July 12, 2010

2010 Second Quarter Review

The month of May sits right in the middle of the second quarter every year. This year there was nothing “merry” about it as the sell-off in financial markets produced the worst May for the Dow Jones Industrial Index in 70 years, and the worst May for the S&P 500 since 1962. That was a rude interruption of the advance that had previously proceeded much more genteelly from the lows of March 2009. Fortunately, a spirited rebound appears to be in place with the averages recovering quickly so far in July.

By the end of the second quarter the Dow Jones Industrial Average was down 6.27% for the year, the Nasdaq down 7.05%, and the S&P 500 down 7.57%. Bonds generally rose in value during the quarter as international investment funds fled troubled Greece and Spain for the relative strength of the United States. Fears of a slow recovery or a “double dip” recession, shaky European banks, financial reform legislation, and slower Chinese growth, as well as the economic, environmental, and psychological impact of the BP gulf disaster all weighed on investors minds, spirits, and pocketbooks. It was a good time to be playing defense.

Our equity exposure has not been overly aggressive. Even so, we jettisoned a few positions that appeared to be vulnerable to a weakening economy. Volatility has increased lately and there is much talk that it may be the effects of “high frequency trading” that we are seeing. This is not your average day-trader playing his hunches, but institutions and hedge funds with large pools of money buying and selling a very few of the most liquid stocks, using algorithms to automate the trades, and trying to make, literally, a penny here and a penny there. Acting in concert, these funds can produce swings in those few large stocks that can have a large effect on the stock market indices, which in turn effect the futures contracts and leveraged ETFs (exchanged traded funds) based on those indices. Although regulators are looking at these practices, there is nothing illegal about them. We should just be aware of the other sharks and whales that are swimming in the tank with us dolphins (or minnows?)

One of the more interesting questions before investors is whether inflation or deflation will be the wave of the future. Milton Friedman, the dean of the monetarist school of thought in economics, famously said that inflation is “always and everywhere a monetary phenomenon.” That is, inflation is caused by excess supply of money. Dr. Friedman taught at the University of Chicago, but he was also a partner at Oppenheimer and Co. when I was a young lad there learning the ropes. Although I didn’t learn at the master’s knee, I was at least exposed to some of his work and it is not as simplistic as some might suggest. Most authors and newsletter writers are currently making the case for inflation based on the easily understood argument that the government is creating a tidal wave of dollars in an attempt to bail out the economy. What is not so easily understood is that dollars are also “destroyed” in defaults and credit contractions like the one we’re having. That’s why Bernanke et al believe they must create dollars to counteract the effects of defaults and foreclosures, as well as reduced lending, all of which are deflationary. Surprisingly enough, the “monetary base” (the sum of currency and bank reserves) has declined by 8% since February (when the Fed stopped buying mortage-backed securities under their emergency powers). Estimates of the broader-based measure of money that used to be called M-3 show that it has fallen by 7.6% in the past three months. Both measures of money supply have recently been *fallin*g at an annual rate of 24%. Many investors wonder why inflation has remained so low thus far, with a rise of only .9% in the core CPI (consumer price index) over the last 12 months even while the government has printed so much money. The answer may be that the countervailing forces of debt repudiation and credit contraction have soaked it all up.

Current inflation levels have stayed tame according to the CPI. But, the price of gold shows that investors are worried about the future. I do believe that Bernanke et al are committed to fighting deflation, even to the extent of reigniting inflation. This will probably take more time to play out than the dollar doomsayers and newsletter writers currently predict. Eventually, however, we will likely have to deal with the inflationary consequences of the Fed's recent actions. There is also the possibility of a Fed Intervention Phase II if the economy falters. Bernanke has promised to print as much money as necessary. We'll have to wait to see how much that turns out to be.

Right now there appear to be opportunities in "blue and gold," by that I mean blue chips and inflation hedges. Jim Grant recently pointed out that "the equities of well-financed, high-yielding, U.S. multinationals are selling at some of the lowest valuations in years." Jeremy Grantham, another well-regarded value investor, holds a similar opinion. We have continued to take positions in those kinds of equities that can provide a good current yield and also raise prices in an inflationary environment. In essence, we get paid while we wait. Precious metals are a "sterile" asset, in that they provide no income. They are of benefit to us only if their prices rise. Companies that mine precious metals can provide an "earnings yield" as well as appreciation if the price of the metal rises. For that reason, we favor a mix of assets that benefit from inflation without necessarily holding large positions of bullion through exchange-traded funds or direct ownership. There is the temptation when investing to make "all-in" bets when conviction is high. "Gold Bug" newsletter writers often take this position and encourage others to do the same. However, these types of strategies often end in pain as both *the direction and the timing* of the move must be correctly anticipated. That is not an easy thing to do. Seasoned investors remain wary of market gurus who have been "right one time in a row."

Slower economic activity has allowed interest rates to stay low and bonds to do fairly well recently. However, yields are so low that if rates begin to rise, bond investors will quickly be underwater. Accordingly, we will remain underweight in that asset class. We will continue to balance blue chips with inflation hedges and "deep value" stocks in the equity portion of our portfolios to take advantage of the changes that are coming in the investment world.

Enclosed you will find your statements and reports ending the second quarter. Please review them at your leisure and give us a call if you have any questions or suggestions. Otherwise, I hope you enjoy the rest of this beautiful (and hot) summer.

Sincerely,

Claude Carmichael CFA