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Investment Strategy
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Rumours

"Rumours," yet I am not talking about the 1977 smash album by Fleetwood Mac, but rumors that I heard while watching last Thursday's Tumble. The two most credible were: 1) A major rating agency is going to downgrade the U.S. credit rating; and 2) A major institution is in trouble and is being forced to liquidate its portfolio. Obviously, one was right and the other wrong as late Friday Standard & Poor's downgraded our nation's debt rating to AA+. And, "There is no joy in Mudville – mighty Geithner has struck out," as our Treasury Secretary has repeatedly declared, "There is no chance the U.S. will lose its top credit rating." Such statements have left a bevy of cries for Secretary Geithner's removal fostering at least the illusion of a shakeup in the country's financial course. While it is doubtful Timothy Geithner is even marginally responsible for our debt debacle, in politics it is all about "illusions." In fact, the current national malaise reminds me a lot of President Jimmy Carter's 1979 "Crisis of Confidence" speech. If you have five minutes, click here: (http://www.youtube.com/watch?v=1IlRVy7oZ58).

So what are the implications of Friday's downgrade? While it will likely take weeks for that question to be answered, as of this writing the answer seems to be "not much." That "consensus call" is based on what happened to Canada, Australia and Japan when they lost their AAA status. The result was only a minimal economic impact in those countries. That said, we are not so certain that will be the case here given our nation's reserve currency status and the fact there are so many other financial instruments geared to U.S. Treasuries. As our economist Dr. Scott Brown writes:

> "It should go without saying that nobody knows precisely how things will unfold from here. One issue is that while S&P downgraded, Moody's and Fitch have not. Some have suggested that a downgrade would lead to higher borrowing costs for the U.S. However, we haven't seen much of an increase in bond yields in other cases where sovereign debt was downgraded. Treasuries are still considered to be the "safe" asset – so, I wouldn't expect a big increase in Treasury yields. The bigger concern will be second and third round effects through the financial markets. Downgrades to agency debt (Fannie Mae, Freddie Mac), a number of states, and municipalities will follow on Monday. Money market outflows are likely to increase (as people move to insured bank deposits). The Fed is likely to move to support the money markets (as they did during the financial crisis) and may set up other liquidity facilities. In issuing guidance to banking organizations for risk-based capital purposes, the Fed indicated that risk weights for Treasuries and agencies will not change. Still, a number of banks have large holdings of agency debt and may be inclined to increase capital and tighten loans for consumers and businesses. We'll have to wait to see how markets react and what the expectations are for U.S. equities."

Accordingly, we wait to see the economic impact of recent events while contemplating Soren Kierkegaard's sage words, "Life can only be understood backwards; but it must be lived forwards."

So what do we think we know about "living forwards"? Well, while I didn't believe it was going to happen, the D-J Industrial Average (DJIA/11444.61) confirmed the D-J Transportation Average (TRAN/4693.59) last week when both of those indices broke below their respective March 16, 2011 closing reaction "lows," thus rendering a Dow Theory "sell signal." It was the first such "sell signal" since November 21, 2007. Unlike the November 2007 "sell signal," this one came at much lower valuation levels and following a nearly 11% decline since the selling stampede began on July 8, 2011. Recall, however, that selling stampedes typically last 17 – 25 sessions with only 1 – 3 session pauses/corrections before they exhaust themselves. Last Friday was session 21 in the selling skein making this decline long of tooth. Also of note is the Dow's Dive has left the NYSE McClellan Oscillator more oversold than it has been in years; likewise the percentage of stocks above their 10-day moving averages dropped to 0.79%, the lowest reading (most oversold) since 1991. As the "must have" InvesTech Financial's astute James Stack writes:

"On today's close [8-4-11], our short-term Pressure Factor hit an extraordinary oversold -169 (normally, -80 is an 'extreme' oversold reading). There were only six occasions in the past 60 years when the Pressure Factor has dropped below -160. . . . None of those instances saw the S&P even 1% lower one week later. Only one instance saw the market negative one month later – last summer which marked the correction bottom. And interestingly – perhaps coincidentally – 5 of the 6 saw the market up over 19% twelve months later. *Such oversold extremes typically do not mark the beginning of a bear market."*

While I certainly hope Mr. Stack is correct, I must admit the Dow Theory "sell signal" concerns me. Still, the bone-crushing decline since early July has used up so much energy (read: extremely oversold) making it is reasonable to expect a "throwback rally" from

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some sort of stock market low. Indeed, just like you can only press down on a spring so far before you get a “boing” bounce back, the same is true in the equity markets. Moreover, I think the recent rout is more about the aforementioned “Crisis of Confidence” environment than the fundamentals. To be sure, as of yet there is no economic evidence the country is sliding into recession -- slow growth, yes; recession, no. That view is reinforced by the Yield Curve, which has been one of the most reliable predictors of recessions. To wit, every recession for the past 50 years has been preceded by an inverted Yield Curve (short-term interest rates above long-term interest rates). Currently, the Yield Curve is very steeply sloped as can be seen in the chart on page 3 from our friends at the Bespoke Group. In fact, the U.S. has the steepest sloped Yield Curve of any I can find.

