

A Special Report May 6th, 2011

Party(ing) Like it's 1999

In 1982, the “Artist Formerly Known as Prince” released his album, *1999*, whose title track was an apocalyptic tune with rather foreboding lyrics that may have strangely presaged the last months of the secular bull market we were then enjoying, a nineteen year bull run that coincidentally began the year of the album’s release.

“I was dreamin’ when I wrote this. Forgive me if it goes astray.
But when I woke up this mornin’, coulda sworn it was judgment day.
The sky was all purple. There were people runnin’ everywhere. Trying to run from the destruction.
You know I didn’t even care, cause they say two thousand zero, zero party over.
Oops, out of time. So tonight, I’m gonna party like its 1999.”

Prince may not have known what was coming, and he probably wasn’t singing about the equity markets, but I can’t help wondering if bullish market participants “partying” in the equity markets today may be oblivious to a coming “storm” that could remind us of a couple we’ve experienced during the past decade.

As this is written, equity markets continue the strong upward surge initiated in the fourth quarter of 2010.

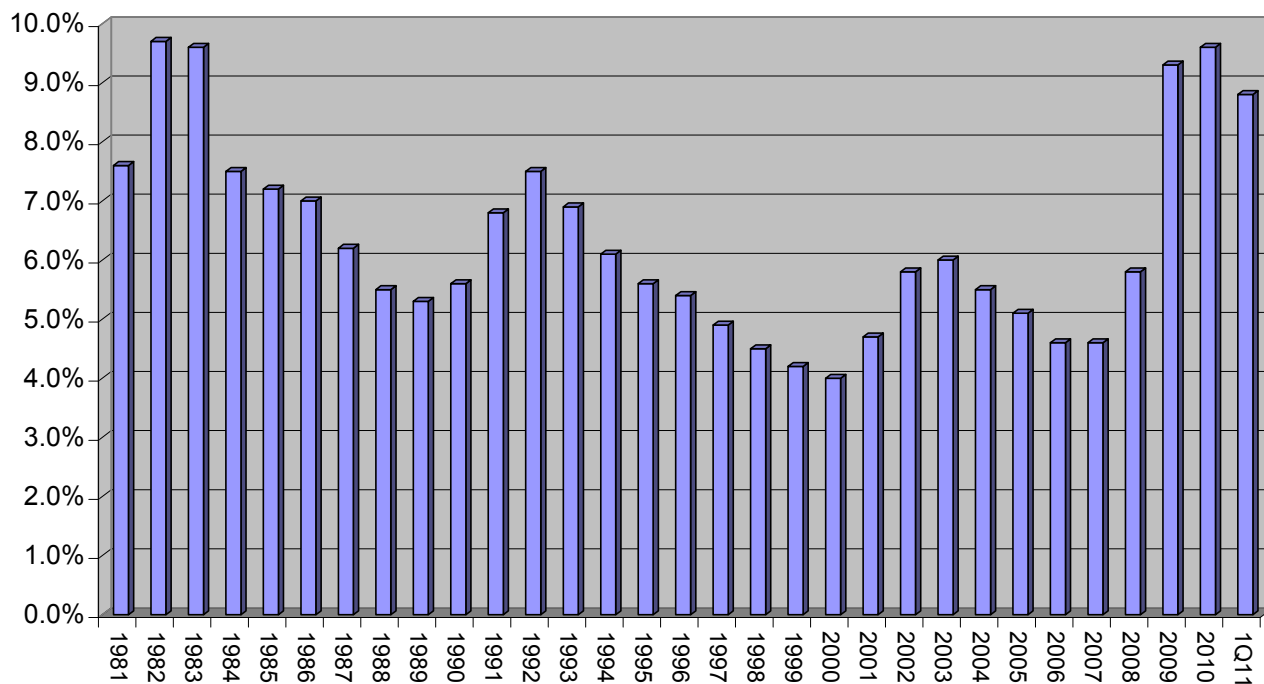


While corporate earnings are at record levels, a continued testimony to the depth and breadth of U.S. corporate management skill, much of the earnings gains and price advances have been achieved *in spite of* current economic data, which has been largely negative. Let's review some of the major economic indicators that keep me up at night, to get a flavor for the health of our economy.

