May 14, 2010

Dear Clients and Friends,

At the end of our letter to you a month ago, we commented that we would not be surprised to see higher volatility in the financial markets over the next few months. While the longer-term outlook is favorably supported by rising corporate profits, overall levels for stocks and bonds are at best "fair," and growing economic headwinds are a cause for concern. Given the strong rally from the February lows, we thought a bit of back-filling seemed likely.

That said, we confess we did not anticipate the extreme volatility seen over the past two weeks, with triple-digit moves in the Dow Jones Industrial Average in eleven of the past fourteen trading sessions. Further, yields on US Treasury bonds – widely expected to rise on growing inflation expectations – have actually fallen to the lowest levels of the year!

While many factors are currently at play in the domestic and global economies, the proximate cause of these market gyrations has been the European Union's inability (or unwillingness) to deal with Greece's fiscal woes. The Greek credit problems, rooted in welfare-state policies and the country's outright misrepresentation of their financial condition to their EU cousins, are feared to spill over to other fiscally hamstrung countries like Portugal and Spain, among others. Germany and France, the largest of the Eurozone players, have been faced with a tough choice: spank the problem children, or bail them out. The debate has been heated, with French President Sarkozy threatening to pull France from the EU just last week. And now that a bailout package has been proposed, a dubious market has responded by punishing the Euro currency.

***"Cause and effect are two sides of one fact."*** – Ralph Waldo Emerson

Why do these Greco-Euro problems impact financial markets in the US? The most immediate effect has been the rise in the US Dollar relative to the Euro. This makes US-made goods less competitive overseas, and our fragile economic recovery has, in part, been dependent on exports. Also, there has been a global shift away from risky assets (stocks) toward lower-risk assets (Treasuries) in recent weeks as the European crisis unfolded. And, most important from our perspective, a weaker Europe, coincident with a forced slowdown in China, casts a harsher light on the earnings outlook for US companies.

Even as the depth of Europe's problems became more evident in recent weeks, another highly disconcerting factor has emerged: computer-driven trading of stocks and bonds, once constrained by regulations imposed in the wake of the 1987 stock market crash, is now back in full force, and is one of the key forces contributing to the market's recent swings.

***"I am putting myself to the fullest possible use, which is all I think that any conscious entity can ever hope to do."***
– HAL-9000, the computer in "2001: A Space Odyssey"

The press has largely ignored the impact of momentum-based algorithmic trading, instead chasing after bogus rumors of a "fat finger" trader who mistakenly entered billions of dollars of erroneous trades last week. We believe the recent extreme volatility serves as evidence that rapid-order trading methodologies have been a major factor, at times overwhelming a system that is unable to provide stability when the going gets rough.

Imagine being able to bet on a horse race *during the race*, and being able to magnify your bets when your horse pulls ahead, and make adjustments to your bets with each footfall. You'd expect the track owner to quickly adjust the payouts or place limits on your bets as the race proceeded. But what if the track owner is simply overwhelmed and can't respond in time? That's essentially what has happened in the stock market on a few recent trading days, with computers placing ever-bigger bets as momentum accelerated and liquidity disappeared from the market. The machines ran amok.

So now, with Europe's finances in disarray even after the reported bailout package, and currency pundits calling for the Euro to continue its decline against the dollar, we expect financial market volatility to persist for several more months, and possibly be exacerbated by computer-directed trades. The key factor to watch will be the earnings outlook for the remainder of the year and 2011. If earnings expectations remain robust, the volatility could present attractive buying opportunities. Conversely, if the earnings picture no longer supports valuations, we will look to reposition portfolio assets accordingly. In any case, we believe the fundamentals of the companies we own are strong, and through the noise, cash-flow driven businesses should provide a more attractive return than cash or low-yielding Treasuries over time. We think stocks with higher dividend yields, lower-valued technology plays, consumer staples, and some secular exposure (industrial and consumer) all make sense.

Sincerely yours,

Mitch Schlesinger