



## SPOOOOOOOKY

The most frightening costume imaginable this Halloween would apparently have been a chart of the stock market's rally since the early-March lows. "Too far, too fast," fret the terrified market commentators, petrified of a collapse to perhaps even fresh, Roubini-pleasing lows. It's harder to find an outright bull on this market than it is a **PALIN 2012** bumper sticker in the MSNBC parking lot. This rally has precious few friends.

The biggest reason to doubt the validity of the rally is the combination of its impressive size (the S&P 500 rallied 65% from the March intra-day lows to the October peak) and the lack of coincident economic justification for a rally of such magnitude. Despite a positive GDP print in the third quarter, unemployment remains disconcertingly close to the 10% level, companies remain exceedingly cautious and house prices (arguably the factor that precipitated the crisis) have yet to be rekindled. Absent any other information, the fact that things are not getting worse at the same pace they had once been would understandably seem to be a fairly tenuous foundation on which to build a 65% stock market rally.

But, of course, no one single factor determines the direction of the stock market. Even being able to predict the economy with perfect accuracy does not

guarantee that one can predict even the direction of the stock market. There is a persistent tendency in market commentary to justify or dismiss a move in a stock or the market based on whether it seemed proportionate to the latest news that appeared to precipitate the move. High-flying stocks that fall 30% the day after missing earnings by a few pennies are frequently recommended due to the market's "overreaction." This recent market rally is increasingly being dismissed as being "too far, too fast" because it is hard to pinpoint any particular data set that has been unveiled in the past seven months that would make stocks worth 65% more than they were in early March.

The problem with this line of reasoning is that it is only useful if one assumes that the starting valuation was at least a reasonable one. If not, the entire thesis collapses. With the aforementioned high-flying stocks, what has usually happened is that a slight stumble has occurred after a period of overvaluation, leading to a quick realization of this in the marketplace. A 1% earnings miss wouldn't seem to justify a 30% share price decline, but it may justify a reassessment of whether utopian valuation remains appropriate. The earnings miss is more of a catalyst in a numerical reaction than an algebraic input into a linear valuation equation.

### Mused Upon in This Issue:

It is fashionable to warn that all material rallies off of significant declines (when coupled with tough economic times) are fraught with risk by citing the parallels to the failed rallies of the 1930s. This was popular in 2002, 2004 and again most recently. This is too cute by half. From inside:

*"Charts overlaying current market movements with those of the '30s are interesting parlour tricks and might be made good use of in The Amazing Kreskin's show, but they should not be taken as the writings of Nostradamus."*

### S&P 500: March to October



It would not be a stretch to admit that the market's rally has at least been pretty far and pretty fast!

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## STOCKS MAY STILL BE CHEAP

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With respect to the most recent rally in the stock market, I will grant that nothing can easily be pointed to that would justify a 65% increase in the underlying intrinsic value of equities. If one could accept that the pricing at the March lows was reasonable, then one would have a difficult time accepting the extent of the rally.

I would submit, however, that the problem is much less a case of “too far, too fast” but, rather, that in March, pricing was “too low, too pessimistic.” The reference point was not a reasonable valuation zone and thus the thesis of “too far, too fast” collapses upon itself.

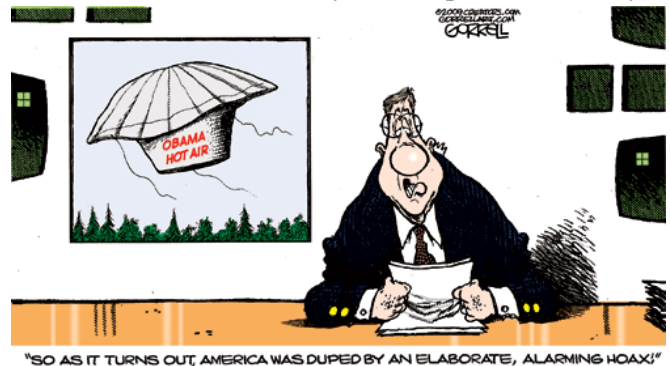
A few factors give me comfort in making this bold assertion. To begin with, even as I write this on Halloween, surrounded by ghosts and goblins of all kinds, I have difficulty being terribly frightened by a market that has soared all the way back to levels first seen in 1998. Too far, too fast? More like the milk run to Snoresville. I am also not swayed by the frequent comparisons of the recent rally to “similar” rallies off the lows during the 1930s which were followed by further market plunges. Correct me if I’m wrong, but the world seems to have changed a little from the one I read about in textbooks about the Depression era. I will grant that human emotion has probably changed little, and the animal spirits that drive stock markets remain similar over generations. But the facts on the ground and the actions taken by companies, governments and individuals are not exact mirror images in this period. The differences are not all positive, but they are real and material. Our situation will unfold differently than that of the 1930s. Charts overlaying current market movements with those of the ’30s are interesting parlour tricks and might be made good use of in *The Amazing Kreskin’s* show, but they should not be taken as the writings of Nostradamus. (Of some interest, an Internet search for comparisons of the rally to that of the ’30s shows the same case being made in 2002 and 2004—obviously, this is a popular bugaboo!)