Unemployment

The "official" unemployment rate, which understates the true rate of unemployment as it ignores discouraged workers who've given up looking for work, and "underemployed" workers as well, is slowly improving, but remains at levels unseen since the early 1980's.

Seasonally Adjusted Unemployment Rate (1981 to Current)



Source: <http://www.bls.gov>

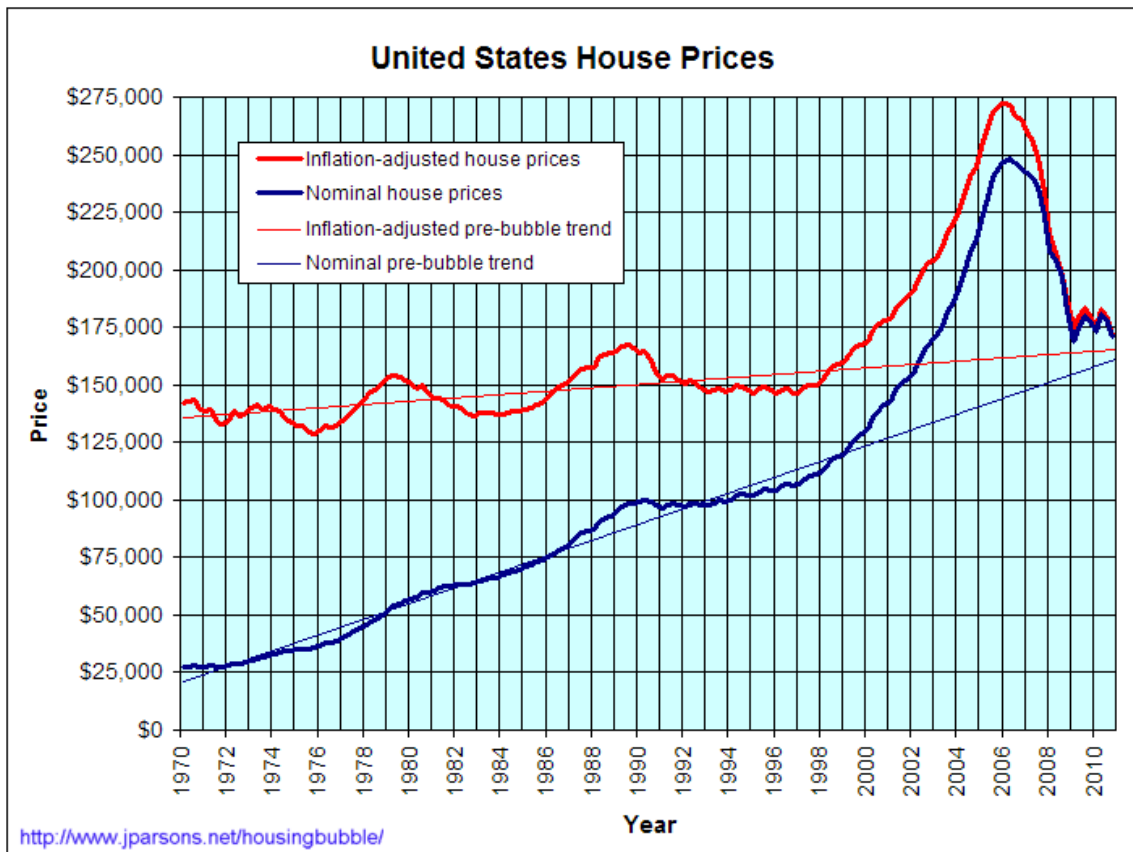
Housing Data

The housing market's "recovery" from the bubble's burst, is effectively stalled. On Thursday, Clear Capital, the California-based provider of real estate valuations and broker services, announced their findings that housing prices have officially "double-dipped", falling 11.5% nationally over the last nine months, and are now *below* their previous "trough" levels seen in March 2008. The markets are awash in foreclosures despite relatively low mortgage rates. (Source: Clear Capital May 5th, 2011 Press Release)

