Stepping Stones Management, LLC

Third Quarter 2009 Commentary

October 14, 2009

The big story on Wall Street is the declining US dollar resulting in the best third quarter stock market performance since 1939. The thought is that a weakening currency is good for our economy and therefore good for stocks. This is from the same conventional wisdom that says we need to spend our way out of our debt problem. The theory says that if our currency is worth less, exports will increase as foreigners will be able to buy more of our products that will cost less in those foreign currencies. Furthermore, our multinational corporations will get a boost to earnings when they translate their foreign earnings into depreciated dollars, which should drive stock prices higher.

The first point, regarding the effects on the broader economy, seems to ignore that the United States consistently runs a trade deficit; we import more then we export. So increasing exports is certainly good but a weaker currency will increase the prices of all those things we import. I could easily drink less Italian wine and more California wine to avoid this dynamic but unfortunately we can't substitute domestic oil for foreign oil because we don't drill enough domestic oil. Oil is the main driver of our trade deficit and the declining dollar will drive up the price of that oil and all its derivative products such as gasoline, plastics, fertilizers and a myriad of other products essential to our economy. That is one reason why declining currencies almost always result in higher inflation which drives down real earnings and living standards. Not a good thing in a consumption based economy such as ours.

On the corporate earnings front, a lower dollar does indeed boost the earnings of multinational corporations with large overseas operations, although it does not do much good for domestic companies that need to import some of their components of production. Even focusing solely on the largest companies of our economy, this theory of the positive effects of a weak currency misses the point that the stock prices of these global companies rely on global investors who don't want their investments parked in declining currencies. I wrote about this quite a bit over the past decade when our country seemed to have a weak dollar policy. Compare this to the late nineties when the US unmistakably had a strong dollar policy that was met with inflows of foreign capital that drove one of our greatest bull markets ever. If a weak currency was the best path to national greatness, George W. Bush would be king of the world.

Positioning oneself against conventional wisdom is not comforting and in fact the correlation between a weak dollar and strong stock market has been clear and present for several years, even though it goes against long term empirical data. Over the past couple of years, when the economic news got bad we saw money flow into safe dollar based US Treasury securities and out of equities. Conversely, when the economic news has been better, money has come out of that US Treasury bomb shelter wanting the higher risk and reward of equities, and often foreign equities which has driven down the value of the US dollar. Prior to the financial crisis, the weak dollar was in fact boosting exports which explains some of the weak dollar/strong stock market correlation since 2003, although I think that is better explained by the cheap money that drove the debt and asset price bubbles. It works until global investors sense it is the actual policy of the government and begin to shun dollar based investments. I think that point is close to re-emerging.

The economic recovery has been stronger in foreign economies than the United States as international capital has flowed to those countries where investors expect strengthening economies and currencies. The difficulty is determining to what extent those other economies are reliant on exports to the United States. This is why China doesn't want to pull the rug out from under the US economy and threaten their exports to our market. They would rather lose some money on currency exchange in order to keep their export machine churning out products for US consumers. Although Chinese officials have suggested plans to diversify their holding away from US dollars, they don't want to cut off their nose to spite their face with actions that would drive up interest rates in our economy and snuff out the nascent recovery.

U V W or L

That recovery is of course the most important factor to our stock market. As I have been teaching my 3 year old his letters, I might as well throw in an economics lesson as we see commentators debate the shape of the economic recovery. Will it be V shaped where we recover what we lost in as much time? How about W shaped where we get an initial sharp recovery followed by another downturn before a more lasting recovery? Some are calling for a U shape that sees us muddle down low for a while before the actual recovery takes hold. Still others call for an L shaped recovery that doesn't really recover but just stops deteriorating. Investors have been pricing in the V shape as my son could recognize from looking at a stock market chart. We have seen some economic strength as inventories get replenished and pent up demand gets satisfied but most statistics suggest we are not out of the woods yet and the market appears to have gotten ahead of itself. The economy did register some meager growth in the second quarter and most economists predict more robust GDP numbers to be reported for the third quarter. This is not too hard to predict as the components of third quarter GDP are already known. Models that predict the future economy lack much predictive value though. I don't know how much I'll be spending during this upcoming holiday season and I don't think some econometric model would know much better. Without an improvement in employment, further economic growth in the fourth quarter will be hard to achieve.

