Islamorada
Investment Management

Why We're Buying in This Market

How The Risk of a Double Dip Recession is Being Overblown

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Letter to Tarpon Folio investors, June 2010

Since you're all out of perspective and no one else seems to have it in this bloody town, I'll make you a deal: you provide the food, I'll provide the perspective.

- Anton Ego, Restaurant Critic

Like many value investors, my skepticism of economic predictions and forecasts runs fairly high. There was a time when I rarely devoted any serious time to thinking about GDP growth, unemployment levels, or our government's fiscal policies. Not because such things aren't important, but because they are so difficult to accurately predict. Successful investing is much more about solid bottoms-up analysis than accurate top-down forecasting.

In recent months, however, my skepticism about the usefulness of macroeconomics has been dulled by my contrarian streak. When every headline seems to be cause for a sell-off on Wall Street, I find myself reflexively searching for silver linings. And I'm pleased to say that despite recent headlines, there are more reasons for optimism out there than you might think.

But first, let's review the main drivers of the stock market's behavior over the last three months. Sovereign debt fears - in Europe of all places - seeped into the market's consciousness around the same time some of the biggest banks on Wall Street started getting sued and subpoenaed by the U.S. government. Meanwhile, the biggest financial reform legislation of seventy years was being debated in D.C.

Then, the biggest environmental disaster in our nation's history tragically unfolded live on YouTube. It was ridiculous, infuriating and entirely preventable. Strangely, Goldman Sachs appeared to have nothing to do with it.

All this was going on, mind you, as the country tried to emerge from a recession that began more brutally than the Great Depression. Let the resulting anxiety about jobs, real estate prices, and unsustainable deficits continue to build. Add a thousand click-happy hedge fund traders using leverage like it was table salt. Withdraw a huge amount of government support in the markets. Throw in a few datacenters full of buggy computers causing inexplicable 1,000-point drops in the major indices. Finally, give everyone with an opinion about any of the above a microphone, blog, camera or column.

What we have ended up with is utter information chaos. It is historic, it is unsettling, and is completely irrelevant when it comes to long-term investing.

Fortunately, there is some signal in all that noise. Alas, it can take a bit of wading through some macroeconomics to isolate it. I've found that to be a bit more tolerable, though, if you keep three things in mind:

First, to paraphrase one wise economist, the point of tracking economic data isn't to be able to answer all kinds of questions – it's to learn how to tell when you're being buffaloed by an economist.

Second, until proven otherwise, assume all economic predictions reflect a strong, covert political ideology of one stripe or another.

Finally, keep in mind that, as one of my veteran friends recently reminded me, the entire field of economics is BOGSAT. As in: a Bunch Of Guys Sitting Around a Table. They contribute so little to GDP. Step it up, fellas!

Five Crises At a Time, Please

The long-term economic threats this country faces – from our federal deficit to inflation to the rise of China - concern me both as an investor and an American. We unequivocally need to get thrifty again. High inflation should be avoided at all costs. And I find it unsettling that the Chinese government is run by driven engineers, while ours is run by bickering lawyers.

To be clear, I have nothing against lawyers. Just constant bickering.

In any case, those threats are better discussed another day. If the markets aren't concerned about them, then it seems more appropriate for me to stay focused on what is more immediately in front of us - our portfolio.

I know. Some portfolio manager in Greece probably wrote the same thing to his investors six months ago. The difference, though, is that our country actually has time to solve these issues.

I say that because right now the bond markets are not at all worried about U.S. deficits. The rates on U.S. bonds have dropped through the floor, meaning bond traders are remarkably unconcerned about our spending. The Greek government makes ours look Amish, I suppose. The spread between inflation protected Treasury bonds and regular bonds is currently low, too, implying that inflation is not a serious risk to be concerned about yet, either. Far be it from me to speak for bond traders - do you all still eat onion cheeseburgers for breakfast? - but my point is that the bond market is not telling me to figure out how to fix social security prior to buying more shares of Google.

The Downside

This next point in particular seems to be getting lost in all the noise.

Let's assume for the sake of the argument that I am horribly wrong, and that the economy continues to dive right into a double dip recession. Let's tack on other assumptions, too, including a double dip in Europe (which does seems likely, though no one is talking about it), persistently high unemployment and a bleak outlook for home prices. Let's also assume our political leaders remain reasonably rational in their response to this scenario - or at least that they fake it for a while.

Should a double dip occur, even under those circumstances, it's hard to see it being anything other than a mild recession.

Housing is already near a bottom, banks have already been re-booting themselves with new capital, and big companies have already gone through rounds of deep layoffs – and they're sitting on historically high piles of cash. And whether you're a supply-sider or a Keynesian, that we're coming up on election season means that a double dip will certainly not go unaddressed in D.C.

