



Commentary  
by Steve Henningsen

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## A Charlie Brown Moment



*In the book of life, the answers aren't in the back.*  
–Lucy

*“Being human, I made all the mistakes there were to be made, but I learned to learn by realistic recognition of the constituent facts of the mistake-making and attempted to understand what the uncovered truths were trying to teach me.”*  
–Buckminster Fuller, *Crunch of Giants*

Investors were expecting stock markets to rally at the beginning of the year, but once again, Lucy lured investors in and promptly snatched the ball away sending them reeling. She's well aware that the great majority of investors suffer from a common ailment called *premature bullishness*. I must admit, by the beginning of March that siren vamp had me thinking about giving it a go – or, in my case, reallocating more heavily to stocks – but I decided against it. I'll explain why in a moment. By the way, I have been periodically updating clients with articles of interest or general comments on the markets via email and, therefore, will be attempting to make my commentaries shorter going forward.

As clients know, I have been cautious for years and have endured being called a pessimist, Chicken-Little, gloom and doomer – yada yada – while the markets had continued their merry way upwards. Then investors experienced a devastating 2008, which tumbled into the first couple of months of this year, when I noticed a change. I was no longer the gloomiest guy in the room, and pessimism was permeating the markets. This is one of the classic signs contrarians look for, and even CNBC's Larry Kudlow looked like he needed a hug. With the markets down over 20%, I made the decision at the beginning of March to eliminate our market hedges for the time being by liquidating the Prudent Bear Fund (the fund manager “shorts” stocks), which we had held for five years and which had grown to represent a large position in our portfolios. This was fortunate – some might say lucky, but I'll take it – as the markets began to rally a few days later. I was beginning to consider moving back towards a “normal” weighting in stocks, but my enthusiasm waned as I observed the momentum swing back to positive too quickly, in my opinion. Therefore, we have not fully benefited from the equity market's rally over the past few weeks.

*“Our activity as investors is not to try to identify tops and bottoms– it is to constantly align our exposure to risk in proportion to the return that we can expect from that risk.”*  
–Dr. John Hussman, investment manager

What troubled me was the dramatic change in psychology that occurred during the market rally. Typically stock markets bottom out when everyone has given up on equities; usually there is a moment of capitulation when investors just want out and the Wall Street prognosticators are tired of incorrectly calling “the bottom.” We then begin a slow advance back up from the bottom – not a 24% rally within weeks. I thought we were almost there, as the financial “entertainers” on TV were sounding downright depressed after finally putting down their pom-poms. But suddenly after several days of positive returns, they were back on their feet again jumping up and down while the Wall Street peddlers fell over each other scurrying for a camera to call yet another bottom to the stock market and the beginning of a shiny new bull market.

*“Policy makers and forecasters who see a recovery next year are probably lying to boost public confidence. And the crisis will eventually provoke political conflict, albeit not on the scale of a world war, but violent all the same– There will be blood.”*

–Niall Ferguson, economic historian

At the same time, the economy (different from the stock market) continued to lose steam. Nonetheless, the media was getting excited, as the economic news was “less bad” than before and the Obama team was throwing every kitchen sink available in Washington into the system. Bernanke went on the CBS program *60 Minutes* to state that the “*green shoots*” of economic revival were already evident while his wingman, Turbo-tax Timmy over at the Federal Reserve announced that they were firing up the printing press and would be buying back \$300 billion of U.S. Treasury debt – basically monetizing their own debt. (Mark my words that he will be announcing additional programs in the months ahead, as he needs trillions to fill in the financial hole, but is afraid that he will spook the markets if it is announced it all up front.) That left the President to hit the late-night television circuit to talk up his policies on the *Tonight Show*. A full court press had begun to attempt to change the public’s confidence.

One could state the case that “Steve ate sour grapes” since I didn’t get fully on board the stock market train before it left the station. However, if there is one thing that has served me well over the years it is being a skeptic and knowing my history. As I’ve shown in past commentaries, bear markets that occur in deep recessions typically don’t bottom out until the price-to-earnings (P/E) ratio is in the single digits, and we aren’t anywhere near there yet. Now that doesn’t mean we have to get that low, but I find it difficult to believe that we won’t, given that we face one of this country’s (and the world’s for that matter) worst financial crises in history.

