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Investment Newsletter – June 2010

This month we start with a short discussion of stock market dynamics. Then we'll look at important macro-economic trends that will shape the market environment over the rest of the year. Finally, we'll explore the implications for investors.

Fundamental Investors versus Technical Traders

There are basically two types of market participants – fundamental value investors and technical/psychology traders (though some fundamental investors keep an eye on technical signals for trade execution purposes when entering or exiting positions). Making money as a fundamental value investor requires good analysis, patience, and the ability to resist making emotion driven investment decisions. To make money as a technical/psychology trader, you need speed and the ability to predict other traders better than they predict you. Because psychology traders don't calculate fundamental values, they must guess what fundamental investors will do before the fundamental investors figure out what they will do. It's often not difficult to figure out if news is bad or good. The hard part is figuring out the correct magnitude of the price adjustment required. This results in prices seesawing between too high and too low as technical traders duel with fundamental investors. This is why the academic world refers to technical/psychology traders as "noise traders" – they create a lot of incorrect price signals and obscure the underlying trends driven by the fundamentals.

For big news on an individual stock, psychology driven traders who are fastest will make money but the slower ones will cause prices to over-shoot. Many of the slower technical traders lose money during the adjustment process. This is the driving force behind the new breed of computer driven market makers – also known as high frequency traders or quantitative traders. Judging by the market action day to day without much news, far more trading volume comes from technical/psychology traders than fundamental value investors. This means that prices can become unhinged from value for long periods while the gentle force of fundamental value investors slowly exerts itself. As prices diverge more from fundamental value, sharp investors will sell (if prices are too high) or buy (if prices are too low). When fundamental trading volume in a stock reaches a high enough proportion of overall volume, technical traders observe this signal and start following the new trend established. This may speed the stock back towards true value and if enough technical traders pile in, it will eventually overshoot again to a point where fundamental investors intervene again (slowly).

We care about these market dynamics because if we understand why things happen as they do, it helps us understand how to devise strategies that we can successfully follow to outperform the overall market. Unless we have the best computerized trading system in the market and a high tolerance for the risk that we will eventually lose our edge, then we should avoid trying to play the psychology speed trading game. This means we need to be astute in observing and analyzing economic and fundamental information. If we have skill in such analysis, we can be "slow" and still buy and sell in advance of the market moves – because we are buying based on an estimate of true value before the technical traders can figure out what that target is. After all, their form of analysis is inherently a following strategy if you look at longer time horizons. Now we'll do some analysis to see where fundamental analysis is pointing these days. This will help us devise a strategy to ride through the volatility of the market and earn good returns over the long run.

Double Dip Recession Dead Ahead?

Leading indicators are now pointing to a recession – most likely starting in the 4th quarter or 1st quarter of 2011. If you're of the mind that the U.S. came out of recession in 2009 then this would be a double dip recession – two recessions sandwiched around a short period of growth in Gross Domestic Product (GDP). If indeed the other shoe drops and we see a contraction in GDP by early next year, I expect that the National Bureau of Economic Research will rule that the first recession never actually ended and that the additional deterioration is a continuation of weakness that was masked by the government's extraordinary stimulus spending.

The leading indicators I'm talking about are from research by an economist named John Hussman. These criteria, taken together, have always correctly indicated when the U.S. was either in or about to enter a recession. Here are the current readings:

1. Increasing credit spreads over the past six months – yes.
2. Spreads of less than 3.1% between 10-year Treasury yields and 3-month Treasury yields – yes (10-year is 2.96% and 3-month is .17%)
3. S&P 500 below level of six months earlier – yes
4. Unemployment up .4% or more from its 12 month low OR employment growth below 1.3% over the prior year – yes (employment growth is negative).
5. A negative reading of the Weekly Leading Index (WLI) from the Economic Cycle Research Institute (ECRI) – yes.

This last indicator, WLI, is currently at -6.8%. There has only been one reading this low that was not associated with a recession (in 1988). It could be different this time and perhaps GDP will continue expanding, but the probability of that result is low.

The Limits of Borrow and Spend

All the GDP growth in the past year came directly from government stimulus spending. As the housing bubble meltdown and job losses turned consumers toward debt reduction (and therefore consumption reduction) governments stepped in to borrow and spend on citizens behalf to grow the economy. While this has helped in the short run to turn around negative psychology, in the long run it will stop working and eventually it becomes a drag on growth. To see why, consider an analogy.

Imagine you were earning $100,000 per year and you had become accustomed to a 4% raise every year and corresponding increase in spending. Let us further suppose that you had run up $80,000 on your credit cards for various "one time investments" in things you needed. You've always paid your bills so lenders only charge you 5% a year - $4,000 of spending is for interest. Then, one year your boss says times are tough and you're getting a 4% cut rather than the usual raise. Rather than reducing spending you give yourself a raise by charging another $8,000 to your credit card ($4,000 to make up for the pay cut and $4,000 to give yourself a raise). In total you can spend a total of $104,000 (including the interest expense) just as if your income were at that level instead of 96,000.

The first year you do this, everything is fine. You get to increase spending just like before. But suppose times are still tough in the second year. Your boss doesn't cut your pay again but he doesn't raise it either. Now, if you want to keep growing your spending, you need to charge $8,400 to stay even (including interest on last year's new debt) plus $4,000 to further increase your consumption. So in 2 years your debt goes up 26% to $100,400. Eventually your creditors will get nervous about you and raise your interest rate and refuse to lend you more money. If you don't *increase* borrowing again in the 2nd year, your growth in spending stops, even though your debt is still growing by $8,400 per year.