The “wealth effect” of rising home equity that fueled America’s spending spree the first half of the past decade has been completely dissipated. It has been recently estimated that 23% of homeowners with mortgages in America today are “underwater” (i.e. owes more than their home is worth), with (approx.) \$750 billion in “negative equity”. (Source: CoreLogic Report, March 8, 2011)

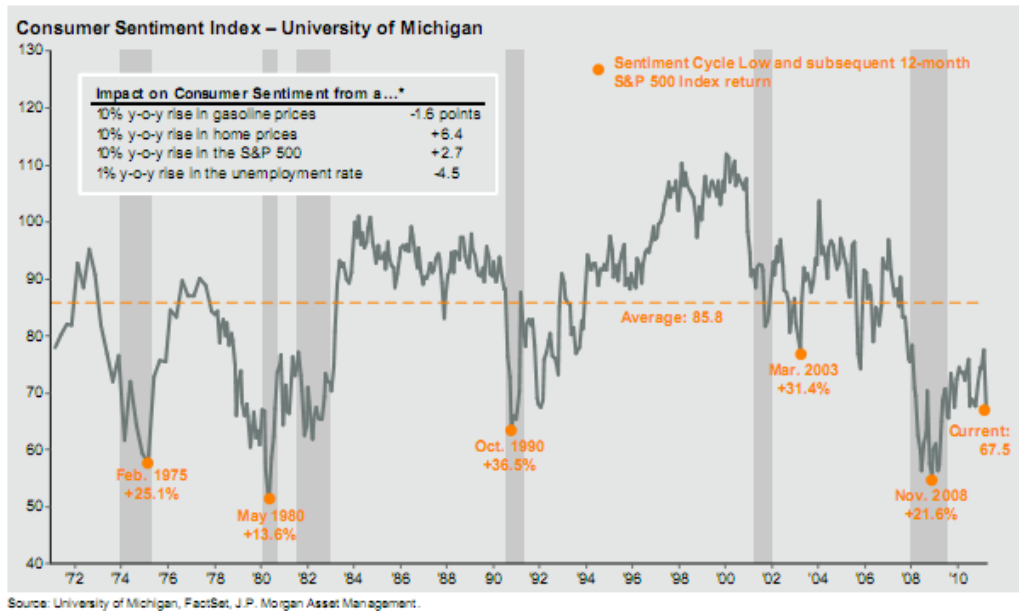
In nominal dollar terms, median home prices nationally have fallen back to 2003 levels, and on an inflation-adjusted basis, we’re back to 2000 housing values.

Inflation-adjusted house prices



Consumer Confidence

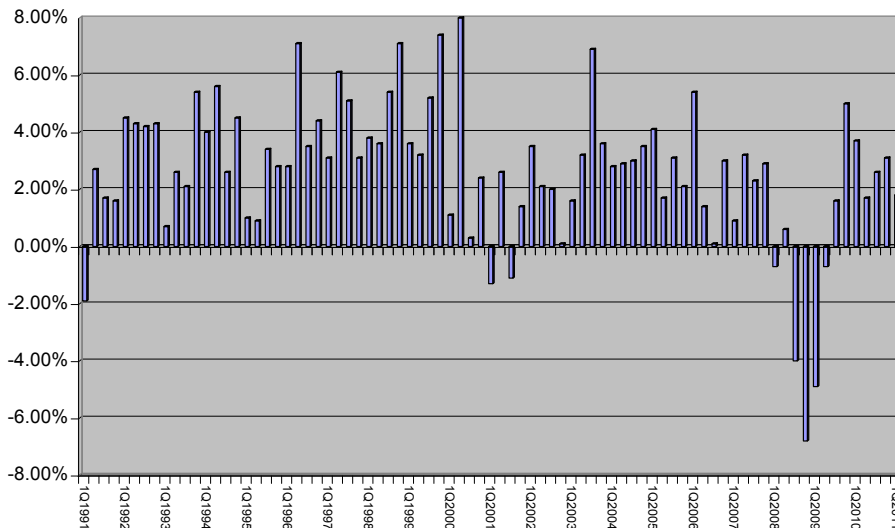
Not surprisingly, consumers remain extremely worried, and while sentiment indicators show improvement from the depths of recession in November 2008, confidence remains well below averages reported over the past forty years.



