, it is money-creation that QE2 refers to, and a lot of it. Estimates are for a $1 trillion stimulus in 2011. "QE1" was, of course, the first barrage of emergency measures to provide liquidity during the height of the financial crisis in order to shore up failing institutions, forestall deflation, and keep the economy from going into a depression. QE2 will be launched in the desperate attempt by the government to get the anemic economy growing again. The implications for investors are many.

But first, we'll do the numbers. During the third quarter the stock market regained the ground lost in the second quarter's decline. Last spring included the worst month of May for stocks in generations. Stock market averages dropped 17% from April to July, but it was the best September for stocks in 70 years. By September 30th, the S&P 500 was up 2.34% and the Dow and Nasdaq up 3.45% and 4.38%, respectively, for the calendar year. The 10-year US Treasury Bond yield is now around 2.5% and the short term rates for Treasury bills and "money markets" hovers near zero.

Last week, the Bank of Japan fired what might be the first shot in another round of "global easing." At the same time the governors of the Federal Reserve are making speeches telegraphing the next wave of US liquidity in QE2. This has gotten stock market participants excited as they believe it is tantamount to the Federal Reserve going to the NY Stock Exchange and hanging a sign that says, "Next Bubble Here!" It appears as though the Federal Reserve is committed to inflating asset prices in hopes of translating that inflation into a stronger economy. There is logic to their thinking. People buy more when their assets go up in value. However, we should maintain some healthy skepticism before we buy into the Fed's belief that easy money is the answer to our economic woes. It will certainly have some benefits, but the degree is key. Plus, there are always those pesky unintended consequences.

The Federal Reserve has kept short term interest rates near zero in order to shore up the banks' balance sheets and try to stimulate demand for borrowing and spending. In other words, we pay them (for loans), but they don't pay us (for deposits). One unintended consequence includes punishment for the "saving class," forcing investors to accept almost no income or take more risk to gain the income they need. This happened just a few years ago in the "reach for yield" that preceded the mortgage crisis. It is happening again, and it often doesn't end well.

One of the risks we mentioned during the crisis (and again last quarter) with the first "quantitative easing" was that there might be a second round if the economy faltered, and it might be less affordable and less effective. We are there now. Inflating asset prices may be similar to “pushing on a string,” a phrase I first heard in the Nixon years when monetary easing produced little economic punch. The rise in the price of gold signals the fear that QE2 may serve more to debase the currency than to ignite the economy, a fear I have shared for some time. It now appears more nearly certain that the Fed will err on the side of inflation.

All countries seem to be creating money, trying to devalue their currencies in order to boost the demand for their exports, because it makes their products cheaper for overseas buyers. It is common wisdom (an oxymoron if there ever was one) that the trade barriers put in place after the stock market crash of 1929 exacerbated the crisis and helped to create the depression. It is odd that, though economists have long learned that lesson, politicians still find it expedient to talk about trade tariffs (against China) at a time of weak demand. Human nature has not changed while politicians play to the local crowd to the possible detriment of all.

So, we seem to be set up for asset bubbles and currency revaluation (i.e. a weaker dollar). Investing in bubbles can be very profitable, particularly in the early stages. They tend to persist longer than skeptics can hold out against them, then burst with terrifying suddenness. We’ve seen this movie before, and it didn’t end well; e.g. the tech stock bubble, the real estate bubble, the tulip bulb craze, etc. However, they are great fun when they are inflating, if you own them, and if you get out in time. Soon we may be able to add the US government bond market as another bubble burst. Long-term bonds may be the new Titanic if interest rates start to rise. With yields so low, a small increase in rates can translate into large capital losses on those investments.

The strategy we are pursuing includes a mix of investments that we think will provide the best reward for the risk we are forced to take. This includes multinational companies with pricing power that will be able to benefit from a weaker US dollar and still benefit from inflation. Precious metals, oil and gas, and other “real” commodities should perform as well, as they are traded internationally and would presumably rise in price as currencies weaken. We place a premium on income-producing investments that help to offset the very low interest available on cash reserves. (However, we are avoiding the “safest” long term US Treasury bonds for reasons above.) Finally, we are always on the lookout for small companies where the prices appear compelling cheap. It is a combination of these assets that we believe will offer the best protection against inflation and currency debasement while providing the opportunity for growth. If we are correct in our strategy, we may well earn enough to book a cruise and set sail someday on the “QE3.”

We have enclosed your statements and reports for the third quarter. Please review them at your convenience and, as always, give us a call if you have any questions or suggestions.

Sincerely,

Claude Carmichael CFA