Economic growth is often driven by credit demand and availability, both of which are presently anemic. I've written about the crowding out principle where banks are lending to the federal government at the expense of businesses that need to fund projects. Bankers respond that qualified credit demand is not present so they are left to buy Treasury securities. One reason for the lack of qualified credit demand is that the qualifiers have become more stringent which needed to happen after the loose money of recent years. However, another more potent reason is that we are still struggling with the deleveraging process of the last two years. On net, more individuals and businesses want to reduce debt rather than take on new debt to capture new opportunities, and only hindsight will tell us when that phenomenon has run its course.   So even if the federal government were spending less and the Fed were pursuing a more regular monetary policy, those individuals and businesses would still need to reduce the amount of debt built up over the biggest debt expansion ever. This means that assets are being sold to pay off debt which drives down the prices of those assets which feeds those deflationary forces. Yes, that tug of war between deflation and inflation is not yet resolved.

Deflating Jobs and Homes

The third quarter provided a glimmer of hope that the deflation in housing may be subsiding. The jury is still out as to whether the price improvement that emerged in the spring is sustainable as weakness reappeared later in the summer. End of year accounting at financial firms could produce another foreclosure wave which would result in another leg down in home prices and the follow on effects to the economy. We all know what the consequences of that can be, although another autumn crash is close to impossible as all the government safeguards are still in place. However, weaker housing prices over the past couple of months have coincided with weakening employment statistics that show an acceleration of monthly job losses and weekly jobless claims persistently higher than would be the case in an economic recovery. It seems the new normal is for about 200,000 jobs to be lost each month in the non-farm payrolls report which is not commensurate with economic growth. Commodity prices that signaled an improving economy in the spring have also turned down which is especially striking in the face of the declining dollar. Demand just doesn't seem to be there. An exception would be gold and other precious metals prices which are more an inflation proxy than indicative of economic demand.

We did purchase an ETF made up of the major gold mining companies at the end of the quarter, one of our first anticipated inflation trades. Gold has gotten a lift from Chinese government officials expressing a desire to diversify away from their massive US dollar holdings and I see the price of the metal rising even in a deteriorating economy. Recent stories about other countries wanting to form a new reserve currency have given another boost to gold and further weakened the dollar. I have plans to buy other commodity based ETFs that would benefit in an inflationary environment but I think prices of those other commodities could be driven more by end demand than by currency effects. Likewise, I want to wait on initiating any technology positions until the market corrects its recent surge which has been based on a V shaped recovery that I do not see materializing.

It may be that the stock market is looking beyond the domestic US economy at the improving world economy which will provide sales to our multinational companies benefiting from the declining dollar. I don't like to fight the market which is the single best economic predictor, but best does not imply perfect as the dot com and real estate bubbles demonstrate. I also have a problem with a rally that is being justified by our weakening currency which has never led to prosperity. Another explanation is that the rally is just factoring in higher inflation as the stock market is flat in relation to the price of gold year to date. Before initiating more inflation trades though, I am inclined to take on global investment positions, but only after some more assurance that the world economy is indeed improving. My hesitation to invest in some of those stronger emerging markets derives from the question of how much they rely on a strong US economy. A fourth quarter correction would be a welcome opportunity to buy into some of the emerging markets at better prices than currently available.

Getting back to the letter analogy, I obviously don't subscribe to the V shaped recovery thesis but I do think we are experiencing something better than an L. The Fed agrees that the economy has yet to heal as they have kept in place their extraordinarily low interest rate policy. The stock market rally since early March has just been too enthusiastic for me to jump on board more than we have so far. A correction of that rally would give me the confidence to buy into what I do believe is a growing economy at a more reasonable level. I don't like sitting on cash during such a strong market but it would be far worse to buy at a market top. That is the difficult decision we are faced with currently and I appreciate the trust you have given me to make that decision. And as always, I appreciate your business.

Yours truly,

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