So even if I'm wrong, I believe the downside is limited - at least in terms of investing. You are on your own if you quit your job to flip condos in Vegas again.

This, by the way, is also why you need a margin of safety in the companies you buy shares in, too – in case things go south for reasons you don't originally contemplate.

Lastly, pundits calling for the end of America and/or a great depression are being, in the strictly academic sense of the word, asinine. You feelin' me, Krugman? How about you, Elliott Wave guy? No more crazy talk outta either of you. We are America, dammit - the land that brings you moments like in this video.

(Wait for it....wait for it... and watch the guy in the lower right.)

The Big Picture

Here is my attempt to frame the current macroeconomic angst the country is experiencing:

Our economy, compared to a year ago, is in good shape. Compared to what it was before the Great Recession, however, it's still in rough shape. Pundits, armchair economists and politicians from both ends of the ideological spectrum have abnormally high levels of confidence about how to best fix this problems. Some are still peeved they were ignored last year. All tend to broadcast their opinions loudly. Their approaches vary dramatically. None can be tested empirically, though, because economics is not a real science. Thus, there is much noise.

Our economy is recovering weakly from a brutal recession. Numerous risks remain that demand watching closely. We have a huge long-term challenge ahead of us in terms of our federal deficit. Nonetheless, the economy is in a recovery. It's important to distinguish between the slowing of a previously high rate, and a definitive downward trend. And right now, no data supports that latter conclusion. In fact, if you look at each of the significant macro data trails over quarters instead of months, the recovery becomes much clearer.

Many stocks are cheap again – if nothing else, than at least in the relative sense. As I write, the yield on the Dow Jones Index is higher than on Treasury bonds. This is good for long-term investors.

It doesn't feel like we're in a recovery yet, however, and that is the problem. Behavioral economists (the cool ones) call this 'recency bias.' People systematically and predictably project their current circumstances into the future. We put too much weight on recent events. Think of the gambler doubling down after winning the last two hands. The odds have not changed, but the perception of them has.

Recency bias played a key role in the recent housing bubble. The vast majority of the population of this country believed home prices would keep going up, simply because they had been going up. Recency bias also probably has a good deal to do with the long run-up in stock prices last year. I believe it's affecting the stock market today, too, in the opposite direction. The jarring market drops of 2008 and early 2009 will forever be etched in the minds of anyone who was paying attention. The uncertainty created by recent economic data is leading many people to jump to premature conclusions based on some very unpleasant recent experiences.

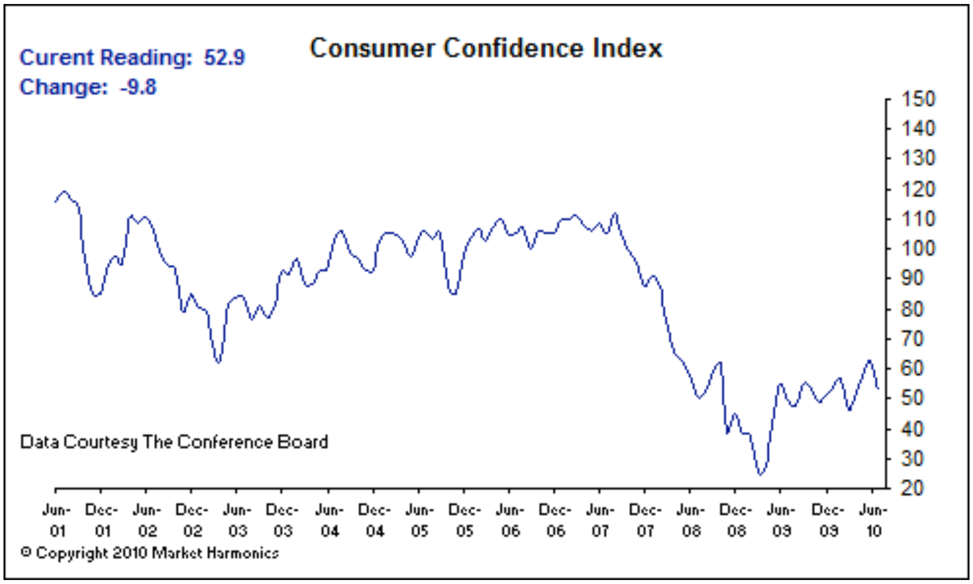
When it comes to the economy lately, high unemployment and poor housing data are the numbers most of us tend to latch on to. Although we're probably through the worst of it, housing will likely continue to be a drag on the economy the rest of the year. Unemployment will stay uncomfortably high. This oil spill is going to seem like it will go on forever. Each of these will cause continued angst. None should be confused, however, with things that will derail the ongoing recovery. That's because big business is going to save us.