Economic Output

On April 28th, the Bureau of Labor Statistics announced their findings that the US economy, as measured by Gross Domestic Product (“GDP”), expanded at a 1.8% annualized rate during the first quarter of 2011. This is relatively anemic growth in GDP, especially considering the massive amount of stimulus dollars the government has pumped into the economy the past couple of years. Recoveries following recessionary periods typically occur at greatly expanded rates of growth, but this recovery is painfully weak, owing, I suspect, to concerns over government deficits, and the expectation by consumers and producers alike that given their weakened fiscal state, the feds will not be able to provide much more stimulus if needed.

GDP percent change based on chained 2005 dollars

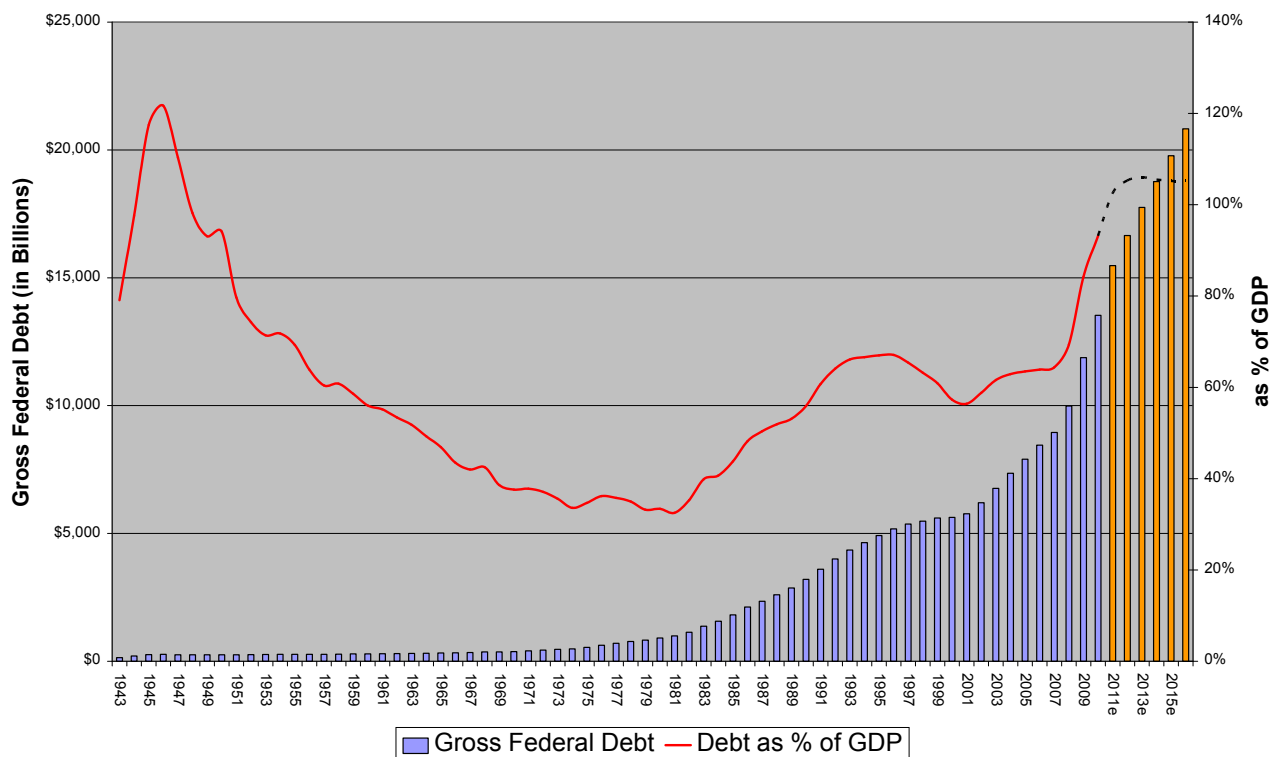


Source: Bureau of Economic Analysis

Government Deficits

As we've all heard ad nauseam in the press, the Federal and State governments aren't doing a lot better than their taxpayers, with Trillion dollar deficits as far as the eye can see. There has been little progress made by a polarized Congress on structural solutions, and it's easy to come to the conclusion that the folks in Washington just doesn't seem to "get it". Standard & Poor's shocked the markets April 18th, by announcing that it had changed its outlook on the U.S. Treasury's prospects from "Stable" to "Negative", warning that unless lawmakers take deficit reduction efforts more seriously, a downgrade from the Treasury's AAA credit rating, previously an unthinkable, *unimaginable* occurrence, was a distinct possibility:

"We believe there is a material risk that U.S. policy makers might not reach an agreement on how to address medium- and long-term budgetary challenges by 2013," New York-based S&P said today in a report. "If an agreement is not reached and meaningful implementation does not begin by then, this would in our view render the U.S. fiscal profile meaningfully weaker than that of peer 'AAA' sovereigns." (Standard & Poor's 4/18/11)



Source: <http://www.whitehouse.gov/omb/budget/Historicals>

Sovereign (government) credit rating downgrades are especially unusual, given their unique ability to legally *print* the currency needed to pay their obligations. But if Greece's experience is any indication of the markets' reaction to such downgrades, the U.S. Government should take great care to convince the rating agencies that we are very, very serious about managing our debt responsibly.

Greek Sovereign Debt Interest Costs



Source: Bloomberg.com

In recent years, the ratings agencies have focused investor concerns on Greek debt levels, and their (mis)handling of their budget has caused the government's cost of financing their debt to skyrocket. The 10 Year Greek Bond, sold to investors as recently as eighteen months ago at a relatively modest 5% yield, is now commanding 15.75%! Can you imagine what that does to their ability to re-finance maturing debt, and to meet their governmental obligations? And Portugal, Spain, and others are right behind them. U.S. policymakers would be wise to heed Standard & Poor's warnings, before the markets take matters into their own hands, and demand much higher yields to lend it money.

Inflation Concerns

Federal Reserve Chairman Ben Bernanke held a historically unprecedented press conference last week, intended to settle market jitters over his fiscal policies, the prospects for inflation, and the upcoming end (for now) of his Quantitative Easing Programs (a.k.a. "QE I" and "QE II" - more on these programs later.). While the "Core" CPI (Consumer Price Index) rate remains a relatively "tame" 2.7%, seasonally adjusted, over the last 12 months (Source: Bureau of Labor Statistics), the measurement (amazingly) excludes food and energy. (I guess if you can avoid having to purchase food or energy, you're OK.)

Labor costs are the largest single component in the calculation of the CPI, but with unemployment as high as it is today, wage growth is virtually nonexistent. Commodities and metals the past few days have moderated, and some are predicting commodity prices are the next "bubble", ready to burst. But there is no denying the massive increases seen in commodity prices in recent months. Here are just some of the percentage price changes over the past year:

Commodity/Metal

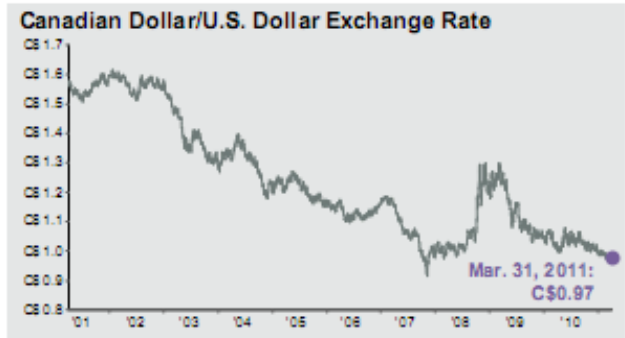
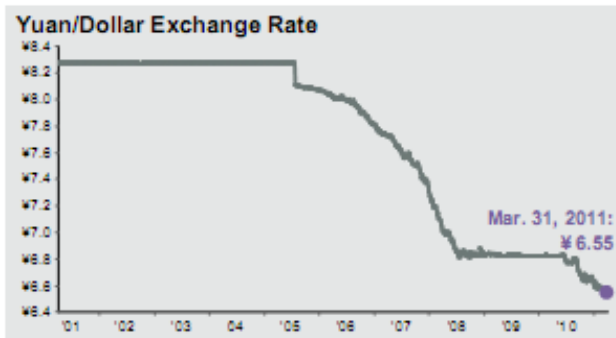
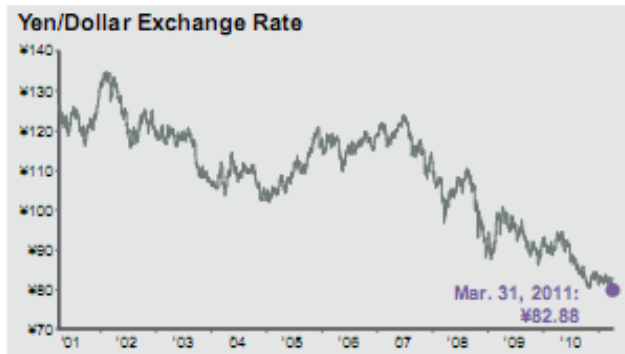
12 Month Percentage Change in Price