Additionally, I believe Wall Street is ignoring the psychological change that has occurred with consumers. I have no evidence of this besides viewing the actions of those around me, and I have been wrong about calling the demise of the U.S. consumer in the past, but I believe that U.S. consumers will continue their deleveraging (paying down debt) and new-found thrifty ways for years to come.

If I am wrong and Joe Sixpack comes back strong, then earnings will increase again and the worst of it will be behind us. However, I believe the probabilities are on the downside, and that earnings will continue to be poor over the next several quarters (with the exception of banks who now get to hide their bad assets again thanks to the change in FASB accounting rules forced by Congress and a steep yield curve), and I don’t expect recovery to begin until 2010. The government can talk budding greenery all they want, but we are far from recovery. As Barry Ritholtz stated recently, one needs to “... *understand the difference between an economy that is improving versus one that is getting worse more slowly.*” As another commentator put it, “*We suspect investors are confusing a moderating, but still severe, recession with a recovery. The two are not the same.*”

**“We're from the government and we're here to help you!”**

*“Bringing the government in to run Wall Street is like saying: “Dad burnt dinner, let’s get the dog to cook.”*  
– PJ O’Rourke

Being a gardener, I know something about “green shoots” and one thing I know is you don’t want them to come up before the conditions are right, for a late frost could kill them. Another gardening tip is to properly diagnose a problem before applying pesticide, as one pesticide can benefit one type of plant and kill another. Instead of diagnosing the problem, Team Obama, The Federal Reserve, The Treasury and Congress are too busy throwing trillions of taxpayer dollars at everything that moves – and things that don’t move as in the case of insolvent financial institutions and automobile companies – to try to figure out what works. They seem to believe that additional debt will get us out of our debt problem and get consumers once again buying things they can’t afford. It’s like watching an “Abbott and Costello” movie. There is hope though, as I did read some articles of individuals, both in the corporate world and the government (unfortunately, not ours) that “get it”:

*For the past 25 years, the world has certainly enjoyed incredible, incredible global growth. Average incomes around the world grew at unprecedented rates, millions of people moved from out of poverty into the middle class for the very first time. I think that expansion was built on three things: innovation, globalization and debt, increasing debt...*

*But over time, over the last period of time, the balance has really shifted. Instead of innovation and productivity driving growth, it’s really been unsustainable levels, particularly of private debt, that have been a key driver of economic growth. The hard truth is this, in my opinion: The private sector of our economy has borrowed too much money...*

*In my view, what we now have will be a fundamental economic reset. The economy is going to have to re-establish itself at a level of spending that reflects the real value of underlying assets before we can all start growing again at a healthy rate. This may not be the thing that people really want to hear, but it’s certainly what we’re planning on, and it’s the truth on which we’re basing sort of our model, if you will, at Microsoft.*  
–Microsoft CEO Steve Ballmer in a speech he gave at the U.S. House of Representatives Democratic Caucus Retreat on Feb. 6, 2009

*“This crisis did not come about because we issued too little money but because we created economic growth with too much money, and it was not sustainable.”*  
–Angela Merkel, German Chancellor

The battle rages on between consumers doing what is prudent and necessary for their long-term viability – deleveraging and saving – while the government does what the politicians believe is best for *their* short-term viability – get voters happy again by getting the economy moving by enticing consumers to act irresponsibly yet again.

### **Government Do-gooders!**

*Congress is as responsible as any entity for the regulatory policies and lapses that led to the current financial collapse. Instead of trying to divert attention from its own failures, it should be apologizing to the American people and moving with all deliberate speed to implement responsible policies to move this nation forward. Such policies do not include an earmark-laden stimulus bill, a confiscatory ex-post facto tax on financial executives, or a continuous trail of show trials intended to publicly humiliate men and women who are no more culpable than the members of Congress of creating this mess. It is time for Congress to take a deep breath, man up, and start solving problems instead of creating new ones.*  
–Michael Lewitt, *The HCM Market Letter*

