Round Trip to Nowhere

John Gustafson – 8 January 2012

Like a bad cruise through a hurricane – last year was certainly no vacation that you would care to repeat. However, just like the cruise, at the end of the year we found ourselves generally back in port, according to the U.S. indices at least, and slightly worse for wear from the punishment felt in Europe and parts of Asia.

Reviewing what I wrote to end 2010, I'll attempt to not completely repeat myself, but not only was the market basically flat – so were all of the political and economic situations we faced. We hear a lot about the do-nothing Congress (& White House & EU), and for 2011 it was absolutely spot on – plenty of noise, emotion, smoke, mirrors and posturing, but with very little action. We first outlined the problems in Europe way back in May of 2010, and the year ending note discussed the American political discord as well as the slow (and generally ignored) improvement in the economy. All of that was accompanied by the general malaise and fear of any risk from the public or investment professionals. A year later and not much has changed…

The politicians on both side of the pond – while continuing to be completely spineless, leaderless and selfish – have proven at least one thing which is a positive for the markets and probably explains some of the recent calmer seas: they will take action if they absolutely have to in order to avoid complete disaster - and not a moment sooner. This appears as though the direction we are finally heading, especially in Europe. Very similar to a teenager writing a term paper, unfortunately these issues are slightly more important... As has been discussed ad nauseum in our headlines of the past year, the problems we face financially on both sides of the Atlantic can no longer be partially solved (the vernacular being "kick the can down the road") without causing far more damage. We have some time, but it is running very short.

Another potential positive is that everyone has become too irrationally negative; it's almost the antithesis of the late 1990's. I don't like to be a contrarian just for the sake of being a contrarian, and the old saw about a market's ability to remain irrational longer than you remain liquid is a truism, but any positive comments currently put forth are shouted down immediately with a million statistics behind the vitriol. Exactly the same as happened to folks who uttered a remotely negative phrase in 1999 or 2006. The wall of worry is being rebuilt daily, with reinforced concrete! I'm not calling for a dramatic turn right now because we are knee deep in political mudslinging, which is a real wildcard in the short term, but at least in bond-land, I haven't seen this many people piled up against the gunwales on one side of the boat since NASDAQ at the end of 1999!

It is one of the main reasons it's wise to not strictly rely on any single set of data or reports out there. Instead, try to look at everything in context. As I listen to the daily negative spin from the talking heads of the investment media, I am reminded of a study out sometime in the past few years discussing how very smart people may not make as many mistakes as people who are not as smart, but when they are wrong it can be spectacular. The core reason behind the conclusion was that the very smart person can always find some kernel to support his or her thesis once they buy in, and it may be more difficult to argue against the position as they build their wall and become even further convinced of their own brilliance.

It showed up this past year in the form of several wildly successful fund managers who survived and even thrived in 2008, having seen the financial tsunami coming and possessing enough guts to position for maximum advantage at that point, but absolutely came apart at the seams in flat but volatile 2011. It seems to be something we have all intrinsically known for a long time – and as Mark Twain stated over 100 years ago, “There are lies, damn lies, and statistics.” I think it’s good to be reminded of that when the media is driven by whatever is the popular message of the moment. Also another reason the famous mainstream magazine cover indicator is somewhat effective – following the herd is rarely profitable in the longer term. Or as one of my degenerate gambling pals likes to say – “fade the public.”

Something else I’ve also noticed over the past several years, there are now a large percentage of folks in the investment business who have never seen a real bull market as a pro - the complete opposite as to how the 1990's to early 2000’s appeared. While this probably breeds those who are a little more contemplative than a monkey with a buy-button (to quote a favorite 1990’s blast), but what this also does is lead to wildly misallocated portfolios in the opposite direction. For you football fans out there, you know that prevent defense only prevents wins. You play to win (cue the Herm Edwards drop) – you do not play to simply “not lose.”

A symptom of all this angst and fear is that the term “Black Swan” has gone from signifying a rare statistical outlier (that most had not even heard or thought of) to being viewed as a rational, regular expectation. The reason they are called “hundred year floods” is not because they happen every three or four years. That’s not to say I don’t think there is downside risk with the continuing EU disaster as well as our own political folly, but to constantly be looking for the next catastrophe like the dot-com bubble or Lehman dying as the canary in the housing bubble coal mine is counter-productive.

A good rule of thumb – and the basis for fantastic annual prediction lists from the likes of Barton Biggs and Doug Kass (“possible improbables”) – is that you invest for what is *probable* and hedge for or speculate on what is *possible*. Don’t ignore the risks, but it’s an enhancement to the long term core, not the entire strategy. A “perfect hedge” provides a zero return.