You're welcome, economists.

Overblown, You Say?

Some of the facts which lead me to believe that fears of a double dip recession are overblown:

- Quarterly GDP growth rates moderated after the recessions in 1990 and 2001, too.
- There is only one historical precedent for a double dip recession in the modern U.S. economy – back in 1980 – and that one is somewhat debatable. The National Bureau of Economic Research actually considers it to have been two separate recessions.
- In Q2, 'employee hours worked' grew at a faster rate than at any point in the previous ten years. Next step? Hiring, because people can only work so hard until new help must be hired.
- Assuming some gain in productivity in that last bullet, GDP growth in Q2 may prove to be better than in Q1.
- In Q2, monthly gains in private sector employment averaged 119,000, up from 79,000 in Q1. Yes, the June number was a bit unimpressive, but it was nonetheless positive – and any analysis based on just a one month snapshot is, well, bad analysis.
- The Institute for Supply Management indices, though down slightly, are still indicating the economy is in expansion mode. Anything above 50% is considered good. We were at 56.2% in June.
- The U.S. Treasury yield curve continues to be steep.
- World trade is now back to pre-Great Recession levels.
- Credit markets bounced right back from that whole Greece scare.
- Consumer confidence, though down for what I believe are explanatory reasons - it's the oil spill, stupid! - will likely increase considerably if it does nothing more than revert to the mean. See below.



- GDP growth looks like the below. If you did nothing but look at the three bars at right, you'd intuitively grasp that the probability of a double dip is quite low. We're doing okay, all things considered.

Real GDP growth is measured at seasonally adjusted annual rates.
Note. Real GDP growth is measured at seasonally adjusted annual rates.

U.S. Bureau of Economic Analysis

Because of the above, I also think it's safe to say that the odds of being spectacularly wrong about the course of the economy over the next twelve months are much higher right now on the double-dip side of the debate. I don't consider myself a permanent bear or a bull, mind you, but it's seems considerably more likely the bears are wrong here. So, label me what you may.

To be clear, it's also relatively easy to come up with a list of things to be concerned about in the economy these days. Some are significant, and all are worth keeping an eye on. In a nutshell, though, I believe that list is shorter and less relevant than the one above.

What Happens Next

The manufacturing sector of this country is improving faster than the rest of the economy, and in the macroeconomic sense, it is buying time for everything else to catch up. It, too, produces confusing economic data points, and it certainly won't go straight up forever, but core capital goods data (riveting!) indicates that businesses will continue to invest strongly the rest of this year. In the aggregate, corporate profits right now are high - and increasing. This gives firms the ability to invest and hire. That will eventually improve job growth, which will, in turn, improve "consumer confidence" – a slightly more pleasant turn of phrase than "people will go to the mall," but basically meaning the same thing.

Because the Federal Reserve will continue to keep interest rates very low, access to credit for small businesses will improve as banks earn their way out of their past sins. Once housing prices truly hit bottom, even more credit will flow. The recovery will then be able to sustain itself without being dependent on government stimulus. Then, we'll be really growing. No training wheels or nothin'.

This will take time, though perhaps not as long as you might think. And it won't be the kind of recovery that will knock your socks off. Again, job growth will probably be anemic, and housing will remain ugly for a few more quarters. But things should soon start to feel better than they do right now.

And the Market?

The stock market is down about 15% from its peak earlier in the year. This sell-off began, you'll recall, when those men in Greece reminded us that debt is bad. That brought back bad memories of the 08-09 stock market drop(s). Some stocks are very cheap again now, although risk is high, too. The probability of continued wild market moves is much higher than normal. But barring any other large shocks to the system, an improving economy and increasing credit will begin to show up as higher company earnings. That will cause the stock market to rise – all things being equal.

If I am wrong, then, again, we should have limited downside, both due to the mild nature of a second recession, and the margin of safety that exists in the securities we own. The price to fair value ratio of Tarpon is notably higher now than it was a year ago.

This next part may sound hopelessly optimistic, but it's essential to understanding what I'm doing in the portfolio lately:

If the country manages to plod through these current economic headwinds, and I believe it will, then the next few weeks and months will be a terrific long-term buying opportunity. (By long-term, I mean years, not months.)

We can make quite a bit of money without impressive economic growth, and even in the face of stubbornly high unemployment. For one, we're getting great prices on some wonderful businesses. Soon, macroeconomic factors could be a wind in our sails, too. Here's what I mean:

The U.S. economy has over the long-term grown at about a 3% annual rate. This is due to 1% growth in employment and 2% growth in productivity. So even if employment growth struggles, the economy can still grow at an annual 2% rate due to productivity gains – meaning the ability to make more with less.

