INVESTMENT UPDATE
NEWSLETTER

ALLEN TRUST
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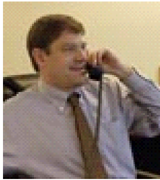

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The Great Derangement

Why are so many people falling all over themselves to hail that we're entering another Great Depression? Reasons for their eagerness may differ: Wall Street doing it for exculpation ("*We* didn't lose your money, the new Great Depression did"), news media because ominous imagery grabs attention, politicians either to grow their scope of control or at least to appear to be doing something, Detroit executives to scare their way to a place at the public trough, and regular folks because, well, how else can you explain markets so suddenly gut-churning and out of control? And indeed there may be more than a kernel of truth or justification in each of those explanations, along with data aplenty to assist in the pitch.

But if we slip now into a new slough of financial despond, it will be as much because we embraced the notion as it will be in spite of our efforts to resist its eventuality. If bad fundamentals aren't bad enough to get us there on their own, maybe the negative feedback loops of panic and opportunistic pessimism will serve to do the trick.

At Allen Trust Company, we recognize our inability to predict the future, yet we work hard to suss out the themes which will define it. Underlying all our attempts at prognostication, however, is one bedrock fundamental precept: that the American system of political economy will shoulder forward in the long haul, and ultimately benefit those who participate patiently.

So folks, I hail not the new Great Depression, but the Great Derangement, an epoch in which macro- and micro-level forces alike have become dysfunctional to an extreme that defies not only expectation but also logic. Diseconomic relationships which ought to be unsustainable in a rational world have nonetheless endured for months on end now. How and why? Because 2008 (re)introduced a world no longer sufficiently liquid or solvent to operate efficiently or even consistently. Time alone will tell what cures it (and my belief is that time itself is the likeliest cure), but for now consider its main symptoms:

Extreme Volatility

Whether measured by the Chicago Board Option Exchange's volatility index (VIX) blowing out to all-time highs, the number of 10% intraday swings in the stock market, oil prices leaping past $140/bbl and promptly plummeting below $40/bbl – well, pick your metric, and it likely describes a wild ride. While news flow has inspired some of the swift jags up and down, much of it seems attributable to one thing: a breathtaking compression of investment time horizons. In the markets at least, life has been lived as if the next 10 minutes decide everything. I don't know if that fits a textbook definition of insanity, but unless you're a two-year-old, I think it does well enough.

Perverse Valuations

While the current price of any asset is always rationalized by someone (otherwise that price level wouldn't obtain), recent valuations have seemed intrinsically out-of-whack:

- T-Bills versus the Number Zero: This month, 4-week T-Bills have changed hands at negative yields to maturity, i.e. investors are voluntarily "breaking" their own buck, making the number zero a superior prospect to what orthodoxy deems the ultimate harbor of safety.
- Treasury Bonds vs. AAA Munis: At some maturities, AAA-rated general obligations are yielding nearly twice what Treasuries yield on a pretax basis, and nearly three times as much after taxes.
- Closed-end fund prices vs. Net Asset Value: Even on respectable funds of investment grade bonds, discounts to NAV have widened to double digits.
- Tax-exempt municipal money market funds this fall briefly yielded over 6% vs. 2% yields on taxable corporate money market funds. Huh? 'Nuff said.

…and these are just highlights from the bond and money markets. Wading into the equity and

structured product markets in the 4th Quarter has likewise made for a funhouse experience in distortion and disorientation.

Clamoring for a *Deus ex Machina*
Week by week, different individuals and institutions have been cast as the beneficent almighty on whose actions we can pin hopes that the markets will recover not just their senses but maybe even their formerly lofty values. Some of these have been dragooned into the role, and others have eagerly volunteered themselves. But Bernanke, Paulson, Buffett, Obama and his wunderkinds, the central banks, major banks (JP Morgan, Bank of America, and Wells Fargo as erstwhile blue chip repositories for newly dead or dying assets), and gosh forbid, Congress, have all been called upon and yet found wanting. There are no magic bullets here, and lousy economic and financial fundamentals cannot be reflated, jawboned, recapitalized, or legislated away without pain and major sacrifice.

Investment Themes Looking Forward
So what's next? As the markets gradually recover their senses, a new set of criteria is evolving for rational standards of valuation, and we believe these are among its characteristics:

- Investors, so obsessed with balance sheet issues of late (and appropriately so, given that solvency is akin to survival), will rediscover the income statement; with market stabilization at any level, issues of profitability will come to the fore as instances of seemingly overnight insolvency fade to memory.
- The trend I identified in my July letter about stockholders rediscovering the residual nature of equity will continue to resonate: going forward, they'll continue to demand higher risk premia; this is no good for buyers seeking rapid appreciation, but it's great for long-term, judicious dividend compounders.
- "Safety" as currently bid won't stay safe. I refer here to the Treasury market in particular, where yields either don't make sense (T-bills trading at negative yields to maturity) or won't make sense for the long haul (a 30-year T-bond yield hovering around 2.6%).
- We will start getting better clues as to whether the enormous expansion of the Federal Reserve's balance sheet and federal obligations in general will merely dilute the dollar's value or ensure its ultimate debasement; the key factor is whether or not the conjuring of currency presently rushing into the vacuum left by catastrophic asset deflation gets the machinery working again or merely gilds a broken engine. Our bet is that the machinery will grind gradually back to life, albeit with much backfiring and belching of smoke; an alternative and grave concern is it may jump off the blocks altogether and bounce down the road like a crazed robot. We're approaching a dangerous level of stimulus and nationalization of private functions here, a trend at once potentially debasing and uncontrollable in its unintended consequences.
- Diversification, so ineffectual this year because so many asset classes started it overbid, will reward the patient from here on out, both because over time its benefits are tantamount to a mathematical identity, and because so many assets are now cheap.

Last of All, and Most of All
We will survive, and our portfolios will too, though as I've written before, it may hurt like hell along the way.

May the New Year find you and yours in robust health and high spirits, and taking heart that life is good even when it is hard on us.

William A. Harris, CFA