Market Commentary, August 6, 2003
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S&P 500: 967
NASDAQ: 1652

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Okay, so you've figured I've finally lost it; using song titles for a serious financial commentary. Well, believe it or not they are all appropriate. And I am excited—we've got READER ANECDOTES!!! They are near the end. Thank you for all the stories-they are great and please keep them coming. First, let's get down to business.

Communication Breakdown

"A particularly severe crises in 1907 prompted Congress to establish the National Monetary Commission, which put forth proposals to create an institution that would counter financial disruptions of these kinds. After considerable debate, Congress passed the Federal Reserve Act, which President Woodrow Wilson signed into law on December 23, 1913. The act stated that its purposes were 'to provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.'" (Source: Overview of the Federal Reserve System by the Board of Governors of the Federal Reserve System, Washington, D.C. 1994 http://www.federalreserve.gov/pf/pdf/frspf1.pdf)

As you can imagine, this is one of the most significant events of the 20th century, in my view. First, it was created to "counter financial disruptions of these (severe) kinds": This is where the "invisible hand" theory of Adam Smith was put aside to allow the Fed to attempt to "smooth out" volatile periods of trade, banking and financial imbalances and that which I will focus on here: inflationary and deflationary periods. The "elastic currency" they are to furnish is just that: a currency which when compared to a basket of goods and services, fluctuates in value as measured by the fluctuating values in dollar terms (prices) of those goods and services. (Inflation=currency worth less compared to what you can buy and Deflation=currency worth more compared to what you can buy) So what do I mean by "Communication Breakdown". In its efforts to calm markets during uncertain times the Fed, along with being able to target short tem interest rates and to some extent long term rates, issues public statements which serve to guide markets as to the intent of its future direction. At the end of its statement May 6, 2003 following the Federal Open Market Committee meeting the following comment was made: "the

probability of an unwelcome substantial fall in inflation, though minor, exceeds that of a pickup in inflation from its already low level. The Committee believes that, taken together, the balance of risks to achieving its goals is weighted toward weakness over the foreseeable future." (Source: FOMC statement http://www.federalreserve.gov/boarddocs/press/monetary/2003/20030506/default.htm) This caused bond market investors to think the Fed's bias was toward lowering short term rates in the near future to offset the threat of a fall in inflation (deflation). They were also led to believe the Fed may follow through on previous implications it made about attempting to lower long term rates by using "unconventional methods" (methods other than interest rate adjustment) and going into the open market and buying long term treasuries in existence. (In the event you did not know, the way the Fed sets short term interest rates is by literally setting a target rate it intends the market to maintain. It does this buy buying and selling short term treasury securities. So if the Fed sets the target at 1% and the market starts moving it to 1.1%, the fed will go in and buy enough notes to get the yield back down and vice versa) If bond investors think rates will decline, they will buy bonds thinking they will only be more valuable in the near future (bond prices rise as prevailing interest rates fall and vice versa). These statements caused the final surge of buying in the much heralded "bond bubble" which has directly influenced the dramatic decline in mortgage rates thus making housing more affordable, the final effect being the increase in value of homes. THEN, following the June meeting, at which short term rates were cut .25 percent, the Fed had this to say: "The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. In contrast, the probability, though minor, of an unwelcome substantial fall in inflation exceeds that of a pickup in inflation from its already low level. On balance, the Committee believes that the latter concern is likely to predominate for the foreseeable future." (Source: FOMC http://www.federalreserve.gov/boarddocs/press/monetary/2003/20030625/) This statement was construed to imply just the opposite as the last, as you can imagine, despite how difficult it is for me to interpret it at all. The vagueness and the seeming abandon of the idea of going into the market and buying longer term bonds to bring down long rates caused a flurry of selling activity which has sent the 10 year Treasury from a yield of about 3.2% to today's 4.29%. That is a HUUUUUGE move in a very SHORT period of time. This is the yield on which the 30 year mortgage is most correlated-no surprise mortgage rates have gone from the low 5's to the low 6's. Not only has it all but shut down refinancing activity and slowed mortgage borrowing in general but also the implication is the main forces driving a very weak economy will be retarded to varying extents. The economy has been surviving on the equity individuals have pulled out of their homes to consume. We don't know exactly how much this thrust will be stymied, but it certainly will to some extent. This is all crucial, but a second unintended consequence is the dramatic erosion of the credibility of the Fed. This is perhaps more important than everything else on the global stage, particularly at a time when the U.S. is mounting record trade imbalances and fiscal deficits that I have discussed before today. The credibility of the U.S. and its ability to pay off its debts without having to resort to printing dollars, is at the heart of the value of the dollar. Just as the value of your credit fluctuates (the interest rate you are required to pay on a loan) when you exhibit "uncertainty" in your ability to make due on your obligations.