Finally on the positive front: jobless claims continue their downward move. (it’s the direction, not the absolute rate that moves the sentiment needle) The U.S. economy is still growing despite almost everyone’s call to the contrary after the EU disaster and concurrent debt ceiling debate meltdown. And consumer sentiment improved again, driving Christmas sales up dramatically – we are a consumer-driven economy in America after all. On top of all that, I learned last week on a research call that we ended the year with almost $9 trillion (with a “T”) in cash – with a third of that in money market funds. Lots of dry powder waiting for the emotional spark…

Although, the Christmas shopping item was a bit of an odd story and why I continue to state that what the politicians *say* in the media truly matters to the economy almost as much as their actions. (or lack thereof) When asked this year in the pre-Christmas economic surveys, the majority of people said they were going to spend more this year, but still stated they thought the overall economy is worse with little sign of improvement. Perception is reality in the short term…

Now let's look at what negative headwinds we're probably still facing for 2012:

The elephant in our American living room, politics and the messy sausage-making process of the primaries, has revealed no real details or reasonable economic plans from any of the Presidential candidates. All they want to do is throw bombs at each other and spout vague, unverifiable talking points. This is why I will stand by a statement made in one of these letters back in May of 2011 (before Europe flared-up again and the SEAL Team had just killed Osama bin Laden) – the GOP continues to overlook the enormous advantage of incumbency in general and specifically the bully-pulpit of the Presidency.

Can anyone recall the Democratic strategy in 2004? That's right; they were exclusively and rabidly focused on getting "Dubya" out of the White House no matter what. So blinded by the extremist nature of the attacks that not only did they lose; they failed to significantly cut into his majority in Congress. The GOP is currently employing their own circular firing squad technique and completely ignoring the wide-open opportunity amidst heavy Democratic retirements to capture the Senate and solidify overall control of Congress.

This, as longtime readers will all recall, is where my rooting interest truly lays – actual parity and balance in our government: one party controlling the full Congress and the opposite in the White House. That situation has been proven to be far more pro-business and pro-U.S.-economy than any of the dogmatic hogwash to spew forth from one-party rule from either side of the aisle. (I shared a chart from JP Morgan confirming that very position last summer.) That is the ideal, but since everything political has gone against the markets over the past couple of years, I'm putting this in the negative column for now. (i.e. similar to the 2011 market, lots of smoke, noise and emotion as we roll toward the elections, but no real change once the dust settles.) Something to keep an eye on - I truly hope I'm wrong on this one…

Another negative is the continued, political criticism of Ben Bernanke – he is doing what he's doing to combat the dangerous inaction of the current White House and most egregiously, the Congress. (as well as the Europeans who have meetings to schedule meetings and discuss points to put together a schedule to, blah, blah, blah…) He would likely not need to employ many (or any) of the current hated techniques (Operation Twist, QE1, QE2, et al) if there were some form of fiscal rationality or consistency coming from anyone inside the beltway. Again, nothing likely to change until at least next year – circling back to my analogy above - when I believe our term paper will be due. (Bush tax cuts expiring again, more debt ceiling issues, etc.) The one positive I see is that Helicopter Ben & the Fed governors do seem to grasp what needs to be done to keep this ship sailing and have shown that they will act when necessary with creativity not seen (or required) from the Fed of old.

The case against a change in personal outlook & investor sentiment this year goes back to politics and the media as well – I hate to keep harping on all of this circumstantial stuff, but as I mentioned above, in the U.S. the actual numbers continue to improve. Politics and the uncertainty driven by political flip-flops are what are keeping us down. Every print & broadcast media report is so negative it's mentally draining and the Baby Boomers have seemingly given up. They have spent their lives in the land of milk & honey with not a care in the world except "what will I buy next?"

Boomers as a generation epitomize the "Grasshopper" from the old parable – and winter (retirement) is on the way. (I know, I know not everyone fits the description but the generation is large enough that the majority has always mattered economically.) We know their parents more embodied the "Ant," and many of the generations behind them will be forced to think that way because of the irresponsible economic largesse.

The formerly irrationally exuberant members of the 80's "me generation" need to stop worrying about what they didn't do prior and look forward with a positive & realistic eye to see that retirement has never been one point in time from a financial perspective – it is a long period over the final stage of life.

Being wildly conservative (so you think) with your remaining capital after you have already failed to save properly merely gives you zero opportunity for improvement over the years ahead. Does anyone think that locking into less than 2% for 10 years is a sound financial idea? I'm not saying push it all in and spin the wheel, but you always have to have a little bit of growth potential on the books. There have been periods this extreme in outlook a couple of times before, but none this negative since the mid-1970's.

The cry of "risk on" or "risk off" on TV has helped to make watching the flickering ticks almost like sports, but for the majority of folks out there it would be best to just turn it off. Our investing culture has fallen prey to the short attention spans and the immediate gratification or disappointment of other phases of life. We spent two recent decades always looking for what might work – we're now spending one looking for everything that won't. Be careful on the crowded port side of that boat - sometimes things go well.

My bottom line for 2012: I think those continually beating the negative drum will have a few wins (thanks mostly to politics), but I think those that have good balance in their allocation will be rewarded for patience – especially here in the U.S. The increased volatility of the recent few years is likely with us for good, so strategize, hang on tight, and have a great year.

Thanks for listening – I appreciate your continued trust and continued referrals to new folks – it's the only way we grow. Please let me know if you have questions or would like to discuss anything I've outlined further.

Cheers!