One can also be scared away from the current market by analytical pronouncements that price/earnings ratios are too high. I’d be very wary of placing too much faith in this assessment. What earnings are being used for the calculation? Trailing earnings? I would suggest the recent 12 months would be an overly pessimistic input for a forward-looking decision. Next year’s forecasted earnings? The immediately coming year remains a crapshoot

and forecasts probably retain the scars of the current recession. I might even go so far as to say that forward earnings estimates are too pessimistic. They might not understate next year’s earnings by much, but they might be underestimating true earnings power over a future cycle.

This is a particularly good time to pay attention to my favourite valuation tool, the price/sales ratio. For profitable non-financial companies that will likely return to average levels of profitability at some stage in the future, this tool is particularly adept at spotting excessively pessimistic (low p/s ratios) valuations. From my perspective, the valuation of many companies that would someday return to average profitability was insanely depressed at the March lows. Despite a material rally off those lows, significant appreciation potential remains over an investment horizon. That there can remain a still-high positive potential, even after a significant rally, is a result of what Anirvan Banerji of the Economic Cycle Research Institute refers to as the “error of pessimism” which, after a crisis such as we have just seen, “is born not an infant, but a giant.”

I agree that the pessimism of March was of giant proportion and hold that stocks will deliver positive returns over an investment horizon, even from present levels. In October, though, stocks frequently sold off despite favourable economic or earnings news. This is the classic signal of a market that no longer wants to go higher, and the recent weakness is consistent with that. The market never rallies in a straight line (unless you happen to be short) and it feels, even to a bull like me, that the current move has entered a corrective phase. Just as the size of the recent rally was inversely proportional to the degree of pessimism that preceded it, the size of the rally may lead to a fairly sizable corrective phase. But a correction is what I see (perhaps a significant one), not a fresh bear market, to be followed by a resumption of the rally.



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## BUSH LEAGUE

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Over the years, I have moved from being a strongly partisan political junky to more of a bemused, somewhat despondent libertarian. Bill Buckley's line, that he supported voting for the most conservative candidate electable, would be a good description of my current view. My bemusement comes from the dearth of opportunities to vote for electable conservatives that I am presented with in Ontario. I do not consider Stephen Harper's Conservatives a particularly conservative bunch and the less said about the provincial Conservatives the better.

In the U.S., however, the situation for conservatives is both dire and electric. It's dire because Democrats control all three branches of elected government, with President Obama and Speaker Pelosi being the most left-leaning liberals in those positions in recent memory. It's electric because the U.S. system makes it possible for the electorate to fight back and for the minority party to at least run out the clock and keep down the score. And the fighting back and stalling were in full throttle this summer and fall.

Saturday Night Live recently did a funny skit that poked fun at the fact that President Obama had really accomplished nothing to date in his presidency (ironically, that was immediately followed by his winning the Nobel Peace Prize, a headline that most assumed contained a link to *The Onion's* web site when they first saw it). While there is a lot of truth in that assertion (fact-checked though it was by the dying-before-our-eyes CNN), it certainly hasn't been for a lack of trying. Barack Obama is actually attempting to do very, very big things. Democrats have passed a carbon bill in the House and, as you may have heard, are attempting to pass a health care bill. Both of these pieces of legislation will have massive, profound (and, in my view, disastrous) consequences if passed. Thus, while it may be fair to say that President Obama has been ineffective, his aim is not to preside over a caretaker administration.

It almost seems to me, in fact, as if the Democrats are trying to govern as a Republican caricature of the left-wing liberal. No area of the economy is too big or sacrosanct that they would not take control over it, no spending bill is too large that they can't stuff more pork into it, no foreign thug is too tyrannical that he can't be cozied up to, no insult to the United States is too grating that it can't be a good thing (as long as it refers to the pre-

ascension period), no opponent of the administration too inconsequential that they can't be demonized. The "we won" attitude is great if you have the people on your side but evidence is growing that this is not the case. The tea-party movement slowed the health-care steamroller enough that it may never actually succeed. These popular uprisings were of a spirited citizenry, quite clearly not an angry mob (for an example of a bona-fide angry mob, merely see each gathering of the G-8), and the message was firmly transmitted that the American public is not yet ready for a headlong dash into socialism. While Harry Reid, Nancy Pelosi and Barack Obama may not have fully received the message, it appears to have been successfully transmitted to all House and Senate members up for reelection in close races next year, and that's actually what matters the most.

