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OBSERVATIONS ON THE MARKET No. 219*By Greg Denewiler, CFA*

“As if they really knew, leading economists predict that the recovery from our Great Recession will be plodding, gray and jobless. But they don’t know, and can’t. The future is unfathomable.” This is a quote from James Grant’s article in the *Wall Street Journal* last Saturday. I can not remember a time since 1979, when I started as a stockbroker, that it has been this easy to make money, nor this challenging to figure out what to do next. The reward for waiting for more clarity in the economy is \$.83. This is what your \$10,000 earns in the average money market account for one month. You will have earned enough to buy lunch by this time next year. Ironically, this is exactly by design.

The world’s central bankers are forcing investors to take risk. They want you, the investor, to buy riskier assets. This is because demand for credit-backed assets is the lubricant that keeps the machine running, and it is working. Since the bond market low of around nine months ago (the credit markets actually bottomed before the stock market did in March) the credit markets have experienced an incredible rally. Many sectors of the bond market have now reached levels that are higher than they were before this whole mess started. The corporate bond index that trades as an index mutual fund is back to the level it traded at in the beginning of 2006. The explanation for this is pretty simple.

The global central bankers have pumped \$9 trillion into the world’s economy through cash, asset purchases, and guarantees. The banking sector is not using the money that has been pumped into the system. They are not lending unless you have collateral that makes the loan virtually risk free. Corporations have not used any capital to expand, they remain in a wait and see mode. So that basically results in the stimulus money finding its way into the markets. Since buying lunch is not

what most investor’s consider a return, they have started buying riskier assets. So when does this stop?

The good news is that the stock market, even after this incredible rally we have experienced in the last six months, is still down 30% from the high. By this simple observation the market cannot be a huge bubble. The debate is whether it has priced in a faster recovery than we are going to experience. One point to consider is that the March low in the stock market may have occurred almost exactly six months before the economy actually bottomed. This is a textbook stock market reaction to predicting the future. Mr. Market knows more than the rest of us, at least this time, and may be telling us that the recovery is stronger than the consensus is predicting. However, the easy money has been made, and sometimes Mr. Market is wrong.

Everyone is convinced the future is obvious. There is a new paradigm, which means slower growth, less debt, and everyone has become more financially sensible. The first two may in fact be obvious, but history suggests that we are never sensible for very long, we are in various states of fear or greed. Which makes the whole investment environment extremely hard to predict, currently. This means the forces of money chasing returns may go farther than we expect, or should, and no one can predict the short-term outcome.

Personally, when in doubt, I move towards quality. It is always safe to think; what if I am wrong? Quality lives to fight another day. When you wake up in the morning, do you want things to get better or worse? Given enough time, the system always heals itself, which was the point of James Grant’s article. To his credit, he is usually not an optimistic person. It is too bad that those who played by the rules are being rewarded with only 83 cents.