I have been bashing Uncle Sam a lot lately, but hey – he deserves it, and unfortunately it seems that most Americans believe that government’s the only solution these days. There have been many good articles and blogs written lately; many of which I have been passing along through emails. Here are some comments from other investors/bloggers that I thought accurate:

The blogger “Prudens Speculari” had this nice rant; “*Yes the powers that be and their influencers will fix everything. We just have to let them at it! If you look closely you could conclude that everything the government touches in its attempt to make it more accessible and more affordable turns into an unmitigated disaster resulting in the polar opposite result. You doubt this?*”

*They tried to make home ownership more accessible and affordable to all and we got a housing bubble.*

*They tried to make elementary level education more accessible and affordable and we rank near the cellar in reading, writing and arithmetic.*

*They tried to make student loans and college education more accessible and affordable and we got the highest tuition ever seen resulting in the most useless pieces of parchment to show for it.*

*They tried to make credit more accessible and more affordable and we got the mother of all credit bubbles via their surrogate banks.*

*They tried to make securities markets safer for the layperson to venture into (think SEC with Chris Cox) and we get Bernie Madoff, Sir Allan Stanford, AIG et al.*

Peter Boockvar had this to say over at Barry Ritholz's site *The Big Picture* concerning the government's new vendetta on those evil “short-sellers.” “*Short sellers (SS) didn't get people to buy homes with no money down, SS didn't convince people to buy homes with teaser rates, SS didn't convince people to lie about their income on their mortgage applications, SS didn't tell banks/brokers to lever up to such huge levels, SS didn't tell Greenspan to cut rates to 1% and leave it there, SS didn't invent FNM [Fannie Mae] and FRE [Freddie Mac], SS didn't tell the OTS, OCC, FDIC, Fed, SEC, FFIEC, FTC, FHFA and all the state regulators to twiddle their thumbs all day, SS didn't tell the rating agencies to rate AAA on anything that moved, SS didn't tell banks to lend to commercial real estate investors on a property where the rent didn't cover the mortgage payment, SS didn't tell the average consumer to spend more money than they make and borrow [the] difference. Short selling is a legitimate form of speculation that fully enhances market liquidity and price discovery.*”

And what did Mr. Practical from Minyanville have to say? “*The logic that there's no cost to any of this is flawed. The logic that we must do something, anything because the consequences are too dire is flawed. The logic that an economy is based on consumption and lending is flawed. The FDIC is the taxpayer. The Treasury is the taxpayer. All government programs are the taxpayer. All costs will be borne by the taxpayer. As the actual number of taxpayers dips below 50%, it will become politically easier and easier to pass these costs onto the taxpayer. The government is a zero sum game: it can only take from one person to give to another.*”

Methinks Mr. P is a fan of Ayn!

*"When the curtailment of government spending is imperative, they demand more welfare projects. When the need for men of productive ability is desperate, they demand equality for the incompetents. When the country needs the accumulation of capital, they demand that we soak the rich. When the country needs more savings, they demand a "redistribution of income"."*

*– The Ayn Rand Letter – July 1, 1974*

Dr. Hussman puts a pretty bow on it:

*Look. You can play hot potato with the toxic assets all day long, and [the] only outcome will be that the public will suffer the losses that would otherwise have been properly taken by the banks' own bondholders. You can tinker with the accounting rules all you want, and it won't make the banks solvent. It may improve "reported" earnings for a spell, but as investors who care about the stream of future cash flows that will actually be delivered to us over time, it is clear that modifying the accounting rules doesn't create value. It simply increases the likelihood that financial institutions will quietly go insolvent. I recognize that the accounting changes may reduce the immediate need for regulatory action, since banks*

*will be able to pad their Tier 1 capital with false hope. But we have done nothing to abate foreclosures, and we are just about to begin a huge reset cycle for Alt-A's and option-ARMs. As the underlying mortgages go into foreclosure, it will ultimately become impossible to argue that the toxic assets would be worth much even in an "orderly transaction."*

*I have no idea how long investors will remain enthusiastic about trillion dollar band-aids and eroding the integrity of our accounting rules. I do know that at the end of the day, what matters is the long-term stream of deliverable cash flows that investors can actually expect to reach their hands. It's exactly that consideration that makes it clear that we will sink deeper into this crisis until we observe debt restructuring on a large scale. If we don't restructure the debt, the debt will fail, because for many borrowers, the cash flows aren't there, and it is not possible to service the debt on existing terms.*

