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Teflon-Coated Market

I am paid to be paranoid, and I think it is a trait that lends itself to preservation of capital. In my 15 years as a portfolio manager, when I feel the momentum is too strong and valuations are stretched, I typically go in the opposite direction of the crowd. This paranoia, coupled with analytics, helped guide me in the decisions for getting out of tech stocks in late 1999, housing in 2005, and banking in 2007.

For most clients, we were close to fully invested in 2009 & 2010. In late 2010, I started to raise cash, thinking we would have year-end correction from people taking profits. I was wrong! The market did not pull back in any meaningful way. It is my opinion that investors that were sidelined in cash for most of the rally finally capitulated and have been buyers. Average volume is not that great for a bull market that simply says, more people are buying than selling. Additionally, about $2,735 trillion dollars is still in money market.

It's like a coating of Teflon has been sprayed on the market as nothing bad seems to stick. Take a look at the following recent events over the last few months:

- Japan…with gross-to-debt ratio of almost 228% (2x that of America) gets hit with an earthquake, tsunami and possible nuclear meltdown. The Government announces a stimulus package requiring more debt to help rebuild. What does the Teflon market do? It goes down briefly, and the buyers look at this as an opportunity to invest.
- Libya is in chaos, which followed Egypt, and who knows what other oil-producing nations are next. The result is that oil is back over $100 a barrel, and the stock market keeps moving higher. High oil is typically a market killer.
- The euro is looking less stable with Germany being the tallest midget in the circus, and England looking wise for not joining the Euro. But not so fast in praising the UK, because their problems are being dealt with through austerity measures. The rest of the world (politicians) is closely watching how the citizens have rioted in support of being told to cut back. Greece, Ireland, and several other nations need to do the same.
- Gold is at record highs as people around the world are afraid of the Fiat currency (paper money IOU), and they have made a bet that shiny metal is better than paper. The reality is that both are worthless in the bleak scenario painted by some. I would argue that a can of beans and a handgun would be worth more than a pound of gold if such dire predictions came true.

- Commodity costs, especially food, have skyrocketed around the world. This has had a very material effect on the profitability of many companies. More importantly, nations that subsidize these costs to their citizens are facing increased political pressure. Iran's internal citizen unrest has little to do with democracy and freedom, but much to do with higher gas prices. Hugo Chavez, the communist leader of Valenzuela, is facing his toughest challenge yet. Where his political stance is usually the cause for unrest, high inflation is now the cause for the latest public outcries.
- The unemployment rate is starting to show some signs of a rebound, but I don't know anyone that is feeling excited about strong job growth in America. The US Government lies and manipulates data! "There, I said it". That is my opinion, but I think the Us Government manipulates the data, and has for quite some time because it is in their best interest. Can you imagine what would happen to budgets around our country if all the pensions tied into Cost of Living Adjustments (COLA) showed inflation was higher? The unemployment number conveniently omits those that have dropped out of looking, or are working but underemployed. http://www.bls.gov/cps/
- Try getting a loan in America right now. I warned all my clients of the coming liquidity crunch I saw forming in 2009. Right now, I have retired millionaire clients that have spent months trying to refinance, and small business owners trying to expand and grow their businesses. The citizens of America helped bail out the banks, and the banks have responded by tightening lending standards. Banks borrow cheaply from the Government and offer very low rates on deposits. When they do loan, they cherry-pick the best and most profitable loans. America can't grow out of its problems without successful small businesses and entrepreneurs, and the grease that lubricates that growth engine is loans.
- Municipal bonds in America have sold off fears of default triggered by a report from analyst Meredith Whitney and her interview on 60 minutes. Warren Buffet has also made comments last year that said without Government backing, we could have problems in determining what muni Bonds are worth. Also, institutions are not buying muni bonds like they once were. I have personally met Mrs. Whitney a few times, and I follow her comments, and I respect what she has to say. Because of this, I am being cautious on what muni bonds I continue to hold and new ones I might purchase.
- For economic geeks like me, there is a 268-page report published by financial analyst Mary Meeker that analyzes USA as a business. For the full report go here, or for the summary go here for slides. The bottom line is that our nation needs to address these issues, because sticking our heads in the sand is not working on either side of the political aisle. Refer to the previous bullet point on how austerity measures are being received by the citizens of nations implementing tough choices.

- USA homeowners are selectively walking away from their non-recourse loans. Why? Because they can, and their neighbors are doing so. Why shouldn't they walk away instead of making payments on an underwater home? This is the definition of moral hazard, and America is knee deep in this issue. This is a concern for me in evaluating the future health of our economy. It is one of the reasons I have not bought back bank stocks, which was one of my core holdings for almost 13 years. I like the banking business for investing, but I am still not sure of the fallout of housing. Time will tell on this issue.

So how do we invest in a choppy market coated with Teflon? I think the answer is; "Tactically with fewer big bets".

Here a few of the ideas I am deploying in this type of market:

- I have made investments using ETF's (Exchange Traded Funds) that represent countries that have been benefitting from outsourcing or commodity exports: India, Vietnam, Mexico, and emerging markets to name a few. Additionally, I have placed an emphasis on small cap companies, as merger activity is picking up, and they seem to benefit. Plus, on a fundamental level, small caps typically do well during an expanding market of earnings growth.

- I added a new money manager for fixed income bonds, Double Line, which was recently profiled on the cover of Barron's magazine for its success.

- I have added an ETF for exposure to managed futures. This is a newer fund managed by Wisdom Tree, but I like the non-correlating aspects of managed futures and also the low fees of .95%. Plus this ETF offers liquidity, where most other exposures to this asset class are very costly (3-7% per year) and are not liquid daily.

- Covered-call writing is something that has been sporadic. The premiums thus far have been very low for my value stocks. I also see a potential problem with growth stocks not being given a chance to run like they should.

- I have been researching ways of investing in volatility, namely the VIX, but have not reached a conclusion as of yet.

- My state of California has been in the news regarding our fiscal dysfunction, but I suggest that readers and investors consider that California is a $1.85 trillion economy. Our state is 13% of our nations GDP, and I believe there are many quality bonds to own. Specifically I like state general obligation (GO), school GO bonds, utility revenue bonds like LADWP and many others backed by solid taxes or revenue.

As I said before, this is a nervous market coated in Teflon, but there are positive facts out there:

- GDP for America and many other nations is growing.
- Employment numbers are improving.
- Corporate profits and cash levels are strong.
- New inventions are coming to market, and business disruptions are happening; for example Netflix, iPad, and Green Technologies.
- Forward PE ratios on major indexes are reasonable on a historic basis.
- The world is expanding, and that is presenting opportunities globally for multi-nationals and others on a local level.

Sincerely,

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