The Markets

Recently I have had conversations with many of you regarding our stock market exposure. Some want more stocks because the market is achieving new highs, while others want to sell stocks for the same reason. I learned a long time ago that to buy low you had to sell high. A few lucky souls will be credited with selling at the top this go around, but they will not be the same people that buy at the low when the market goes down (and all markets go down) and they will not be the ones that sell at the high next time the market has a bull run. I have called a couple of tops and one bottom in the 39 years I have been doing this. I feel lucky to have done so.

History shows that about 80% of a portfolio's return is allocation: how much do you own on the way up and how bad were the losses on the way down. Undoubtedly the best performers in today's market are those perennial bulls, investing as if there is no risk in today's 3rd most expensive market in US history, being 6 times more expensive than "cheap" and 2 standard deviations higher than normal. When reality sets in and the market returns to the mean (normal prices) perennial bulls will look just as silly as sellers of stocks look today. Except, today's sellers will have cash to buy valued assets while the perennial bull will be flipping losing stocks into what is hoped will be the next great sector (like pharmaceuticals and bio-tech are today).

The dotcom market was a great example of an expensive market that went ultra expensive. This market could also, but just as there were signs that the dotcom bust was coming (the advance decline line had peaked 18 months before the indexes did) there are ominous signs today. Unlike any bull market I have seen, this one does not have a thriving economy pushing earnings and employment to new highs. But that has been true since the market bottomed in March 2009. However, the number of stocks advancing versus the number of stocks declining peaked 3 months ago, while the NASDAQ advance/decline line has never reached its' previous high. Market highs almost always correspond with high margin balances (money borrowed to buy stocks) and margin borrowing is at record highs (as a side note, consumer debt recently went to new highs). Market highs typically correspond to massive initial public offerings (IPOs), and there are record new offerings today (50% more than last year's record). Business owners know when it is good to sell some of their ownership! On the other side of the coin, business' themselves are buying their own stock because their return on equity is greater than the cost to borrow funds. This diminishes the number of shares outstanding and increases profits per share. According to Dow Theory, the Dow Transports typically lead the industrial average because goods must be shipped (transported) prior to manufacturing and retailing. Dow Transports are down 12%. There are many lesser indicators that point towards a market long in the tooth, but raising cash when times are expensive is simply the best plan for success. I hope the market goes higher as I would enjoy selling more stocks at inflated prices and I will not bet the farm on this time "being different".

The bond market has been pretty straight-forward lately. Rates bottomed nearly three years ago, and yes the Fed has not raised rates, but the 5 year treasury is nearly 3 times higher in yield

(lower in price) than October of 2012. All eyes are fixed on when the Fed will raise rates. But why: Except for the Fed controlled short term rates, interest rates are already moving higher which has steepened the yield curve. Junk bonds are already in bear market territory. The yield on the German 10 year bond rose 10 fold in the past few months! Russian rates went to 15%. Greece is the first country to truly have to address its' inability to pay its' debts. Chicago Teacher pension bonds (tax free) are yielding nearly twice what a similar maturity bond pays. Illinois bonds are being priced as if they are of concern also. Puerto Rico simply has no money available to pay its' debts, but that is what happens when unemployment pays more than gainful employment. Spain, Portugal and Italy are all on the precipice of bankruptcy and the politicians in Washington have spent $18 Trillion of borrowed money. Our debt will be paid through forgiveness, increased taxation or inflation because we simply cannot repay the money. The best place to be in the bond market has been and should continue to be in short term quality bonds.

Now the quandary: How much longer can the US Dollar appreciate against the other major currencies? The question dovetails into the price weakness of natural resources, assuming you pay in American Dollars. Gold, silver, and even oil in some places, are more expensive because their currency has declined. The US Dollar is the dominant world currency. Some look at it being a safe haven. I suppose relative to a questionable Euro, a war-like atmosphere in Russia, a broke Greece that might utilize a "bail-in" which literally takes bank deposits from customers, a slowing Chinese economy, a troubled South America, and a socialist Europe, our Dollar looks attractive. However, fundamentals always win and it is a fairly sure bet that the Dollar will lose purchasing power and yet still be the prettiest pig.

So, lighten equity exposures, shorten bond maturities, and continue to own those natural resources.

I appreciate your trust in these unusually trying and exciting times.

Scott