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Investment Strategy

"Character"

"The true prophet is not he who predicts the future, but he who reads history and reveals the present."

. . . Eric Hoffer, American moral and social philosopher

I could almost hear my history teacher espousing Eric Hoffer's words last week as I was asked by a particularly prescient media type if trust and character would really command a "premium" price/earnings multiple for the stock market? My response was "of course," and as an example I referred him to a quote from John Pierpont Morgan, who built his family's fortunes into a colossal financial empire. The referenced verbal exchange took place when an aging J.P. Morgan testified before a House of Representatives' committee investigating the financial interests of the "House of Morgan." A tough lawyer named Samuel Untermyer queried him. The conversation went like this:

> Untermyer: "Is not commercial credit based primarily upon money or property?"
>
> Morgan: "No sir, the first thing is character."
>
> Untermyer: "Before money or property?"
>
> Morgan: "Before money or property or anything else. Money cannot buy it . . . because a man I do not trust could not get money from me on all the bonds in Christendom."

While Morgan's language is from an era gone by, the essential insight is as clear today as it was decades ago. I recalled the Morgan/Untermyer exchange as I read Friday's *Wall Street Journal,* in particular, "Robbery at J.P Morgan." The article began, "Government lawyers are backing up the truck again at J.P Morgan Chase (JPM/$52.24/Strong Buy) to extract another haul from the country's largest bank." Recall that JPM is one bank that did not need taxpayer assistance during the financial fiasco of 2008, or ever since. To me that speaks volumes about the character of JPM's CEO, Jamie Dimon. This lack of government dependence, combined with Mr. Dimon's remarks about how the Dodd-Frank financial reform act is hurting the economy, is likely what put Mr. Dimon in the government's crosshairs. This also explains why the government is beating up on JPM again over the "London Whale's" $6 billion trading loss, even though there were NO public costs. The irony is that Jamie Dimon is one of the few bank CEOs who avoided the credit excesses. He also, at the pleading of the government, rescued Bear Stearns and Washington Mutual (WaMu). Then-FDIC Chairperson Shelia Bair said, "[The WaMu situation] could have posed significant challenges without a ready buyer. . . . Some are coming to Washington for help; others are coming to Washington to help." Now it appears Washington is suing JPM for helping. I have no doubt about Jamie Dimon's character. I do, however, doubt the character of some of the folks inside the D.C. Beltway, on both sides of the political equation, who are about to close down the government.

As of this writing, it looks like a governmental shutdown is a *fait accompli*. But having lived in D.C., many times these things are over-dramatized. Tonight marks the end of the U.S. fiscal year and without an agreement on a "continuing resolution" (CR) the government will indeed shut down at midnight. Following that comes the much more important "debt ceiling" debate to prevent a U.S. Treasury default on October 17th. Since 1970 there have been 17 "shutdowns," and guess what, we have survived every single one of them. Interestingly, the stock market has historically done worse the day and week after the shutdown than it did leading up to the event. Moreover, in 11 of those 17 instances the S&P 500 (SPX/1691.75) was higher one month later. Like I did with all the "tapering" noise, I tuned out the noise (hints, leaks, etc.) and paid attention to the data, not the rumors; I am doing the same thing here. That "tuning out the noise" was why I was adamant there would be no tapering at the September FOMC meeting. I think the same holds true with this "shutdown" and/or "default" situation. The way Washington works is all about political interest and political survival. As Senator John McCain told the *New York Times* last week, "We will end up not shutting down the government, not defaulting and not defunding Obamacare. I've seen how this movie ends, but I don't know all the scenes." Speaking to this "political interests/survival" issue, the President is not up for election again, the Senators and Congress folks are. It's pretty easy to figure out who wins that game of chicken. Moreover, the budget deficit is collapsing at a much faster rate than even the non-partisan CBO suggests. That trend reduces support for tax increases and spending cuts. As the astute GaveKal organization notes:

Please read domestic and foreign disclosure/risk information beginning on page 4 and Analyst Certification on page 4.

> The big spending reductions implemented since the 2011 budget crisis have left little scope for further significant reductions in discretionary spending. Fiscal conservatives now recognize that the only programs large enough to transform the budgetary outlook are Social Security, Medicare and defense – but these programs tend to be strongly supported by elderly and conservative voters. That, in turn, implies a political transformation. The Republicans are no longer trying to extract major spending reductions in exchange for their budgetary votes. . . . Republicans are now using budget votes to advance a political cause, the abolition of Obamacare, which is purely symbolic because it offers no scope of compromise with the President and therefore no chance of enactment.

