INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
COMPANY

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Risk Factor Round-Up

After springtime's drop in global stock markets, summer has been serene… which makes this a good time to remind ourselves of the investment risks still out there. After all, serenity's nice, but complacency can put your cart into the ditch.

Europe: I've said plenty about Europe's problems over the last couple of years, so I won't repeat myself other than to say that the fixes tried so far will hold things together about as permanently as bubble gum and baling wire.

Emerging Markets: Likewise, I've said plenty about China's problems unwinding a dual bubble in credit and real estate, so I won't go further than to note that Big Red seems to be drawing much of Asia and trading partner Brazil into its slowdown.

Drought: Crop destruction from this summer's record heat is making global food prices spike. This matters in the US, of course, but especially so in the emerging markets where food costs make up a far greater percentage of household budgets. This isn't just about consumer price unpleasantness here; it's about destabilization at the societal level elsewhere, with feedback potential in terms of popular unrest abroad.

US Election Cycle: Marketwise, the near-term importance of upcoming elections is not who looks to be gaining or slipping in the polls, but rather the deferral of critical decisions beyond November 6th. Capital gains and dividend tax rates are scheduled to jump next year; yet the market seems unconvinced, holding out hope for a post-election extension of current sweetheart rates. Whatever Congress decides and the White House accedes to, this back-loading of the calendar will crowd the markets' reaction function into a scant few weeks. Compounding tax uncertainty is uncertainty as to whether Federal spending will be allowed to dip as much in 2013 as it's presently scheduled to. For a stock market habituated to federal largesse, any major fiscal drawback will hurt.

Process failure in the capital markets: Last month I shared my concerns about "institutions still taking on risks of a complexity and peril akin to business as usual in the run-up to the Fall 2008 financial crisis." As if on cue, Knight Capital Group, which handles some 10% of all US equity trading, nearly destroyed itself by inadvertently releasing a trading algorithm which piled loss upon loss to the tune of $440 million in just a few hours of malfunctioning software; to get a sense of the proportionate damage, as of this writing the firm's market capitalization is just $264 million. As we warned last month about JP Morgan's own huge trading mishap, bad risk management practices tend not to occur in isolation.

Falling orders and order backlogs: These leading indicators of US economic activity have slipped to levels not seen since the last recession; this isn't the end of the world (after all, since recessions are an inevitable part of the economic cycle, we sure *ought* to be able to ride them out), but it suggests that asset prices predicated on ever-rising economic activity are in jeopardy.

Market valuation levels: <u>All of the aforementioned risk factors are survivable, and none precludes investment</u> where asset prices appropriately reflect them. Our concern is that, in large part, valuations do not reflect them. Bond yields weeks ago scraped to historic lows, and stocks are pricing far above trend relative to normalized earnings. In effect, bond and stock gains since 2009's trough have borrowed from future return potential, and in so doing they have hollowed out risk premium and margin of safety. This doesn't mean good opportunities can't be found, just that they're not easily found at the broad asset class or sector level; accordingly, we have to discriminate and differentiate – this means shunning much of what's on offer out there, and being willing to depart from strict benchmark weightings. This is a time not to hug the index, but to step back from it.