Q4 2010 Market Commentary (Excerpt)

February 4, 2011 S&P500 Index 1311

The 4th quarter of 2010 saw a continuation of the stock market rally with the S&P500 (SPX), a.k.a. "The Market" gaining another 10%, with other sectors/styles rallying far more, especially in the Energy, Materials and Miners which ***again, saw increases of 17%-25% or more in the quarter!*** In fact, Q4 was a replay of the Q3, with the exception that the markets went almost straight up without more than a 2 or 3 day pause and the Russell 2000, S&P 600 Smallcap and S&P400 Midcap indices moved up about 1 ½ times as much as the S&P500. Why such a huge rally? Did the economy improve dramatically? Were millions of new jobs created? Was world peace achieved? No, none of the above.

The 4th quarter rally can be mostly explained by predictable human behavior; that is, the end of year "Money Chase" that I wrote about in my 3rd quarter market commentary. With the market rally underway in the 3rd quarter, many professional money managers and mutual fund managers found themselves underinvested after the scary Summer selloff. They were hoping that the market would sell off again so that their 2010 performance would be comparable to the S&P500 index. When that hoped for selloff did not materialize, they found themselves in a desperate situation – underperforming their market benchmark with the market climbing and time running out in 2010. As the market rallied, their underperformance grew and they were forced to buy more aggressive and speculative investments in the hope of catching up. (They didn't). Their relentless buying pushed the markets still higher and this continued into 2011 even as many of the government economic reports showed very slow job creation, rising mortgage defaults and exploding commodity prices (inflation).

Since most fund managers move with the herd – buying only when others buy and selling only when others sell, they, as a group, habitually underperform the market, but expose their fund-holders to ***maximum risk*** in process!

Witness the speculative fervor in commodities caused by professional money managers buying and speculating in commodities such as Crude oil, Wheat, Copper, Silver, Sugar, Cotton, Corn, etc. as prices ***EXPLODED*** higher, in some cases more than doubling in 2010 alone! This happened because of increasing demand for these foodstuffs and basic materials of industry from China, India and Russia but was greatly exacerbated by fund manager buying because $1,000,000,000 (Billion) of buying in these very small markets, has a dramatically greater effect than the same $1,000,000,000 of buying IBM stock. Many college endowment funds and pension funds allocated additional amounts of money to commodity investments and prices took off just like in 2007-2008 (when they peaked and then crashed). In fact, 2011 is beginning to look a lot like 2007 again with widespread commodity speculation, pervasive complacency in the stock market, ridiculous market index predictions like S&P500 2448 by 2013, and the almost daily ignoring of gloomy economic news such as poor employment gains, rising interest rates, exploding commodity prices, lack of home buying, rising mortgage defaults, etc. This does not take into account the recent uprisings in the Middle East and Northern Africa – Egypt, Tunisia and Yemen, and the possible spread to other dictatorships which could potentially destabilize the region and allow greater spread of Islamic Fundamentalism and terrorism and weapons proliferation.

To be sure, not all is going poorly. Many measures of the economy are improving as the dollar has fallen against the Euro, Yen and other currencies, making the goods of US companies cheaper to purchase ***if you live outside of the US.*** This has fueled our export industries in computers, electronics, coal, agriculture, chemicals and energy, to name a few. So, some industries – those that primarily derive their revenues from exporting and selling goods and services overseas, are doing well, while others are suffering as the cost of purchasing that steel, wheat, sugar, cotton, crude oil etc. to make their goods and sell them in the US, has risen dramatically (thanks to exploding commodity prices) at the same time there is sluggish consumer demand and an inability to raise prices. This makes their profit margins shrink, and companies with shrinking profit margins are even less likely to create jobs and hire additional workers. This dichotomy is likely to continue for some time and reinforces the concept that you cannot simply “buy and hold the market”, but rather you must pick the “winning” industries and areas of the world, and avoid the “losing” ones, and be prepared to rapidly change investments as the economy, value of the dollar, commodity prices and interest rates, all change rapidly on a regular basis.

Much of the 2011 stock market rally can be explained by “rotation”, or rapid institutional money movement from one sector or sectors to another. On the first trading day of 2011, money managers sold energy and energy stocks, small caps (Russell 2000, S&P600 Smallcap) and the S&P400 mid-caps and bought Bank Stocks and the S&P500 large caps. Three days later, they sold Bank Stocks and bought Energy stocks (the same ones that they sold in April and May at prices 30-50% LOWER than where they are buying them now!) and bought homebuilders and retail stocks. A week later this was partially reversed as the Russell 2000, S&P600 Smallcap and S&P400 MidCap along were bought along with Retailers and Banks, and then all were sold two days later with continued buying of energy and commodity stocks. There has been no consistent pattern thus far in 2011 except for continued buying of energy stocks and large caps and overall buying of stocks and selling of bonds REGARDLESS of the economic/political/corporate earnings news.

Here is what concerns me as the S&P400 Midcap and Value Line indices quietly make NEW ALL-TIME HIGHS!:

1) The volatility index (VIX), which is a measure of options prices (fear), is very low and at multi-year lows, a sign of great complacency. Like in the old Mad magazine cartoon with Alfred E. Neuman: “What me worry?”

2) “Bulls minus Bears”, a.k.a. “Investors Intelligence” is at extreme levels often seen at or near Bull market peaks.

3) The continuing parade of advisors, financial planners and money managers on CNBC, who as a group, predict a rebound in home prices and the real estate market and rising stock prices to S&P500 1400-1550, by the end of 2011 and are aggressively recommending the purchase of Energy, commodity and Bank stocks. In many cases, these are the same exact people who warned everyone to SELL Energy, commodity and bank stocks in May - July of last year at stock prices that were 30% - 50% LOWER than today! Example: The OSX “Oil-Service Index”, a weighted average of 15 large energy service companies, was at 227 before the BP Oil spill in April 2010. As the Index crashed through 200, then 180 and then to below 160 (OSX bottomed at 157 on June 8, 2010), these managers were telling everyone to SELL these companies and avoid them, though only a few companies had any actual ***potential liability*** for the spill. Later, when the OSX rallied above 200, managers were still avoiding them and only began to recommend purchasing these stocks after the Index broke above 220 in December. Now with the OSX at 267, managers continue to recommend the purchase of these stocks (after a 70% Index rally!). This is typical mutual fund manager behavior. You can draw your own conclusions.

4) The public is FINALLY beginning to invest money in stocks (more $ purchases of Stock mutual funds than redemptions out of them), ***AFTER*** a 90%+ market rally, and after getting hurt in bond funds (which fall in value as interest rates rise).

These warning signs (#1-#4) are primarily psychological are not related to corporate earnings or geo-political events.

In summary, risk has risen greatly and the stock and bond markets are vulnerable. It is much like walking out on a frozen pond on a warm day and you can hear the ice cracking around you. Maybe the ice won't break, but since it is so weak and vulnerable, all it takes is one small disturbance and you can be under water and in trouble very quickly. I would rather wait for the ice to break, and THEN, assess whether or not the ice will refreeze before I decide to walk across.