Understanding these points makes the upcoming battle predictable. Rather than destroy our country's credit with a default, and a long-term closing of the government, this charade will be resolved over the next few weeks. The Republicans, rather than be blamed for the whole thing, will "cave" and the shutdown/debt ceiling issues will be resolved just like what happened with the "fiscal cliff," which at the time I said was also a non-event. While this is not as much of a non-event, we will get through this, just like we got through what the media termed the fiscal cliff "Armageddon." When we do, the equity markets may do what they did following the drama of the alleged fiscal cliff "crisis"; the SPX rallied 100 points before experiencing a decent pullback.

The call for this week: I am in the Washington D.C. area consulting with political types, seeing accounts, and speaking at events for our financial advisors. I began this commentary with the quote, "The true prophet is not he who predicts the future, but he who reads history and reveals the present." If you study the history of governmental shutdowns, there have been 17 of them since 1970 (see chart on page 3), and it becomes clear the shutdown and potential default will get settled over the next few weeks. If so, the stock market's attention should revert to the improving economy, gasoline prices at their lowest level since January, improving earnings, better economic numbers out of China, well you get the idea. Interestingly, it has been the mega cap stocks that have been the weakest, which is why the D-J Industrials (INDU/15258.24) has been weaker than most of the other major indices. I still think the near-term directional battle will be fought at my longstanding 1684 "pivot point" basis the SPX. This week should provide the answer. One of the good things about the recent decline is that you get to see which sectors are holding up the best. Based on my methodology, Financials, Industrials, Consumer/NONCYC, and Consumer/CYCLIC are currently the strongest sectors. This morning, however, it looks like the opening prices are going to slice right through my 1684 "pivot point." But, it is the closing price that counts. Fortunately, you should still have a decent cash reserve since I recommended only recommitting a little of our cash three weeks ago.

S&P 500 Performance Before, During And After Government Shutdowns

Study period: 1970 - 2013 *sentimenTrader.com*

Shutdown Start	Shutdown End	# Of Days	AIM Model	Week Before	During Shutdown	1 Day After	1 Week After	1 Month After
09/30/76	10/11/76	10	64%	-1.6%	-3.4%	-0.8%	-0.2%	-2.8%
09/30/77	10/13/77	12	20%	1.6%	-3.2%	0.1%	-0.8%	2.7%
10/31/77	11/09/77	8	0%	0.8%	0.7%	1.9%	2.7%	0.7%
11/30/77	12/09/77	8	17%	-1.3%	-1.2%	0.0%	-0.3%	-4.2%
09/30/78	10/18/78	17	36%	0.7%	-2.0%	-1.2%	-3.2%	-6.7%
09/30/79	10/12/79	11	0%	-1.0%	-4.4%	-1.1%	-2.8%	-0.9%
11/20/81	11/23/81	2	74%	0.0%	-0.1%	1.6%	3.7%	0.6%
09/30/82	10/02/82	1	62%	-2.7%	1.3%	-0.4%	7.4%	11.1%
12/17/82	12/21/82	3	65%	-1.5%	0.8%	0.2%	1.9%	5.5%
11/10/83	11/14/83	3	28%	0.6%	1.3%	-0.7%	-0.3%	-2.0%
09/30/84	10/03/84	2	34%	0.3%	-2.2%	0.3%	-0.2%	3.1%
10/03/84	10/05/84	1	10%	-2.3%	0.1%	-0.3%	0.9%	3.6%
10/16/86	10/18/86	1	8%	1.6%	-0.3%	-1.2%	-0.2%	1.8%
12/18/87	12/20/87	1	43%	5.9%	0.0%	0.2%	-1.4%	-2.6%
10/05/90	10/09/90	3	23%	1.8%	-2.1%	-1.5%	-2.0%	0.3%
11/13/95	11/19/95	5	60%	0.7%	1.3%	-0.5%	0.2%	2.0%
12/15/95	01/06/96	21	50%	-0.2%	0.1%	0.3%	-2.4%	4.0%
10/01/13	-	-	40%	-	-	-	-	-
Median		**3**	**35%**	**0.3%**	**-0.1%**	**-0.3%**	**-0.2%**	**0.7%**
% Pos				**59%**	**47%**	**41%**	**35%**	**65%**

Source: sentimenTrader.

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