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Trusted Advisor

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Bear Roars as Energy Shock Tackles a Stumbling Economy

What began as a bursting housing bubble, then spreading to the credit markets, is now widening into an inflation fueled recession from which few parts of the nation are immune. Deep injury to credit availability began in early 2007 with the implosion of Orange County's *New Century Financial*, then infected lenders throughout the globe. Tight credit has decimated real estate valuations, both residential and commercial, in formerly overheated markets, with the fall accelerating in recent months. Still, there appeared to be hope that certain sectors, the oil patch, agriculture and even reviving US manufacturing exports, would keep the economy growing, albeit slowly. Now it appears all but certain to me that the Commerce Department will report that the economy lost ground last quarter.

There is no escaping the fact that the financial markets have followed the residential real estate market into bear market territory, with the Dow Jones Industrial Average off 20% since its all time high recorded October 9, 2007. Investors still want to pick up bargains, but the pickings appear slim. Most bear markets last about a year, but I am now concerned that this one could be longer. After all, soaring energy prices act like a tax increase, robbing consumers of buying power. This is the last thing we need at a time when consumers, feeling "house poor" are already curbing their spending. To top off this dark picture, an election is in the offing. Whoever wins, a new, significantly different collection of players will be quarterbacking fiscal policy, and fiscal policy is, it appears, in need of a radical shift.

This is because the Federal Reserve, having lowered interest rates to below zero in real terms (2% minus inflation of 4% = -2%) is nearly out of ammunition. While having successfully headed off the collapse of a Wall Street giant in March, thus averting panic, more is now needed, at least according to a significant number

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of economists. On July 8, Ben Bernanke, Federal Reserve Chairman, asked Congress to expand the power of the Fed to extend credit to investment banks, formalizing the action taken with regard to financing the rescue of *Bear Stearns* by JP Morgan in March of this year. The stock market rallied on this news, but I see it as a veiled suggestion that there will be other big investment banks and commercial banks getting into trouble and in need of help. This is hardly the scenario for a sudden turnabout into a bull market.

At the same time, bond yields rose during the quarter (see graph page 3), a counter-intuitive move. Why would bonds rise, in the face of a faltering economy, slowing demand for credit and with the Federal Reserve trying to make easy credit available and avert a recession? I suspect that our foreign benefactors, the big buyers of US Treasury debt, are less enthusiastic about owning an I.O.U. denominated in a currency that has collapsed. To protect themselves, they simply reduce bidding until interest paid on bonds rises.

There is danger in this: if the cost of money is driven higher at the same time that lending standards have been tightened, how will the economy be revived? If the Fed were to lower interest rates further (and they really only control short term rates), this may drive the dollar even lower internationally, further repelling bond buyers, and driving long term interest rates (which the free market controls) even higher.

Two economic observers from opposite ends of the political spectrum, Robert Reich, Labor Secretary under President Clinton, and Bill Gross, portfolio manager for PIMCO Total Return fund (AKA "The Bond King") have recently opined that the only solution to our economic doldrums will be massive government spending. This is the classic Keynesian response that has pulled the US out of recessions since the 1950's. Congress is the primary engine of fiscal stimulus, but often requires leadership from the Executive branch. There, as in so many other areas, leadership is in short supply. Thus Bill Gross holds little hope for action until a new Congress and Administration are seated in January. This, in turn, implies little hope of stimulus until mid 2009. Taking into account the normal lag between fiscal stimulus and economic results, the economy may not regain its footing until 18 months from now!

Our Client Accounts Are Holding Up

During the quarter just past, we used a rally that began in mid March to trim what appeared to be vulnerable positions. We also took advantage of outstanding buying opportunities in the following areas:

1. A fertilizer company, which rose over 25% in the quarter

2. A Foreign mutual fund representing a resource rich nation, which rose about 4% in the quarter

3. An investment grade bond from a distressed financial company, paying over 11% yield to maturity. Although the bond lost value after purchase, the issuing company reported success in continuing to raise capital to fund operations, and we continue to rate it a "buy"

4. We made our first purchase in seven years of a software company, which dominates the business-to-business arena. The stock rose during the quarter but fell to "unchanged" in the last few trading sessions.

We have entered a climate of fear on Wall Street and, it seems, on Main Street as well. To illustrate how negative market psychology has become, even our most defensive holdings, a consumer goods manufacturer and two beverage producers were marked down. Fortunately, our large position in a highly stable international stock mutual fund fell only marginally. Losses, both realized and unrealized, were largely offset by rising commodity related holdings.
The upshot: most clients surrendered only a modest portion of their assets during a tough quarter.

While we are hanging tough with defensive issues, bonds and a high allocation to cash (money market funds) we also took some counter intuitive actions this past quarter: <u>we reduced exposure to energy stocks</u>. With oil and gas prices soaring throughout the month of June, few if any major energy company stocks achieved new all time highs. I noticed this with Exxon Mobil last year, which is why we exited the stock in November, booking a large profit for nearly all holders. Despite an oil and natural gas price rise of 50% since then, XOM still has failed to price above its highs of late last year! What's wrong with this picture? I happen to believe it has something to do with politics. The landscape in Washington appears destined to change radically this fall. Democrats are poised to pile up strong majorities in both houses of Congress, as well as capture the Presidency. A favorite whipping boy of the Dems are the oil companies. Already, grandstanding has been going on with politicians wagging their fingers at oil executives during hearings staged to play on the nightly news. Having watched this charade for over thirty years and during past oil crises, I'm well aware of three facts:

1. Washington is hugely responsible for the inefficiencies that have led to the current oil crisis.

2. In the short run, the politicians can do absolutely nothing to stop rising prices, because these are set by nations who we may not control and by forces of the free market.

3. Until new production comes to market, only a drop in consumption will bring supply and demand into balance.

Congress appears likely to satisfy popular resentment against oil companies by raising taxes on the oil producers. Money that might be invested in exploring for new wells will likely be siphoned off to fund pork barrel projects. This in turn will hurt net profits in the oil patch. Since stocks today are valued based upon expectations of future cash inflows, if those profits are reduced by the government, the present value of energy company stocks will be negatively impacted.

Bear Market Performance Report

Having reviewed a large number of portfolios, I'm glad to report that we have successfully stemmed most client losses through diversification and defensive portfolio management. Let's consider that since it achieved a record high on October 9, 2007, at 14,164.53, the Dow Jones Industrial Average has shed about 19% in value as of June 30, 2008. The majority of our discretionary managed portfolios lost less than 5% over the same period. Our goal for clients is to capture about 80% of the stock market's gains while suffering no more than 50% of the market's losses. Our long term record, and that for the current bear market, have exceeded this goal.

Below and to the right are some charts of major indexes to help you see the big picture a little better.

10 Year Treasury Bond Yields
(rising bond yields mean falling bond prices)

Dow Jones Industrials