While it is largely the statist-minded policies of President Obama that bother me, I do have issues with his manner as well. Two examples of presidential speech that I found especially unseemly were heard recently. In the first, the President, referring to the town halls and tea parties, said "I don't want the folks who created the mess ... to do a lot of talking. I want them to just get out of the way so we can clean up the mess." That's almost a threat, and it's truly an appalling statement for a man who was heralded as bringing a new era of civility to politics. Later, at the United Nations, the President actually said, "For those who question the character and cause of my nation, I ask you to look at the concrete actions we have taken in just nine months." Has there ever been a more self-absorbed line uttered by a sitting president? The odd concrete action occurred prior to Obama's election that demonstrated the character and cause of the United States. Were these statements the exceptions, I would not have cited them. But they are the rule and they are disconcerting.

The public blowback, the fading polls and the gubernatorial defeats in Virginia and New Jersey show that the bloom is off the Obama rose. My sense is that the Democrats will get slaughtered in the 2010 elections. Then, we will see if President Obama tacks towards the center, takes advantage of likely better economic times and wins a second term, à la Bill Clinton. If he doesn't, if he continues to try to be the President of 50% + 1 of the people, he will be a one-term hiccup. It will be interesting to see which route he takes.

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## BACK OF TOWN

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- The recent cash-for-clunkers program was an extreme example of government waste, stupidity and willful blindness. It also highlighted the fact that there is more to life than GDP and it is an imperfect measure of the economic state of an economy. Sarkozy may be going too far by adding happiness to the equation, but government economic statistics are imperfect measures. In the cash-for-clunkers program, for example, the money paid to the mechanic who destroys a fully-functioning automobile counts as positive output. That would be like paying people to burn down houses and claiming that you were doing good because GDP goes up by the income paid. GDP does not account, in any way, for the value destroyed in these situations. Normally, one doesn't have to worry too much about that flaw in the system because, normally, we don't go around intentionally destroying our assets! But let the government at the problem and that's what we do.

There's an old saying that what gets measured improves. The corollary would be that what doesn't get measured gets ignored. I submit that from a true, all-encompassing economic-state perspective, the cash-for-clunkers program was a net negative to the U.S. economy. When you add to this the fact that it was poorly administered and amounted to tax windfalls to a random slice of the economy, financed by the poor schleps who didn't need a new car (thus being grossly morally unfair), all I can say is thank goodness the program is over.

- Since the onset of the financial crisis, there has been a linkage across virtually all financial markets. It's the risk/anti-risk trade. On days when the market is afraid and does not want risk, the U.S. dollar rises, stocks fall and commodities fall. On days when it wants risk, the dollar falls, stocks rise and commodities rise. It has felt like all correlations are 1.0 or -1.0 these days. It will not last forever. Perhaps, the start of the next leg of the advance will be marked by a breakdown in the extreme degree of inter-market linkage of this past year.

- The minimum wage has recently been hiked in both the United States and Canada. Those who have a modicum of common sense have argued for years that this will only increase unemployment for those who have the least to offer employers. To think otherwise is to be foolish, or a liberal – but I repeat myself. People who work hard don't enter the workforce at the minimum wage and stay there for

the rest of their lives, enslaved by greedy capitalists. What they do is get work experience to make themselves more attractive and then work their way up, either at that company or another company. If you've ever worked anywhere other than government, you'd understand that. But the bleeding hearts can't stop themselves, always thinking they are helping the poor by raising the minimum wage but, once again, failing to account for the damage they are doing (those who don't get jobs because they haven't yet accumulated sufficient work skills and now may never).

It's the kind of idea that is best proven by taking it to the extreme. If \$10 is better than \$9, then surely \$11 is better than \$10, \$20 better still and \$10,000 per hour the Holy Grail of the minimum wage. Sure, the entire economy would grind to a halt and everyone would turn to a black market, but the do-gooders could feel ever so good about themselves due to their noble intentions. The other extreme also works. Reducing the minimum wage to the zero would allow everyone who wanted to work to find a level at which their services would be of value to someone. As we do not yet live in a Communist dictatorship, people who didn't want to work at low rates of pay would not be forced to. The market would find the right clearing rates for various degrees of entry-level skills and overall employment would increase. When one considers the psychic benefit to an individual and to society of people being able to work for a living, the moral brutality of the minimum wage becomes even more disconcerting.

- Due to the foibles of South Carolina Governor Mark Sanford, Mississippi Governor Haley Barbour is now the leader of the Republican Governors Association. Barbour is my favourite Republican and hopefully will throw his hat into the 2012 presidential race. He's bright, economically conservative and gregarious. Oh, how I've longed for the days of an articulate advocate for conservative policies!

Until next time,



November 4<sup>th</sup>, 2009

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