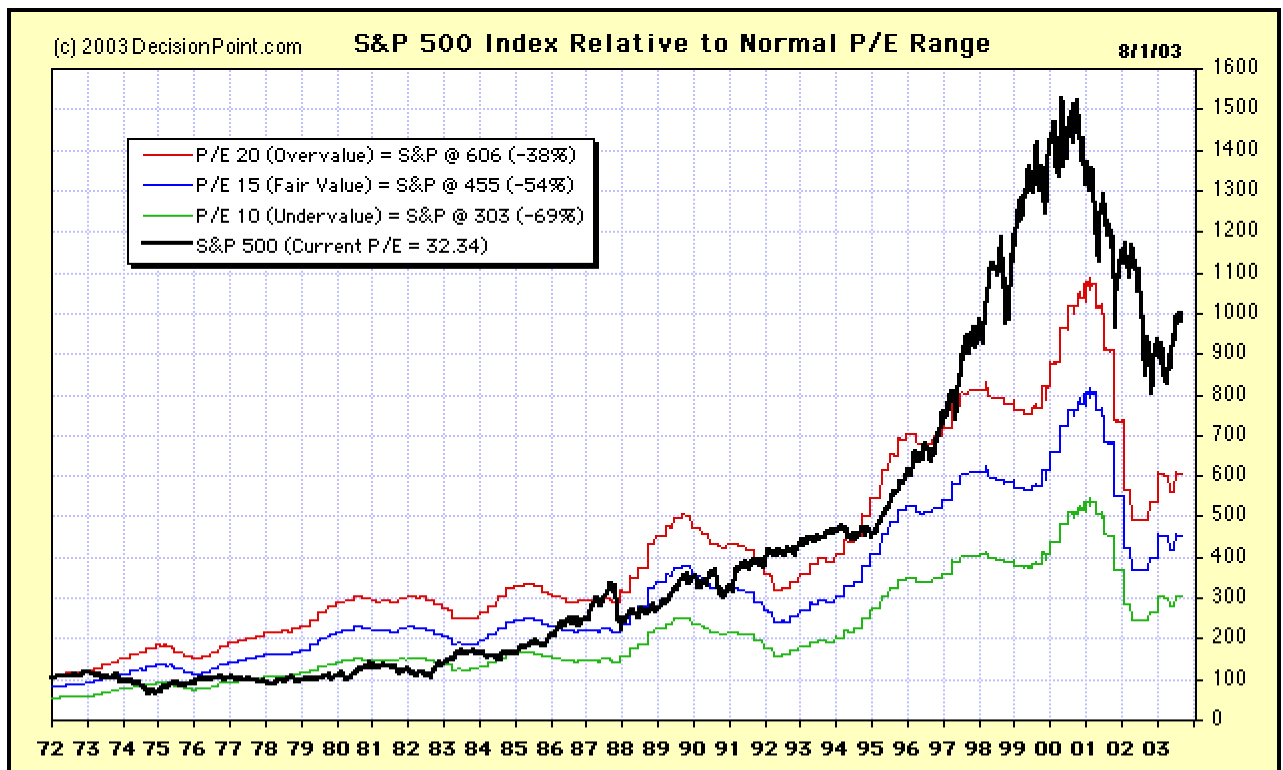
Take This Job (Search) And Shove It

Last week it was reported that the unemployment rate had declined from 6.4% to 6.2%. We also got unexpectedly good GDP growth numbers, indicating the economy grew at a rate of 2.4% during the second quarter (Q2) as opposed to the expected 1.5% and Q1 1.4%. As usual, in its attempt to confuse outside observers the market declined about 1%. Why? The unemployment rate is measured by taking a poll. They ask if individuals are unemployed and then they ask if they are looking for jobs. They are included in the percentage of unemployed only if they answer yes to both. During the month of July, many remain unemployed but over 500,000 stopped looking. So while the headline number looked good the number of discouraged workers (Take This Job Search And Shove It) was somewhat disconcerting. This report was also accompanied by a report which showed that the economy shed 44,000 more jobs in July-the market was expecting a payroll increase of 10,000. Further, June's payroll number was revised from initially reported -30,000 to -72,000. Over 100,000 positions eliminated in two months. Finally, as much as we wanted to believe the economy was getting back on track, looking at the GDP number closely revealed that if it hadn't been for government defense spending increases, i.e. war in Iraq, the GDP increase would have been more like 1-1.5%. Now instead of characterizing the "recovery" as a "jobless" recovery, I am hearing "Job Loss" recovery. I think pretty soon, because consumption based economies have a hard time recovering without jobs, it will be called the "non" recovery. I continue to believe in the games of manipulation played out by analysts and the media. "Spin" is not found in this commentary. You'll get it like it is.

