

INVESTMENT QUARTERLY

IS THIS PERFECT STORM III ?

In July of 2000 we penned our first “Perfect Storm” analysis of the market. Our second projection of this phenomenon came in July of 2008. While both of these quarterly comments preceded significant market corrections, we realize how much luck plays in making any forecast successful. The prior perfect storms arose from different market and economic scenarios. In 2000 the market, particularly high tech, was flying high and the economy was showing the stress of unsustainable growth. The goal then was to slow the economy and cool the overheated markets, a much easier task than we faced in 2008. At that time we were looking at a potential collapse set off by the nearly total implosion of our financial system. Since that time we have learned that it is much more difficult to revive a moribund economy than it is to put the brakes on an overheated one. As we approach the end of 2011 we may be facing worldwide conditions that could lead to the third coming of the “Perfect Storm” phenomenon. Only time will tell if we can overcome the traps lying in wait for us if our politicians and monetary leaders make the wrong policy decisions.

Our domestic economy is muddling along with a growth rate of about 1.5% despite all the money that has been pumped in via stimulus over the last few years. As we surmised in the past, because of a national lack of confidence the stimulus efforts have been pushing on a string, with money just piling up in reserves rather than boosting the economy. The velocity of money has not increased enough to bring about the multiplier effect needed to get our economy back to its sustainable rate of growth. The two main causes of this financial malaise are the continuing slump in real estate and the continued lack of new job creation. While the administration has proposed a jobs bill and appears to be on the verge of providing some package to help homeowners whose mortgages are under water, the former plan appears dead on arrival and the latter will likely not prove to be bold enough to make a difference. The most troubling aspect of our economic malaise is that the very people who got us into this mess are still in charge of getting us out of it. In the business world the people who got you into trouble would be replaced by people with new ideas who are not tied to failed practices. Politics and re-election are more important to our representatives than boldly challenging the issues that are holding our economy back.

With our economy flying barely above stall speed the impact of an economic shock could be devastating in the short term. The efficacy of Federal Reserve action has been reduced by the global economy as we suggested in an earlier quarterly. Where once Fed action could quickly affect our domestic economy, now actions by foreign financial intermediaries can countermand the Fed’s efforts. The European rescue plan of the day has provided a short-term bounce to our equity markets, only to see the market strength erode, as the plan is later judged to be insufficient to provide a cure. If Greece ultimately defaults the repercussions on French and German banks could ultimately impact the US banking industry. We don’t have the reserve capacity now that we had when Lehman and Bear Stearns imploded. Two major stimulus programs and other financial rescue packages have left our cupboards pretty bare. Our deficit is now \$14.5 trillion and

counting. The Fed's balance sheet is overloaded from stimulus actions so there is little room to take any major new steps. The future looks like a minefield requiring correct policy decisions to steer us through whatever develops. Because no one in power has had to deal with this type of global problem before it is an extreme challenge for all parties to work together in harmony and unselfishly resolve whatever challenges arise. With sovereign rights and interests amongst the European Union members not always aligned, it is hard to visualize them coming together with the right policies in a timely manner. This could make our congressional partisanship problems look like child's play in comparison. An additional drag on our economy could result from a strengthening dollar relative to the euro. This could result in increased costs to purchasers of our products and thus lower demand for imports from the US, which has, until now, been one of the strongest parts of our economy.

Is there any bright side to this scenario? Well, companies have large cash balances that they have been reluctant to invest in the face of continuing economic uncertainty. Corporate earnings are looking reasonably good and the price earnings ratio for the market is not unreasonable on the basis of current earnings. Any time there is "good news" about a proposed solution to the economic problems here and abroad, the market has a positive bounce. If we are able to muddle through and avoid a double dip recession we may continue in the current trading range. One of the indicators we watch is the money supply, particularly M2. M2 consists of currency in circulation plus all time-related deposits, savings deposits, and non-institutional money market funds. Normally neutral M2 grows at a rate sufficient to support economic growth plus inflation. At present M2 is growing at 23%, well above a neutral posture. This should be heating up the economy or causing inflationary pressures but it is doing neither at this point. This liquidity could provide protection against a significant decline from these levels.

Until confidence returns to the economy we think we are likely to see an active mergers and acquisitions market as companies use their cash hordes to enhance their product lines while waiting for a return to demand growth. This will provide some support for the market and could calm the potential for the next "Perfect Storm". But, we have a long way to go before our economy returns to normal. While the concerns that future generations would never do as well as their predecessors proved unfounded when they arose during the Regan years, this time we may have really done it to our younger generations.

To have a chance of succeeding in this type of market one needs to focus on quality, diversification, and the sustainability of earnings growth plus the ability to overlook short-term volatility and focus on the longer term. Common stock, in our opinion, still continues to offer greater potential total return than bonds at this juncture. Only time will tell if the markets and economy degenerate into the 3rd Perfect Storm.

For the third quarter, the S&P500 declined 13.84%, the Dow Industrials declined 11.5% and the Barclays Intermediate Government Index was a positive 3.4%, not a Perfect Storm but definitely not comforting either.

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Averages at 9/30/2011	
S&P 500	10,913.38
DJIA	1,132.42