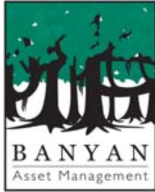

"The Cyclical Nature Of Capitalism"

Market Commentary – May 2009

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The advance reading of Gross Domestic Product (GDP) shows that the value of goods and services produced in the U.S. fell by 6.1% in the first quarter of 2009. This is the first time since 1975 that the economy has contracted three consecutive quarters. On a positive note, the Federal Reserve commented that "the pace of contraction appears to be somewhat slower." Consumer spending, which accounts for roughly 70% of GDP, rose 2.2%.

Using capital letters to describe the shape of a recession, this one may end up being shaped like a "W". A "V" shaped recession is usually short and shallow. With this recession already 17 months old, it is not "V" shaped. An "L" shaped recession implies a prolonged period of economic stagnation, similar to what Japan experienced in the 1990s. Thanks to the stimulus injected by the government, an "L" shaped recession is unlikely. It is reasonable that the recession may end up being shaped like a "U". This would imply a deep period of contraction, followed by steady growth. Most likely, in our judgement, is that the economy experiences a "W" recession: a recession, brief recovery, and then another recession. The logic behind this hypothesis involves the inevitable removal of economic stimulus.

The record amounts of fiscal and monetary stimulus are helpful in the short run, but what will happen to the economy when it is eventually removed? Last month, we detailed the enormous economic stimulus injected by the U.S. government. While these actions will help boost the economy out of recession, the steroids must eventually be removed to minimize unintended consequences. Taxes will be raised, interest rates will be hiked, and capital will have to be given back to the government. All of these factors would weigh on the economy, and possibly put it back into recession.

While numerous catalysts affected the current economic tsunami, the underlying root cause is human nature, especially the cyclical nature of greed and fear in a capitalist economy. Boom and bust cycles are a natural part of capitalism. When someone figures out how to generate abnormally high economic profits, money is allocated to the new money machine, often without careful consideration of risk. Leverage (borrowed money) is used to magnify profits. The money machine works until the money needed to drive price even higher dries up and price collapses. Price declines sharply from bubble levels and overshoots fair value on the downside due to irrational pessimism. The investment is viewed as toxic to everyone except bottom feeders taking a chance on a potential bargain. Over time, more buyers decide the investment is not toxic after all, but rather is a good deal. As price moves higher, money is lured from the sidelines, this time with a healthier understanding of risk. Price reaches fair value again and the cycle starts over. The world's current economic doldrums likely could not have been prevented. As for reversing the downward spiral, growth will always win in the long run. The cycle needs to play out.

Technical factors of the market are mildly bullish (more demand than supply), while fundamentals are attractively priced – therefore, we are mildly bullish on the market. When evaluating the earnings power of stocks in times of economic distress, it is important to consider more normal times. Earnings of companies are unusually depressed at the moment. S&P estimates that S&P 500 operating earnings for 2009 will come in around $59. It would not be unreasonable to see these closer to $80 or $90 in more normal economic times. Earnings of $90 would imply a price-to-earnings (P/E) ratio of approximately 10 with the S&P 500 at 872. Valuations are attractive.

While the market experiences volatile swings up and down, covered calls are an excellent technique to profit from the volatility. We expect the upward bias of stock prices to continue, but it is unlikely that the market will skyrocket without meaningful corrections. There are numerous resistance levels overhead for the S&P 500, including price resistance at 930 and the 200 day moving average at 965. Covered calls allow cash to flow into a portfolio while the bulls and bears have their tug-o-war.