Crude Oil	+ 37.01%
Coal	+ 35.62%
Gasoline	+ 32.62%
Coffee	+ 81.61%
Barley	+ 37.72%
Wheat	+ 65.79%
Sugar	+ 42.78%
Soybeans	+ 42.93%
Cotton	+ 167.71%
Silver	+ 109.54%
Copper	+ 27.27%
Gold	+ 27.90%

Source: <http://www.indexmundi.com/commodities/> (05/02/11)

Dollar Woes

Not surprisingly, the value of the dollar is in secular decline against a basket of alternative currencies, and has been for some time. This does not bode well for U.S. consumers who must buy a fair amount of their goods from overseas manufacturers, and are trying to save for retirements they will be forced to fund in dollars.



Source: Reuters, FactSet, J.P. Morgan Asset Management.

Impacts of the End of Quantitative Easing

Perhaps the near-term risk I fear most is the stock and bond markets' responses to the termination of the latest round of Quantitative Easing by the Federal Reserve, scheduled to end next month. As I mentioned earlier, the Fed began pumping liquidity into the credit markets in 2008, and accelerated such efforts in 2009, by (literally) *printing money*, and buying up \$1.7 Trillion in bank debt, mortgage-backed securities, and Treasury bonds. This program was dubbed "QE I", and when its cessation failed to create sufficiently sustainable organic stimulus in the economy, was followed up by an additional \$600 billion round of such purchases by the Fed, appropriately coined, "QE II". It is estimated that the Fed has purchased as much as 40% of all Treasury debt issued during this period (more than all foreign buyers, combined), and as much as 80% of all mortgage-backed securities issued!

What is the problem with the program's termination you ask? Any time 40% to 80% of the demand for any security suddenly leaves a market, especially when such securities are *sold at auction*, the price commanded by sellers will naturally fall. In the case of Treasury auctions, the seller is the US government, and falling prices means rising yields and interest costs to bear. That's particularly problematic for the federal government, as it has to re-finance (approximately) 20% of its outstanding (Treasury) debt every year. Higher yields means higher interest carrying costs for the Treasury, increasing deficits accordingly, and crowding out other government spending. Today, the Treasury carries over \$14.3 Trillion in outstanding debt (Treasury Bills, Bonds, and Notes) on its books, \$4.6 Trillion of which we owe to ourselves though the Social Security, Medicare, and Medicaid trust funds, with the remaining \$9.7 Trillion owed to individual investors, foreign governments, and central banks as reserves.

A relatively modest 1% increase in the average carrying cost of a debt that large can represent a *substantial* amount of dollars, and some are predicting an almost immediate increase in the yields of that amount or more, as soon as QE II ends. The "good news" (if there can be good news for a creditor that owes \$14.3 Trillion) is that interest rates are so low today that despite the massive size of the debt itself, the interest carrying costs to the Treasury are lower this year than anytime the past five years. According to TreasuryDirect.gov, the Feds will spend \$215 Billion in interest on their debt in fiscal year 2011, at an average carrying cost of 2.99%. Simple math tells you that a 1% increase in that carrying cost adds over \$70 billion in interest expense, and while it would take several years for all of their bonds to "re-price" at maturity, the last thing the government needs right now is higher interest costs.

