



# JMH Wealth Management, LLC

## NOISE ó January 2011

This is the time of the year when market prognosticators weigh in with their forecasts and predictions for the markets, interest rates and the economy. I am always amazed that despite considerable intellectual firepower and financial resources, most forecasters and strategists don't get the direction of any change correct, yet alone the magnitude of any change in the markets or macroeconomic variables. The predictions are interesting to read, in part for the reasoning behind the arguments, but are they actionable, useful or just plain noise? Probably mostly noise.

As Howard Marks of Oaktree Capital Management has noted, maybe it's more useful to evaluate where you are in terms of various cycles than put forth forecasts that inevitably provide little value in terms of portfolio management. So here's my assessment of where we currently reside in the economic, stock and bond market cycles, along with a little extra noise.

### U.S. and Global Economy

We seem to be in recovery mode. I think the economy will continue to muddle through and grow slowly, much in the same fashion as the past year or so. The deleveraging process toward lower debt will work to constrain growth, but we will see an improvement in economic activity, nonetheless. It took a long time to accumulate the debt at all levels (consumer, corporate, and government) and it will take a long time to work through it. The key factors to keep in mind are the incredible resiliency of the economy and the fact that the Federal Reserve has your back. The Fed (and other central bankers worldwide) is motivated to sustain the recovery because the alternative is unthinkable. None of the bankers want to stand by and watch either the U.S. or the global economy revisit the scary scenario that began to unfold in 2008, so expect that whatever support may be needed will be provided. The hard part will be keeping policy mistakes to a minimum in the exercise of Federal Reserve monetary policy or Congressional fiscal policies. The Fed will have to navigate a course between the inflationary and deflationary forces, while pressure will be on Congress to actually work constructively and responsibly to address some thorny issues, and not just engage in partisan bickering for political advantage.

### The U.S. and Global Stock Markets

The stock market is likely stuck in the range bound environment that has persisted since the tech bubble broke in 2000. Research has clearly documented that the higher the

stock market valuation (as measured by the ten year cyclically adjusted price/earnings ratio) when entering a decade, the lower the subsequent return for investors. That makes sense intuitively. If valuations are high to begin with, then a sizable component of potential gain may already be factored into prices. With the current cyclically adjusted price/earnings ratio at nearly 24x, future returns could be well below 10% per annum. We'll see.

The ideal stock market scenario is an environment in which price/earnings multiples are expanding and earnings per share growth is positive. The current situation finds us with earnings growth, but contracting price/earnings multiples as we continue to revert to the mean from the ridiculous multiples of the tech bubble. Furthermore, if interest rates and inflation rise to more normal levels, any expansion of price/earnings multiples becomes more challenging, which means we'll have to rely more on the earnings component to drive the stock market. However, that doesn't mean we can't make money in stocks. It just means that we have to be even more cognizant of the price we pay, and keep an even closer eye on cash flow and valuation.

### **Interest Rates and Bonds**

The nearly thirty year bond market rally is probably over or awfully close to peaking, and that means the risk return tradeoff has shifted decidedly toward greater risk. The undulating pattern of lower rates of the past three decades has likely ended unless deflationary pressures gain traction or the Eurozone completely unravels; neither event has a high probability of occurring. Meanwhile, interest rates are not likely to be raised anytime soon because the Fed would rather err on the side of waiting too long to hike rates, than prematurely take action and risk tipping the economy backward.

Recognizing that we're very close to the tail end of this multi decade bond rally suggests that more defensive bond strategies will be needed to preserve principal and control risk. Security selection will be paramount. My core strategy of exclusively owning corporate bonds with maturities of one to five years remains in place for the foreseeable future. Given the bubble in the U.S. treasury market and the likelihood that the country's AAA rating is at risk, I will probably avoid government securities for now. I'll also be closely watching the municipal bond market. The growing financial distress and negative psychology could well present an opportunity to begin selective buying of municipals over the next year or so. At present, I own no municipal securities.

### **The Eurozone and China**

The Eurozone and China each warrant special mention. The debt crisis in the Eurozone area will continue to convulse the global markets. As I've written in earlier letters, default on outstanding debt or the more polite term "haircuts" for bond investors will be needed to really move past the crisis. Bond investors will be forced to absorb some loss of principal because the debt burden exceeds the capacity to repay it over any reasonable period of time. The risk is the Eurozone economies remain mired in low growth and stagnant employment for an extended period of time otherwise. The quicker all parties face that outcome, the easier it will be for countries to bring their debt imbalances back to more manageable levels. Real political leadership will be required

here. Expect blowback from the average Eurozone citizen as unpopular retrenchment policies are proposed. Considerable market volatility may ensue, once again providing an opportunity to pick up some attractive Eurozone holdings.

China is fast becoming an economic superpower that cannot be ignored. They already exercise their economic might through pursuing and securing long term supplies of commodities worldwide, often with unsavory regimes, and reinvesting their vast currency reserves in U.S. treasury securities. Since unleashing market forces three decades ago, their economic growth has been astonishing even if one adjusts their official government statistics for overstatement and propaganda. And yet, it seems that we are ascribing far too much competence to them as they manage their increasingly market driven economy. The level of bank lending and real estate investing in China over the past 12-18 months has been extraordinary and far in excess of government dictates. Therefore, I wouldn't be surprised to see inflation and asset quality issues become real problems over the next year or so. I'm skeptical that Chinese lenders and investors are any smarter or more competent during bubble economic and lending periods than the rest of the world has been during similar times. So expect further volatility in global markets emanating from China.

### **Portfolio Management**

Knowing what you own, while always important, is even more critical during this period of inflection and recovery in global markets. My job is to spend time working through company balance sheets and cash flow statements that can be analyzed with accounting causality, rather than trying to divine relationships among financial and economic indicators that are, frankly, too complicated and interrelated to predict, and subject to randomness. Investing and portfolio management can often be distilled down to simply finding individual stocks and bonds which are attractively valued. If you find them, you buy. If not, then you wait for the market to provide an opportunity to purchase at a more attractive price. The markets always provide opportunities.

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