Meanwhile, we are wasting a terrific earnings season with 61% of the companies reporting beating estimates, while 68% beat revenue estimates. The result has left the S&P 500’s (SPX/1199.38) earnings estimates for this year nestled around $100 and pushing towards $114 for 2012. If those estimates prove correct, at last week’s intraday low (1168.09), the SPX was trading at a PE multiple of 10.3x next year’s earnings, with an Earning’s Yield of ~9.8% ($114 ÷ 1168), leaving the Equity Risk Premium for stocks at ~7.4% (Earnings Yield – 10 year T’note yield of 2.4%) for the highest ERP in a generation. This implies either earnings estimates are too high (I don’t believe it), the country will slide into recession (I don’t believe it), or stocks are undervalued (my position). Hence, if you did not raise some cash last February – March as recommended, I think it is a mistake to do so here since we should get some kind of rally either off of last week’s low, or a low early this week. In that rally, it will be important to monitor the market’s internal metrics with an eye towards pruning underperforming stocks from investment accounts. While my hunch is last week’s Dow Theory “sell signal” will prove false, like the one that occurred during May 6, 2010’s “Flash Crash,” I would still tread carefully “living forwards.”

The call for this week: For weeks I have stated that a credit rating downgrade was a *fait accompli* and possibly already discounted by the markets; this morning that doesn’t seem to be the case with the pre-opening futures down ~30 points. Whatever the various markets’ near-term reaction, the fact is that everyone is merely offering their intelligent guesses as to the outcome of this historic “downgrade” event. One thing I do believe is what I wrote last week, which is likely a catalyst for the downgrade (as paraphrased):

“While I don’t embrace the Tea Party, their ‘sea change’ is palpable. Nowhere is this more apparent than the current Debt Ceiling debate. The Tea Party seems to have surfaced our nation’s ‘political corruption,’ which hinders the proliferation of prosperity. Interestingly they are not the first, for such thoughts were first scribed by Adam Smith in his book *The Wealth of Nations* (1776). Whether you like, or hate, the Tea Party, there is definitely a palpable change afoot that over the long-term could be extremely bullish for the economy, the stock market and our country.”

In conclusion, I leave with these thoughts from legendary investor Jim Rogers:

When asked how he made his money, Mr. Rogers answered, “I sell euphoria and buy panic.” The way he determines that is to wait until prices are “gapping” in the charts. Gapping on the upside is “euphoria,” while gapping on the downside is “panic.” Currently, gold and Treasuries are gapping on the upside; and, stocks are gapping on the downside. The implication, even though I believe gold is in a secular bull market, suggests partial positions should be sold in precious metals and the freed-up cash should be used to “buy” fundamentally sound stocks with decent dividend yields. Obviously, the weeks ahead will determine if this is the correct strategy. All said, IMO it is too late to panic. The time to panic, and raise cash, was months ago (we did). Now it is time to selectively redeploy that cash into select equities.

P.S. – I am in Chicago this week speaking at conferences, seeing institutional accounts, and presenting at seminars for our Financial Advisors. Hence, I leave you with Vladimir Lenin’s quote, “There are decades when nothing happens; and, there are weeks when decades happen!” Clearly, the past few weeks “speak” to that quote, even though it wasn’t intended for the stock market! Accordingly, we are buyers on weakness in select equities . . .

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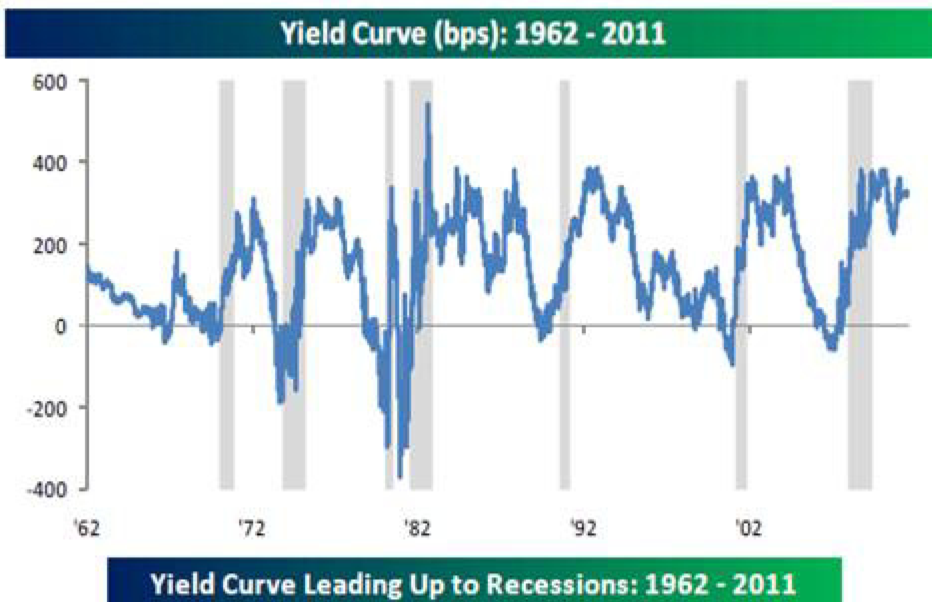
The slope of the yield curve has historically been one of the most reliable predictive indicators of a looming recession in the US economy. While not every inverted yield curve (3-month yield greater than 10-year yield) has led to a recession, every recession since 1962 has been preceded by an inversion in the yield curve. As shown in the chart and table below, given the fact that the yield curve remains at historically high levels and hasn't been inverted since August 2007, if the economy was on the verge of a recession, this would be the first recession in fifty years that was not preceded by an inverted yield curve. Granted, this time could be different as the last several years have been unique by practically every measure, but it is one factor to consider in assessing whether or not the current slowdown will in fact morph into a contraction.



Source: Bespoke Investment Group

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