

INSIGHTS ON FRONT STREET



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AS GOES JANUARY, SO GOES THE YEAR?

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The stock market rally that pushed the S&P 500 Index up about 70% from the low last March stopped dead in its tracks on January 19th and proceeded to fall almost 7% during the last eight trading days of the month. This sudden market drop brought all of the broad stock market indices into negative territory for the month of January, which has the bulls very worried. The "January Barometer" was suddenly forecasting a stormy stock market for 2010.

The old market adage goes, "As goes January, so goes the year". The January Barometer holds that if the S&P 500 Index is up for the month of January then the stock market will be up for the entire year. If the index is down, watch out.

The barometer is not always right. Just look at last year, for example. The S&P 500 Index was down 8.4% in January but finished the year up 26.5%. While that was obviously a big miss, it intuitively makes sense to me that the barometer could be wrong in the depths of a bear market. A turn in the market could happen at any time.

If we look over a long period of time the record for the barometer is impressive. Since 1950 the S&P 500 Index's direction for the full year has matched its January performance more than 90% of the time, according to the Stock Trader's Almanac.

Ned Davis Research also provides additional information that supports the relevance of the January barometer as a market indicator. Using data from 1900 through 2009 they found that in years when the Dow Jones Industrial Average is up in January, the median rise for the rest of the year is 10.4%. In years when the DJIA is down in the

first month of the year, the median return for the remaining eleven months is just .28%.

So maybe the January Barometer is better used as an indicator for the health of the market as we enter a new year and not as a predictor of the actual return. We shall see.

Many of the bulls (including the cheerleading commentators on CNBC) seemed dazed and confused during the last week of last month. They didn't understand how the market could suddenly lose altitude like that when all they could see were sunny skies and economic tailwinds up ahead.

For those of us who have been non-believers that this rally was a new bull market and have accepted the business risk of being "wrong" in protecting our clients' portfolios, we think this downturn is overdue and based on real fundamental concerns. The recent economic news and fourth quarter corporate earnings announcements have not changed our view that this will be a slow and stuttering recovery.

It is interesting that the stock market has been

selling off on better-than-expected fourth quarter corporate earnings, rising consumer confidence and much higher than expected fourth quarter real GDP growth. We think it has something to do with that nagging concern about the sustainability of this economic recovery.

As we have stated in previous commentaries, we think the bulls in this market are “missing the forest for the trees”. That is, they have been focused too much on finding the “green shoots” or signs that the economy is improving. They don’t see or are ignoring the BIG PICTURE of how a decade of excessive debt accumulation on the part of consumers, our financial system, and our government have set the stage for a fragile economic recovery whose sustainability will be in question for years, not months, in our opinion.

While the private sector of our economy is dealing with the contraction of debt as banks and credit card companies continue to reduce their loan portfolios and their customers’ lines of credit, the federal government is leveraging to the hilt to make up for it. The government plans to borrow and spend trillions of dollars to get this economy growing again.

That might have been a good plan if the U.S. came into the *Great Recession* in much better financial condition. Unfortunately, that was not the case and the projected deficits and debt levels are staggering over the next ten years. And that is not including the humongous off-balance sheet and unfunded liabilities we face as a nation for the entitlement programs (Social Security and Medicare).

The long-term ramifications of excessive debt and deficits are fairly clear to not only the U.S. economy but many others in Europe. There are many examples in history of countries that have had to suffer through a deleveraging process like many developed countries are today or will be in the future if they don’t quickly change their ways.

Two recent publications on this subject are mentioned or included on the *Front Street Blog* on our web site. We would highly recommend that you take a look.

One of them is a book called *This Time is Different* written by Carmen Reinhart and Kenneth Rogoff.

The other is a report by the McKinsey Global Institute (the research arm of McKinsey & Company) called *Debt and Deleveraging: The Global Credit Bubble and its Economic Consequences*. The findings in this book and report will be used in the years to come by economists, investment professionals and maybe even some enlightened government officials to help explain the challenges and unpopular choices that many countries will face.

Both published works describe in detail the BIG PICTURE risks and obstacles that the economies of over-indebted countries will face in the years to come. The common messages are that there are no quick fixes and that it is rare that countries can just grow out of the problem. Tougher remedies are usually required.

One reason for the recent stock market decline was the escalating sovereign debt crises in Greece. Basically, they have a lot of debt that is maturing and must be rolled over into new debt. The problem is investors have lost confidence in Greece’s ability to service their debt in the future because of their budget deficits that are out of control. We think this problem is just a preview of coming attractions from what we will see from other countries. Sovereign debt crises tend to follow banking crises. Stay tuned!

We believe that the “relief rally” has about run its course. The negative effects of the credit contraction and de-leveraging in the U.S. economy will become even more evident as time goes by. These effects will limit the growth rate of the economy which will make it difficult to reduce unemployment and generate enough growth in corporate earnings to justify current prices in the stock market.

We think the January Barometer is accurately predicting a turbulent market this year. There are a lot of near-term issues that investors will have to contend with in 2010, including higher taxes, more regulations, a stronger dollar, monetary tightening in China and India and possibly higher interest rates here at home. Oh, and did I mention the debt?