Greece went down this path and had to be bailed out by its European neighbors. But its neighbors were heading in the same direction and now realize more clearly where the limits are. Thus the Europeans are cutting deficit spending and starting to adjust consumption to match actual income. Meanwhile their currency has dropped almost 20% in value. Unfortunately for the U.S., demand from Europe was helping to support our manufacturing sector. This will now reverse itself and become a drag on our economy.

At some point the U.S. must stop accelerating its pace of borrowing. Even some politicians are now getting that picture and resisting the urge to spend freely. This slowdown in borrowing will end the growth in spending. While it may seem that the U.S. can borrow endlessly, there are reasons to be concerned that we might have already passed the point where we can honor our obligations. You may have read about the misleading accounting that kept the Greek problems hidden so long. The U.S. is only slightly better. The U.S. government keeps two sets of books. One is the one politicians talk about; they change the accounting rules for this set whenever it's convenient. The other set is based on generally accepted accounting principles (GAAP) similar to those required for businesses. Although this set is published, politicians don't talk about them and they're mostly ignored. The following are some interesting facts about the true liabilities of the U.S. government taken from the GAAP basis Financial Statements for the US Government for year ended 9/30/2009 (keep in mind that national income {GDP} is $14.6 trillion).

Liability Description	In Trillions	As % of GDP	As % of Govt. Revenue
Official Treasury Debt	$11.5	80%	520%
"Unified Budget Deficit" – a non-GAAP measure	$ 1.4	10%	60%
Present Value of Promised Social Security, Medicare, etc.	$45.9	310%	2,090%
Increase in Liabilities in fiscal 2009	$ 4.3	30%	200%
Fiscal 2009 gross borrowing from the public	$ 8.9	60%	400%

Source: http://www.fms.treas.gov/fr/09frusg/09stmt.pdf

Note that the 2009 information here, excludes the money being spent to prop up the mortgage market and the huge new heath care entitlement spending.

The report shows how to reconcile reality to the politicians' number – the Unified Budget Deficit. Let's just say it's Greek to me. In the real world, total liabilities increased by 30% of GDP – that is roughly double government revenue. It seems clear from these numbers that there is no chance the government will honor its existing social spending promises. These can and will be reduced when we reach the crisis stage just as Greece has. When that will happen we cannot say, but the threat is likely to cause congress to avoid increasing spending over and above the high level they've already set. Thus we cannot count on further economic growth coming from the government side.

Investor Behavior and Implications for Investing

As investors, our dilemma now is that on a fundamental basis our positions look great but the economy doesn't look so great. Other fundamental investors who were expecting uninterrupted growth are now concluding that their stocks are over-priced in the face of a recession and they are beginning to sell. As such selling becomes widespread, it sends a signal of a change in mood that gets picked up by short term technical traders. Sensing the momentum shift, they will stop supporting the market and the entire market will decline, including stocks that were not over-priced. The question is how much the market will need to drop before fundamental investors stop selling. And then - what price reductions will it take for fundamental investors to step back in to buy from technical sellers? It's hard to know because the technical traders add a lot of "noise" to the market with their gyrations in chasing what they think we think.

The standard procedure in such a market is to reduce risk by selling and holding the cash for the right time to buy back in. At Berkeley Investment Advisors we use a slightly modified version of this approach. Rather than selling individual stocks, we sell the overall market short using exchange traded funds. Thus we are buying insurance against a market decline – which we refer to as hedging. This allows us to reduce market risk. Then, if the market does decline, our insurance pays off and we have even more cash to invest when the market has reached attractive levels. In addition, since our individual stock picks tend to do better than the market over the long run, we should earn some returns even if the market stays stuck in a range for quite a while. Thus we plan to beat money market rates in a sideways to down market while preserving capital and staying flexible to take advantage when the big upside opportunities materialize.

As fundamental value investors we need to assess when prices are low enough (and therefore future returns are high enough) to justify removing our insurance and taking on the risks related to the recession. Still, even if the return for risk becomes more favorable, we don't want to miss the chance to buy at even cheaper levels. So we need some assessment of where trading action may take the overall market and by implication our positions along with it. In the end we'll never be able to predict the exact bottom so we must follow an incremental approach. If we look at the historical data on price to earnings ratios using 10 year average real earnings as we did in the March newsletter, we see that this P/E ratio hit 13.3 at the March 2009 low. So there seems to be significant value investor interest at this level. The long run average since 1926 is 17.4 and if we look at the 100 years ending in 1990 the average was 14.4.

Currently 10 year trailing real earnings of the S&P 500 index is 55.15 according to Robert Shiller of Yale University. So the current long run P/E is 18.9. Given that the private sector has never really recovered from the recession, it seems possible we could get back to a P/E of 13.3 in a very bad scenario. Because interest rates are quite low by historical standards, it's more likely we'll end up at a P/E in the range of 15 to 16. Of course, this implies much lower P/E levels for our own portfolio given our value investing style.

The above assessment implies that we want to maintain our defensive stance until the S&P gets to 880 and maintain some hedging until we either see economic improvement or the S&P goes all the way to 730. Admittedly this is not very scientific but that is the nature of predicting market reactions to recession news. The key to making good returns through the market turmoil is analysis, patience, and discipline. We'll keep risks low so we can stick to a fundamental value based strategy and not let the "noise traders" drive emotional investment decisions.

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