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2012 Second Quarter Review

I suppose we are getting used to the "new normal" when the list of crises-du-jour that we've experienced over the last quarter seems not all that remarkable. In Europe and the Middle East we have riots and revolution, in France and Greece we have elections between "austerity" (i.e. the nation pays its bills) and "growth" (i.e. it doesn't). In Greece, the "austerity" party won and the euphoria in the market was over in less than a day. J.P. Morgan's "whale" trader lost ~~$2 billion~~, ~~$4 billion,~~ almost $6 billion (most recent estimate) on a failed "hedging" strategy for the bank. Barclay's was found to have manipulated the "Libor" (London Inter-Bank Offered Rate), on which trillions of dollars of interest charges are based. The conservative Chief Justice of the Supreme Court provided the deciding vote in upholding the President's Affordable Care Act, and Facebook stock was finally sold to the public in one of the most highly-hyped stock debuts in years, only to fall by over 40% from the first days' trading price levels.

The second quarter was generally a tough one for stocks after a nice rally in the first quarter. The S&P 500 peaked on the first trading day April (at 1,419 on the S&P 500), then proceeded to drop over 10% from April 2nd to June 1st (to 1,274). A "summer rally" then set in, raising the indexes somewhat and reducing the quarterly decline to a little over -3% by June 30th. Still, the financial markets here in the United States kept their position as "the best house in a bad neighborhood." Of the 47 national stock markets around the world, only 7 have posted gains for the last 12 months. At the second quarter's end, the Dow Jones Industrial average was up over 5% for this calendar year, while bonds (as represented by the iShares 20+ year Treasury ETF) gained about 3%.

The underlying concern world-wide is, as usual, whether global economies are expanding or contracting, growing or slowing. By way of review, the simple explanation for our current predicament is that individuals, corporations, and banks (the private sector) ran up huge amounts of debt over the past decade or two, mostly based on an unsustainable real estate bubble. Since that bubble burst and the party was officially declared over, the private sector has been busy "deleveraging" and reducing debts to avoid being drowned by them. (Corporations now have record levels of cash.) Paying off debt and saving cash both mean that less money is available to spend on consumption, so economies started to tank. Central banks stepped in to prevent a replay of the Great Depression (when the central banks actually reduced the money supply) and vowed to avoid a "lethal debt deflation" by stimulating the economy with spending and liquidity funded by (you guessed it) increased debt. So the private debt crisis is now the public debt crisis and we are left to anticipate how it all might turn out.

Mr. Bernanke, chairman of the Federal Reserve is nothing if not a student of history. His area of expertise is the economic policies and mistakes of that terrible time that began with the Crash of 1929. It is accepted wisdom that the policies undertaken then were the opposite of what needed to be done to bring the economy back to life. In the choices that he has to make, Mr. Bernanke is committed to erring on the side of too much stimulus versus too little. He does not want to repeat the mistakes of the past.

Recently reported economic data show parts of the economy sputtering after the renewed optimism of the first quarter. Markets often move up or down (on the short-term) based on the reported data and what they might mean to the "tea leaf readers" of the financial world. But, rather than change from a growth strategy to a contraction strategy in reaction to the latest employment report, we keep in mind the possibility (some say probability) that we may just "muddle through." That is why we try not to jump into or out of investments based on the most recent market mood swing. That would also lead us to buy into the periods of euphoria (generally at higher prices) and to sell into periods of panic (generally at lower prices). Insulating oneself as much as possible from the psycho-drama of market forces is one of the most difficult tasks of an investor.

One of the most respected market strategists on Wall Street passed away a few days ago. Barton Biggs was a partner with Morgan Stanley when I first went to work on Wall Street. He had a long and storied career made possible by a facile intelligence that could digest the disparate trends and data to come up with a reasonable investment outlook in unreasonable times. He recently wrote, "As I reflect on this crisis period so stuffed with opportunity but also so full of pain and terror, I am struck with how hard it is to be an investor and a fiduciary." So, if you are frustrated and apprehensive about the economy and the investment climate, you are not alone. A kind of "investor fatigue" is theorized to be setting in. Short interest (those betting that the market will go down) recently hit an all-time high according to some measures. With serial international crises, the sounding of alarms by the 24 hour news cycle, and the volatile swings they bring in investments, many people are giving up and leaving the game entirely. However, Mr. Biggs knew very well the fact that whatever the market "should" do, it often wouldn't. He also warned against the Bernanke-like tendency to focus on a past economic event: "As investors, we also always have to be aware of our innate and very human tendency to be fighting the last war. We forget that Mr. Market is an ingenious sadist, and that he delights in torturing us in different ways." But a quote more fitting the philosophy of the man is probably:

"The history of the world is one of progress, and as a congenital optimist, I believe in equities. Fundamentally, in the long run, you want to be an owner, not a lender."

Our job will continue to be doing whatever we can to help you to own the right stuff.

Enclosed you will find your reports and statements. Please don't hesitate to give us a call with any questions, comments, or suggestions. We wish you an abundant and enjoyable summer.

Best regards,

Claude Carmichael CFA