The Song Remains The Same

We are finally through earnings season (almost) and most headlines are fairly positive. If I just looked at the number of earnings that beat expectations (I don't know how many times I've seen this on the television financial and news networks) I would think it was the greatest quarter in history. Remember what I discussed a couple of months ago about the "earnings game"-well now you are the wiser as you see the market not reacting so well to all of these "unexpectedly" higher earnings. The market is getting so used to the ridiculous practice of preconditioning expectations that it has come to the point where I (and the market) say, "Hey (publicly held corporation), if you can't beat the expectations you set, you've got to be having trouble!" Indeed, according to Thomson First Call's Director of Research, Chuck Hill, while U.S. tech companies reported a 21% profit gain revenues were only up 4%. (Source: Zeal Intelligence July 2003 newsletter). The profits are coming from cost cutting (firing people) and currency adjustments. During the second quarter the U.S. Dollar Index declined over 5% against other currencies. That immediately juices profits from abroad by 5% with out any revenue increase. So far this quarter the dollar has been trying to rally back so third quarter earnings may be hampered by this rally. Now, I believe that profits are profits, don't get me wrong. The only problem with profits coming from a declining dollar is that I believe the declining dollar, while helping profits in the near term, ultimately reflects, as I indicated earlier, an easing of foreign investment in the U.S., investment upon which we are absolutely

DEPENDENT. And if foreign investors have the same perception that I do, i.e. the dollar decline will continue for a while, that takes away incentive to invest now when the dollars you get back will be worth less. I have employed investment strategies in my managed accounts to combat these imbalances. (By the way, I don't list specific recommendations in this letter because I don't want them to be taken as appropriate for everyone on the receiving end. Fortunately, my independent practice has access to many new sources of information and investing and is constantly seeking to add new investments for managed accounts.) Back to the song--the amazing thing is we are still at extremely high valuations: PE on the S&P with 85% of companies reporting (the other 15% are the estimates) is 28. If 2003 expectations are met, the PE will be down to 20. 20 is about as high as the PE has gotten preceding major declines (1929 peak, 1987 peak). I guess the rules have been thrown out the window as we have been above 20 now since 1997. Call me old school, stuck in the mud, negative boy, but…history has a way of smoothing out the ups and downs to the mean. The mean for 200 years is about 14. We'll get there one way or another and probably a lot lower as stocks become a dirty word. This will happen either through a trading range type action such as that which the market is exhibiting now (7000-9300 on the DOW) as earnings catch up OR through a price decline. Either way, we are armed with the knowledge and proceed prudently as usual. See chart below:



Courtesy of www.decisionpoint.com

Reader Anecdotes and other Quotes

Sources remain anonymous unless specifically requested otherwise
(Please send me interesting stories from your day which either arise from this reading or make you think in the future about these readings-especially feed back on my writing clarity-Thanks!)

"What happened in the 80's when values plummeted was people just walked away. Foreclosures went way up. Then, when the 1098's came out, so did the bankruptcies. I had a guy in Denver who bought a new house with 5% down. Came time to transfer two years later & he would have had to pay an additional $6,000 to clear the mortgage if someone was interested in buying the house. No one was, so he sat on it for another 3 years and finally broke even." -banker **Justin comment:** transfers can afford to wait three years, job losses can not.

I hear from one reader that there are some who plan to convert buildings in the fan into condo units by floor; planning to sell a 1500 sq. ft. condo for $525m.

I am amazed at the Wall Street upgrades being reported and how they are reported: I read, "Merrill Lynch raised its recommendation on Intel to "buy" from "neutral" on expectations the chip titan…" CIBC upgrades Merck…the "the stock sprinted 1.7%" Cbsmarketwatch.com 7/14/03 **Justin comment:** note the aggressive language "stock sprinted"==cheerleading. Prior to upgrading Intel, it is up some 50+% from its low.

Quote of the month that I read:

"I never like a market that goes down in the face of "encouraging" news. A market that declines in the face of good news is reacting to forthcoming bad news -- but bad news from a quarter that's not yet in the newspapers." –Richard Russell, Dow Theory Letters 8/5/03 **Justin comment**: Wow, read that one again-this from a guy who has been right during bull AND bear markets.

America The Beautiful

Proceeding prudently is the American way. Or it used to be. It is going to come back. I predict that the following words will someday be bad, bad words, even worse than they are today. And these two words/phrases will drive the present and future "hot topics":

DEBT
Credit Card

And the following words are/will continue to be hot topics:

Under-funded Pension Funds and Social Security
The role of the FED
Personal Net worth

[Current and future "hot topics" (continued)]

Gold (and other-debt free assets)
The Euro
China/India taking over services
Inflation
Micro cars
The gold standard (out on a limb here)
Technology (later)
(eventually) The American Renaissance (you don't want to miss this)

That is why America is "The Beautiful". While these other cultures and economies may sit in the world driver's seat for a while, we are the only country which draws from the best of all creeds, cultures, races and nationalities. This melting pot theory is what got us started. And I think after we complete this boom-bust cycle, it will bring out the best in our nation and put us back in front. The character of the immigrant will be revived in all of us. The immigrant works his/her butt off. Does not ever question "impossibilities" (much like a child). Does not take for granted the life presented to him. Rain doesn't stop him. Joblessness does not exist. Shouldn't we all be like that? UNSTOPPABLE.

Successful Planning to All!

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