

## **Bumping Along the Bottom: How Down Cycles End, Up Cycles Begin**

Since its panic-induced decline in early August, the market as measured by most indexes has been in a see-saw pattern for the past ten days or so. Various commentators have debated whether we are entering a second recession or if we ever left the last one. Program traders have had a field day driving the market down 500 points and then reversing the same in the blink of an eye. All this time the general public has become adverse to the fluctuations and has started pulling out of the market in droves. Mutual fund redemptions, which are considered a proxy for public participation, has reached levels not seen since 2009.

Such behavior (except for the program traders) is typical of market bottoms. In truth, the public has a dismal record for calling the market. Several studies done by the firm of Dalbar Associates have shown public returns in stocks running at a small fraction of the returns from market indexes. The reason for this under-performance is essentially that the public tends to get into markets at the top and out at the bottom. It is always easier to invest in something when those around you are doing the same. To do the opposite is where the real money is made.

A few fundamental facts: the Government Index of Leading Economic Indicators is hitting new highs. Typically, this index turns down six months before an expansion begins. The Federal deficit is tracking to be lower than forecast, in spite of the effects of the doomsday speeches given by politicians trying to influence the expenditures of government. Outside of Europe (which is undergoing a banking crisis similar to what the US went through in 2008), the rest of the world is doing quite well.

Adding to this list are two additional caveats. Corporations are buying back their own stock at a record pace, which tends to shrink supply. Officers of public companies are buying stock in their own firms at a very high level. If earnings were truly at risk, it would be the executives who would be most aware of it and sell or even not buy stock in their firms.

Finally, there is the question of time frame. Investing in stocks should be, at a minimum, a three- to five-year commitment. It can take this long to determine if an investment strategy will bear fruit. Speculators have far shorter time horizons. Program traders consider holding a position beyond a day to be long term. Using powerful computers, program traders try to exploit second by second trends in stock trading. Often a stock is bought and sold in less than a minute. When trading in this fashion, what the company does is of no consequence. What matters are the patterns of trading where stocks can be purchased and then sold based on perceived predictable movements. Since the price of a stock is based on its most recent trade, the result of the speculators moving into and out of stocks is to create gyrations that the investing public finds disconcerting.

The original purpose of the stock market was not to indulge speculators. It was to raise capital for corporations which would in turn create jobs and revenues for the country at large. In the early days stocks moved based on the predicted dividend to be declared by the board for the common shareholders. In those days dividends fluctuated based on profits in a given year.

There was a great deal of manipulation that took place as the stock market grew. Characters such as Jay Gould and Elliott Fisk would try to organize “corners” and “bear raids” on stocks in an effort to drive the price up or down as suited their interest. After the stock market crash of 1929 several rules were put in place to discourage short selling, over-leveraged margin buying and other tools of market manipulation.

Nowadays, in the name of “reform”, many of the rules imposed have been effectively lifted. There are no restrictions on short sales, giving speculators the ability to create unlimited supplies of stock for brief periods. Margin requirements are relaxed for hedge funds which have direct access to bank lines. The reason for these changes has to do with who benefits: the exchanges and the brokerage firms that profit from the volume and the lending.

Eventually something will happen to again turn the tide. Until then, investors can focus on value as opposed to price movements to find bargains left behind by others. The economic outlook is not as dire as people make it out to be. Besides, those who wait for clear skies will miss most of the upswing. They always do.

## **The Economy**

As mentioned previously, the most bullish indicator is the Index of Leading Economic Indicators published by the Department of Commerce. There has not been a recession in the past 50 years since the Index was designed that was not preceded by at least a six-month decline in the LEI.

Having said that, the economy has slowed down. Part of the slowdown is attributed to the supply disruptions due to the earthquake in Japan in April. Another part is the antics of politicians during the debt ceiling debate. Their conduct triggered a crisis of confidence that is still reverberating to the point where people will not shop for homes, even with the lowest mortgage rates in two generations.

It is expected that the Federal Reserve meeting in Jackson Hole, Wyoming going on this weekend will address the need for a jobs program, especially in the area of public works. Whether this will take the form of an infrastructure bank along the lines of Fannie Mae or be more integral to the budget is not known at this time. The goal of such a program will be to increase employment, especially in construction, and restore public confidence.

## **Inflation**

Since last month there have been some signs of inflation in the Government data. Higher prices for light trucks and transportation caused the inflation index to come in at just under three percent on a trailing twelve-month basis.

Truck prices were firmer due to the supply disruptions caused by the Japanese earthquake. This should be reversed in the second half of the year. Transportation costs were driven higher by oil prices that have since declined. It is expected that inflation will be running at two percent or less by year-end. With unemployment at current levels, there is not much impetus to raise prices due to wage pressures.

## **Interest Rates**

With the most recent round of easing, the Federal Reserve has indicated that interest rates will remain at historic lows at least until sometime in 2013. While this announcement condemns risk-adverse savers to little or no return on their capital, it will hopefully offer borrowers an inducement to buy goods that will contribute to an economic revival.

Looking out beyond 2013, it is obvious that the volume and terms of cash creation will lead to a round of inflation at some point. Except for bonds whose returns reach towards the neighborhood of ten percent, the ability of bond investments to address inflation is not good. At this time the most vulnerable investment would appear to be low-yielding Government bonds.

## **The Stock Market**

The market has sustained a great deal of stress this month. The debt ceiling debate without clear resolution, the slowdown in the economy from any number of disasters, and the doomsday forecasts that seem to come out of the woodwork whenever the market heads south have all hammered investors' resolutions. Add to it the elaborate game of chicken played by program traders and it is no wonder investors are confused and upset.

It bears remembering that the difference between investing and speculating is, among other things, one of time frame. As confidence returns and the economy looks more attractive, people will begin to treat this period like 2008-9, but without the substance. A lack of substance is what characterizes panics, be they financial or otherwise. Like its opposite, euphoria, panics are not sustainable over time. They tend to disappear as fast as they came. In the end people wonder why they took them so seriously.

Warren M. Barnett, CFA  
August 26, 2011

© 2011 Barnett & Company