—John P. Hussman, Ph.D, investment manager

Again, it's the debt, Stupid, and one can hide things on a balance sheet but eventually it must flow to the income statement. Still think Big Gov knows best? Back to the banks:

### **Banking: The Mystery Continues!**

*"Treasury Secretary Timothy Geithner is covering up...They're scared to death of a collapse. They're afraid that if they admit the truth, that many of the large banks are insolvent, they think Americans are a bunch of cowards, and that we'll run screaming to the exits"...*

—From Bill Moyer's interview of William Black, ex-regulator and author of *The Best Way to Rob a Bank Is to Own One*

“Ah, yuh!,” Steve says in his best Valley-girl impression. Oh, and you may have heard that the government is putting the banks through a “stress test” to see which ones are fit or could stand to lose a few pounds. Although President Obama was suppose to be bringing a new era of transparency to the White House – he probably hasn't unpacked it yet – details of just what the test involves aren't being shared. I envision CEOs on treadmills hooked up to EKG machines. Anyway, I'm sure they're taking it seriously.

*"I challenge them to release the models that drive macro economic assumptions through the balance sheet and demonstrate credible linkage. Basel tried to do this over 10 years and couldn't but somehow the guys at Tim Geithner's New York Fed were able to? This test was predicated on irrationally benign macroeconomic assumptions and was reverse engineered. C'mon, we can all now acknowledge the actual fact the NY Fed is literally owned by the banks, it doesn't even need to be captured. Good thing that although Wall Street's expectations were falsely set to believe there was something to this "stress test" there is not a single regulator in Washington that I have spoken with that took it seriously."*

—Joshua Rosner, Managing Director Graham Fisher & Co

Wow, pretty harsh, Josh. I mean it's not like they're going to hide the results from us. —What's that showing up on my computer screen? —Per Bloomberg--The U.S. Federal Reserve has told [Goldman Sachs Group Inc.](#), [Citigroup Inc.](#) and other banks to keep mum on the results of “stress tests” that will gauge their ability to weather the recession, people familiar with the matter said.

*"I used to be disgusted, now I try to be amused."*

—Elvis Costello, *Red Shoes*

*"This is a much grander-scale disaster than anything that happened in 1929-33. Worse, it dwarfs the abuses of debt, finance and financialization that brought down previous leading world economic powers like Britain and Holland..."*

*But for the moment, let me underscore: the average American knows little of the dimensions of the financial sector aggrandizement and misbehavior involved. Until this is remedied, there probably will not be enough informed, focused indignation to achieve far-reaching reform in the teeth of financial sector money and influence. Equivocation will triumph. This will not displease politicians and regulators leery of offending their contributors and backers."*

—Kevin Philips, *The Disaster Stage of U.S. Financialization*

Oh, Kevin, always the historian. I mean, it's not like there's been a banking crisis like this in the past...

*"I believe that, if today a really conservative valuation were made of all doubtful assets, quite a*

*significant proportion of the banks of the world would be found to be insolvent; and with the further progress of deflation, this proportion will grow rapidly... And over a great part of the world, and not least in the United States, the position of the banks, though partly concealed from the public eye, may be, in fact, the weakest element in the whole situation. It is obvious that the present trend of events cannot go much further without something breaking...*

— J.M. Keynes, *"The Consequences to the Banks of the Collapse of Money Values"* (August 1931)

## You Go Girl!



It was refreshing to see that Congress put together an “independent” oversight committee to monitor and report on the government's \$700 billion bank bailout plan, “Troubled Asset Relief Program” (TARP). The report came out the other week, and in it Elizabeth Warren (pictured here), a Harvard law professor and chair of the committee, called for the removal of top executives from the financial companies that have received government funds and pretty much called into question the administration's approach to saving the financial system from collapse. She also recommended shareholders in those institutions be “wiped out,” stating that *“It is crucial for these things to happen...Japan tried to avoid them and just offered subsidy with little or no consequences for management or equity investors, and this is why Japan suffered a lost decade.”* She then added that *“All successful efforts to address bank crises have involved the combination of moving aside failed management and getting control of the process of valuing bank balance sheets.”*

Oh, Elizabeth, that is so yesterday’s medicine, and what is good for the goose is no longer good for the gander. Today we reward failure, and as the report outlines how the government is going down the wrong road to address the issues, I have no doubt that her committee’s report has already found its way into congressmen’s trashcans and that she will be “reassigned” to Alaska to study global warming.