The other problem with rising Treasury yields is that they are believed to represent the "risk-free rate" (until and unless the rating agencies downgrade them!), and Treasuries represent the base rate upon which lower-rated credits (i.e. AA, A, BBB, BB, etc.) calculate *their* interest carrying costs. That means that the price of borrowing will go up for *everyone* as the risk-free rate rises, creating further drag on economic expansion.

Conditions for Economic and Market Recoveries

Is it possible that we've been through the worst, and that conditions are optimal for improvement in the economy or the markets? At the end of the last secular bear market (1982), economic conditions were ripe for a boom. Here's how they compare to today:

<u>United States</u>	<u>1982</u>	<u>2011</u>
- Fed Funds Rate	18%, and only one way to go (down)	0.25%, and only one way to go (up)
- 10 Year T-Bond Yield	15%, and falling	3.3%, and rising
- Inflation Rate	10%, and falling	2.7%, and rising
- Savings Rate	10%, and falling	4%, and rising
- S&P 500 P/E Ratio	8 X	17 X
- S&P 500 Dividend Yield	6.0%	1.75%

Source: Standard & Poor's; MJM 401(k)

These data cause me to wonder: With interest rates as low as they can get, what impact will a rise in interest rates and in the inflation rate have on stocks? What about bonds? What about our government's ability to pay its interest costs?

And with blue chip stocks trading at 17 times their trailing reported earnings at current levels, are they "cheap"? Hardly.

With the consumer "de-leveraging" their balance sheets today, saving more than they have in over a decade, will they spend sufficiently to stimulate the economic expansion?

What Should Investors Do Today?

Given these depressing data points, the reader may be asking themselves if economic slowdown or another recession is a foregone conclusion. Please be clear. I am not predicting a double-dip recession, although that would not surprise me. I am not predicting an "up-tick" in the unemployment rate, although that wouldn't surprise me. I am not predicting a major jump in the inflation rate, although that wouldn't surprise me, either.

To the contrary, I am an optimist, and am hopeful that the economy has sufficient traction in the recovery we've seen thus far to withstand the headwinds all of the aforementioned economic data points just covered. But as has been often said of late, "Hope is not a strategy."

For all the reasons I've just detailed, I find myself having difficulty building up a lot of enthusiasm for major commitments to the traditional (i.e. stock and bond) markets. With conditions uncertain, I continue to arrive at the same, unavoidable, in my mind, irrefutable conclusion I came to in early 2009:

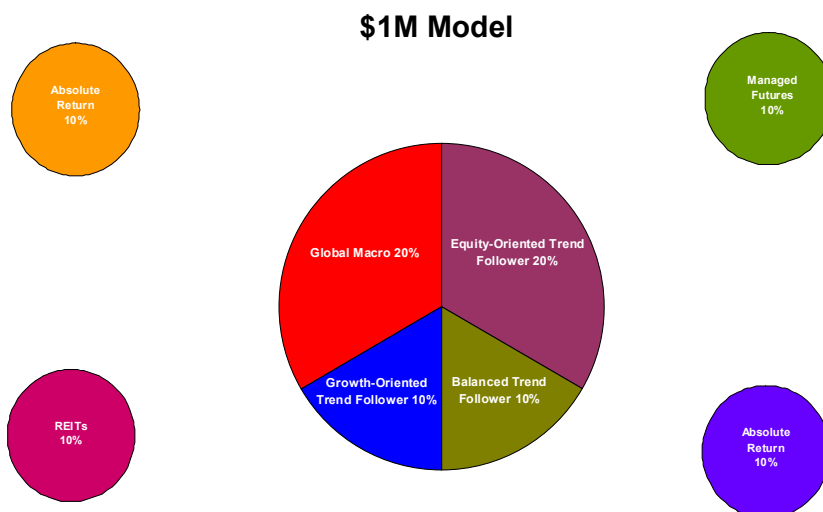
Since early 2000 we have been experiencing, and remain mired within, a secular bear market!!!

