

INSIGHTS ON FRONT STREET



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GOING FORWARD INTO 2010

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Looking backward is often a useless exercise. But, it does help you learn. With a reasonable level of humility and with a tinge of defiance, we now know that the only thing it took to succeed in 2009 - as if the Gregorian calendar is of utmost importance - was to follow the well-worn trader's handbook.

The handbook doesn't include watching the Fed nor does it tell you to buy stocks when Congress begins to stimulate us with tax cuts and deficit spending. This time the Fed started cutting interest rates in August 2007 and Congress began stimulating us in May 2008. Obviously, these actions alone don't faithfully signal that the coast is clear.

However, the lesson of 2009 shows that the three indicators below seem to be the ones to watch when things are darkest. Unfortunately, they didn't work well during the '00-'03 bear market, but we'll ignore that for now.

#1: When new unemployment claims start to fall, buy stocks and make them the most economically sensitive ones, if you have the guts.

#2: When the Index of Leading Economic Indicators and/or the similarly constructed ECRI Weekly Leading Index reverse their downward trend, just shut your eyes and buy.

#3: When the ISM Manufacturing Purchasing Manager's Index turns up, start buying.

Even more powerful is when all three indicators are simultaneously flashing green, as they were last March.

As you'd expect, we sensed the trading opportunity back in March. Honestly, only an illiterate wouldn't have sensed it. What we didn't appreciate was the need to remove our minds from the moment. As you'll recall, we really didn't like the fundamental picture at all and, for the record, we have serious concerns today (see below). Nonetheless, all that was needed was a commitment to an unemotional plan; a plan that took over the incremental decisions without question.

We had built up a lot of chips at the table back in March and we chose not to play a pretty good hand. There is no going back. And, to be fair to ourselves, it's not like we lost those hard earned chips. We actually have more chips today than we had last March. Keeping them is far more important to us than passively watching a pile grow and dwindle repeatedly with each successive market cycle. This is our philosophy.

With lessons destined to be learned again and again, it is still true that looking forward remains the only purposeful challenge. And, as always, what comes next isn't a matter of 20/20 hindsight.

Short-term interest rates are pegged at zero. We absolutely know that this is distorting economic reality. Money market funds, savings accounts and CD rates aren't supposed to feel so terrible. The gun to investors' foreheads isn't supposed to be pressed so hard.

While investors seem fixated on inflation worries, it is apparent to us that the Fed fears the Japanese experience of deflation. It seems that they've been worrying about deflation since around 2000 and

their only remedy has been to try to feed asset bubbles with low rates and easy credit. It is important to note that Japan hasn't solved the deflation riddle. We'll eventually run out of widely-held paper assets to pump up.

Meanwhile, the Fed is talking non-stop about their "exit plan" from their crazy policies. To this point, they've managed to create and unleash around \$1-\$1.5 trillion of cash into the tributaries of our financial system. We feel quite certain that this flood of liquidity will stop flowing in 2010. Why? Because they seem so uncomfortable about what they've done. We can only imagine what they say behind closed doors.

To complement the Fed's zero rate policy, a coordinated effort by the fiscal authorities is clearly afoot. During the last fiscal year the US Treasury has spent around \$1.5 trillion more than it collected in taxes. In 2010, the overspending will probably not shrink much. In fact, they'll be issuing around \$2 trillion of debt next year. Our guess is we'll see the same trend in 2012, 2013 and beyond. That is a lot to swallow.

In total, we can be quite certain that the added debt will be at least \$7-\$9 trillion for the coming decade. By then, our publicly-held debt burden will be greater than 100% of our nation's projected economic output. This figure does not include the under-funded promises of our Social Security and Medicare entitlement programs. The programs' own trustees estimate that the unfunded obligations now total about \$50 trillion. That figure actually makes \$9 trillion of new government debt pale in comparison. Things have gotten to an unreal level. But, it is very real.

We know that this type of spending and under-funded entitlement programs cannot continue without some negative offsets. What are those offsets going to be? To name a few, we'll see higher interest rates than we'd otherwise expect to see, we'll have to try to collect more in taxes and we think people will have a greater desire to save and have less of a desire to borrow. With government borrowing so much we'll see lower private sector investment and we'll likely enjoy fewer government services. Finally, without much doubt, we'll have a lot of political upheaval. These are the types of speed bumps that investors have to navigate going forward.

The latest sign of things turning silly is when investors are overstating the attractiveness of large-

company dividend paying stocks. Collecting a 2% to 3% dividend yield for stocks that are valued at 15 to 18 times earnings isn't historically attractive. That is, except in the "house of mirrors" environment that we live in today. It seems investors are acting like prisoners who've been locked up for too long. The new convict looks an awful lot like their old girlfriend.

As we highlighted in our November commentary, the overall stock market is trading at levels seen only on rare occasion prior to 1993 (the beginning of the bubble). In light of the awful past decade for stocks, we think that investors have drawn the wrong conclusion if they think that stocks just have to be cheap now. We understand it is especially enticing to assume the stock market is now a bargain after a 25% drop from the 2007 highs. The decade's paltry returns resulted from the fact that things were just that far out of whack ten years ago. Excluding the bubble years, the data today shows that markets aren't historically cheap.

We know that nobody has any idea when the music will stop. But, if true to form, we think it's likely that most investors won't even notice the deafening silence when the music does finally stop. They didn't notice it in the summer and fall of 2008. Investors have been fretting about this financial "big picture" for so long that I fear we've all been numbed into submission.

We're aware that trading with one foot near the exit door seems like a pragmatic response. Everything moves faster today. It takes very quick reflexes if you want to try to catch the trading waves. While it is harder than it looks, we're also aware that we didn't try catch the wave in 2009 even as the handbook pointed the way. Trading isn't inherently bad, but it should only be used as a *supplemental* strategy. It is often prone to failure.

The *primary* strategy, however, is having the awareness to recognize when the conditions are stacked against you - as we feel they are today - and to then act prudently ahead of the crowd. This strategy's results are repeatable if you keep things in proper perspective. This is not a game. This is about managing other peoples' "deferred rewards" (a.k.a., managing their money). We're committed to continue to focus on the chips right in front of us, no matter how it makes us appear.