## Stimulus: We’re Going to Need a Bigger Boat!

*“There must be some way out of here,” said the joker to the thief,*

*“There's too much confusion, I can't get no relief.*

*Businessmen, they drink my wine, plowmen dig my earth,*

*None of them along the line know what any of it is worth.”*

– Bob Dylan, *All Along the Watchtower*

If it isn’t painfully obvious by now, I still don’t trust the financial system and don’t believe the “worst” is behind us. I need to see (no pun intended) transparency and accountability (you know, all the things President Obama talked about prior to election). If the government’s going to use U.S. tax dollars, then it would be nice to see them used in a more efficient manner. For example, many of the reports I’ve read show only 5% of the “stimulus” program is stimulating, while the rest goes to pork congressional projects (the type that President Obama said he wouldn’t allow under his administration) and welfare programs. We have a *debt problem* and the only way out of it is to *grow* our economy faster. (On a side note, President Obama’s proposed budget, ironically entitled, *“A New Era in Responsibility,”* should be placed on the bookshelf with other fairy tales, for if the growth projections for our economy over the next several years are anywhere near those used in his report, I will eat every commentary I’ve written over the past five years.) This “non-stimulating” stimulus plan simply won’t do it, so prepare yourselves for more “stimulation” a few months from now. That is if the taxpaying public hasn’t smartened up and pinned down their congressional representatives with pitchforks and torches by then.

Should the government get serious about diagnosing and treating the disease – including putting their own budgets on a diet – and market participants begin to once again view investments as “investing”

instead of entertainment (maybe Kramer goes off the air) then I shall line up to give it a punt and cross my fingers that Lucy doesn't move the ball on me.

### **Portfolio Happenings!**

*Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware the investment activity that produces applause; the great moves are usually greeted by yawns.*

–Warren Buffett in his 2008 letter to shareholders

This past quarter we managed to outperform our benchmark by roughly 12%, as we *gained* approximately 5% vs. a *loss* of 7% for our benchmark. This was the most we have ever outperformed our benchmark on a quarterly basis, and I am fairly confident it will not be repeated. The pendulum swings both ways and as brilliant as I might appear this quarter, I'm sure I'll look as foolish the next. In fact, if the stock markets continue their rally I guarantee it, as we are very underweight stocks and overweight cash, which assisted our appearance last quarter. The other thing going against us is that we have a heavy weighting of gold/silver bullion (~20%) and the summer months are usually poor performing ones for precious metals – it's a cycle thing. However, we shall wade through it, as I expect gold and silver to perform exceptionally well over the next several years now that governments around the world have turned the dials on their printing presses to *Maximum Printage!*

During the quarter, we added to our position in precious metals equities and also increased our position that “shorts’ U.S. Treasury bonds – it’s only a matter of time before investors figure out their true value! I am guessing that I will begin investing back into our stock market hedges (shorts) soon, as the current rally must now face the reality of company earnings. We shall see...

*“We don't do forecasts, we only make guesses about the future based on irrational varying degrees of confidence.”*

–Jack Crooks, investment manager

In closing, I still believe the scale tips to the too-much-risk side of the markets, and we shall remain defensive. Yes, maybe I missed the stock market “bottom,” but I'm not going to play a fool's game. Clients should know that the number of investors with similar outlooks has dropped, as even some of the people that were cautious in years past have now become more optimistic on the investment markets – I am truly lonely now. I am not being stubborn, nor married to a mindset, as given the right set of circumstances I too will step towards the light. I am not afraid of making a wrong step; it is the consequences that I always weigh, as there is a big difference between that light being simply a false dawn or an oncoming train. I have a feeling that we will know within the next six months whether Ben's green shoots sprout wildflowers or weeds.