And for those uninitiated in the industry vernacular, secular bear markets aren't always markets in decline. Sometimes a "cyclical" bull market, even an extended one, can occur within a secular bear market. As we saw from October, 2002 through October 2007, and again from March 2009 to present, *secular bear markets can contain several cyclical bull markets within them*. But in the last secular bear market (1965 – 1982), a period that contained four multi-year market "boom/bust" cycles within it, stock prices collapsed after each cyclical bull, and finished the seventeen year period at the same place (prices) as when it started. This secular bear looks to me to be no different, with two separate 50% (or greater) declines following each advance. In other words, if history is any indication, the "Lost Decade" just finished could turn into the "Lost Two Decades". In fact, when one looks back into market history, one can see that these secular bull and secular bear periods have clear inflection points, persist for 17 to 22 years, and we're only about 11 years through this one. If conditions were different, I could be talked into believing the worst of the economic crisis we've been enduring the past 2 – 3 years is behind us, and it probably is, but as I objectively look around, I don't see what is going to fuel the "boom" some are calling for. I certainly hope I'm wrong, but I can't see what will be the spark for such a boom.

- Will unemployment suddenly and dramatically decline?
- Will interest rates and inflation remain low, or will they rise?
- Will our political leaders suddenly gain perspective and dramatically limit their spending, or will the projected Trillion dollar-plus annual fiscal deficits continue?
- Will the uncertainty and turmoil in the Middle East suddenly turn to our advantage?
- Will housing prices rise anytime soon?
- Will the U.S. dollar rally against foreign currencies, or against commodity prices?

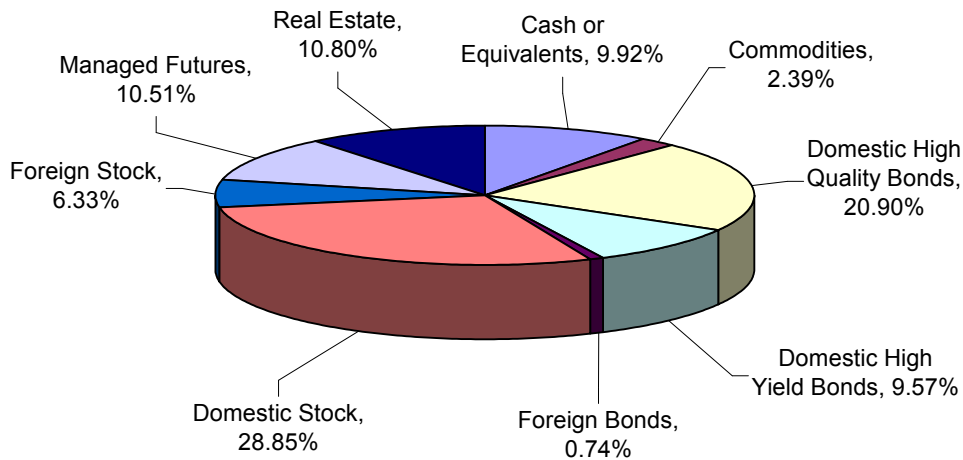
I can tell you that until and unless some of these concerns are answered in the affirmative, or economic conditions improve markedly, we're going to remain tactically, defensively, and broadly diversified with our clients' money. "Buy and Hold" is dead...for now.

For most of you, the diagram of our "Core-Satellite" portfolio construct (below) will be familiar, along with an understanding that our "Core" managers, trading in the stock and bond markets, will be very active, and hopefully very quick to get out of the way of a prolonged downturn.



As we are positioned today in our largest client models, our (approximate) allocation by asset class is as follows:

Current \$1M Asset Allocation



In closing, let me repeat. We are not predicting doom and gloom, and the purpose of this report is not to depress the reader, or to be the proverbial “Chicken Little” in the marketplace. We are just trying to lend some perspective to conditions behind the “party” the equity markets have been having, and to warn that just as for those who drink to excess, there may be a bit of a hangover for those who are not investing responsibly.

As always, we welcome your comments and questions.

- JRP

This article is for informational purposes only. This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice as individual situations will vary. For specific advice about your situation, please consult with a financial professional.

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