INVESTMENT UPDATE
NEWSLETTER

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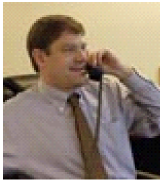

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Dr. Jekyll and Mr. Market: Surely the World Is Doomed – Wait, No, Everything's OK Now!

The stock market has just come through its worst First Quarter since the late 1930s and its best month since 2002 (S&P 500 total returns of -11.0% and +8.7% respectively). So should we fret or celebrate? Are we teetering on the edge of total calamity, or are happy times just around the corner? To the first question, we answer "both." To the second question, we say "neither." More about these answers shortly.

First, let's revisit briefly why the market behaved abysmally coming into early March, when the S&P 500 skipped off 666, down some 57% from its all-time high. Primary reasons are familiar to you, and they are fundamental in nature: house prices worsening and foreclosures without relent; unemployment that keeps rising and workweeks that keep shrinking; "systemically important" financial institutions taking up what looks evermore like permanent residence in the Federal Intensive Care Unit.

Ironically, a missive from the ICU provided the first spark, albeit a dismal one, igniting a market ready to rally. In an internal-cum-external email, Citigroup's CEO suggested his bank might turn an operating profit for the quarter, notwithstanding the reality that it would be insolvent if not for all the tubes plugged into it from the public purse. The Bernanke Fed added tinder by announcing it would buy over a trillion dollars in US Treasuries and agency bonds and mortgage backed securities. Perhaps giddy that the Fed would so vigorously monetize the public debt, the Geithner Treasury trotted out a plan to avail the federal balance sheet to speculators if only they'll use the credit to bid up prices on lousy bank-held assets. As if that weren't enough to fan the flames, the Financial Accounting Standards Board telegraphed that it would emasculate the mark-to-market rules by which companies value their assets (i.e. repeal calling things what they're worth), the G-20 convened without anyone throwing chairs or storming out in a Gallic huff, and IMF lending capacity grew a trillion dollars for heaping onto the fire. And – *Presto!* – we had a toasty bull market in miniature, stocks up over 20% in a scant three weeks.

So why fret? Even leaving aside for a future letter the troubling common thread above – pushing new debt as a cure for old debt, while collateralizing with the same bad assets – we're not yet seeing fundamentals improve of their own accord. While there seem to be process-oriented improvements, we're not at normal yet. Senior bank debt still trades at prices that would make a fishmonger pinch his nose, and General Electric obligations at spreads which give the lie to its new AA+ rating. There's even been some backsliding – the 10-year Treasury has eroded to where it was just prior to the Fed's trillion dollar bombshell. Meanwhile, climbing stock prices defy the tug of gravity in two ways especially: Dividend cuts are becoming commonplace even outside the financial sector, and as Merrill Lynch's chief strategist Richard Bernstein points out, the S&P may be on track for negative aggregate earnings for the first time ever. The market price/earnings ratio, potentially? "N.M." or Not Meaningful!

Then what do we celebrate? When fishmongers pinch their noses, good value may be on offer. We're still finding corporate and muni bonds we like, though fire sale prices seem now behind us. TIPS yields pique our interest as the federal profligacy meter tilts ever toward "Amok." To us, healthcare, defense, utilities and consumer staples stocks hold promise at these levels regardless of hard times. That we spy enticing values even as we fret helps us conclude that the world is not doomed, even if not yet OK. If things remain bad, at least much is priced for it.

The imperative: Look at value, and not the calendar. Steering by one quarter's losses or one month's gains will jerk you about like Jekyll.

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