That 2% real economic growth might not sound like much, but given all the cost cutting done by businesses to survive the Great Recession, even modest gains in revenue will lead to outsized gains in profits. And when it comes to our already undervalued companies, any excessive earnings growth should cause the gap between their market prices and intrinsic values to close that much quicker. All things being equal, of course.

Recent history lends some support to this idea. In 2003, for instance, payrolls were basically flat all year, rising just 87,000 total, or about 7,000 per month. Nonetheless, the S&P 500 rose over 26% in 2003 as the economy recovered from the recession that began in 2001.

That doesn't mean a similar rise going to happen – only that it is within the realm of possibilities.

The Ultimate Echo Chamber

As mentioned earlier, economics is BOGSAT. I love that. Therefore, when attempting to track economic news, it's important to keep in mind the real-work-to-regurgitation ratio. The number of people who, when talking about the economy, actually parse data compared to those who regurgitate others' opinions is remarkably close to zero. It's almost all noise in the echo chamber.

To be clear, I am in the regurgitation camp when it comes to macroeconomics. I feel like I've got my hands full doing real work when it comes to analyzing companies. But if you're not going to track, say, core capital goods shipments yourself, it's important to find sources you can trust to keep you up to speed.

By someone you can trust, I mean a source who will (1) clearly articulate the nuances of macroeconomics, (2) present, reference or link to the data from which conclusions are derived, (3) have either a very transparent political or ideological bias, or none at all, (4) distinguish between opinion and fact, (5) try hard to be insightful, (6) avoid attempts to be clever, (7) learn from past mistakes and (8) possess at least some gray hair.

Also, that source should be thoroughly screened for Stopped Clock Syndrome. Making the same consistently dire or permanently rosy predictions at every point in the economic cycle is grounds for having your house TP'd.

For what it's worth, these sites meet those criteria and have RSS feeds that I subscribe to:

The Big Picture. Barry Ritholz summarizes the best stuff that crosses his desk – including other economic research that costs a ton.

The Dismal Scientist. From the folks at Economy.com. The best, most professional online economic analysis for your dollar.

Briefing.com. More specifically - the "Our View" section. Just the facts, ma'am.

Calculated Risk. Educational and broader than just investing.

Macroblog. A blog from the Altanta Fed. Posts show up about once a week.

Real Time Economics. From the WSJ. Good to understand consensus, and why it may be wrong.

Some of the above are subscription-based, but they're worth every penny. I also habitually read a number of other sources outside of my RSS feeds and the usual daily scans, including Bob Johnson at Morningstar and Jim Grant of Grant's Interest Rate Observer.

The Bottom Line

While there are near-term risks to the economy, I believe they are overblown. I would put the probability of the U.S. slipping into a double dip recession at most at 20%. Recent economic data is less confusing when taken in historical context and after acknowledging the psychological effects of numerous systemic shocks to investors over the last few years. The Deepwater Horizon oil spill in particular comes at a critical time in the recovery.

Nonetheless, to expect 2.5% to 3.0% growth in the economy this year seems both objective and reasonable, and if credit conditions improve, it seems likely we'll see considerably more growth next year. Despite the wild daily swings in the market the last few months, the data does not indicate any trends that would cause me to move any significant portions of the portfolio to cash. To the contrary – eventually we should begin to see positive economic news that will help underscore the depressed valuations of our companies.

And while I would not underestimate the ability of our esteemed political leaders to screw this recovery up, I would also caution against underestimating the desire of businesses to grow when given the chance. Right now is one of those opportunities.

A Qualifier of Sorts

The burden of proof in macroeconomics seems to be, essentially, on those who argue the consensus is wrong. In that light, I should point out two things.

1 – The consensus among the vast majority of professional economists is still that we are in a recovery. So, I am not being particularly subversive or original in any of my conclusions above.

2 – None of the thoughts above should be interpreted as predictions or forecasts of my own design. I review macroeconomic news and opinions to confirm or dispute the implicit assumptions the stock market makes when pricing in that news. If I knew the next recession was to begin tomorrow at 8 a.m., it would not change how I invest in the slightest.

I am in no way qualified to independently and accurately forecast any macroeconomic trends of significance. Fortunately, all I am trying to point out here is that it is highly likely that the market is temporarily confused about the macroeconomic data that has been released lately - and for good reason.

As the fear of a double dip recession begins to diminish, as I believe it soon will, then market prices will move to accurately reflect underlying values. And in the case of our companies, that move should be significant.

In Case It's All Making You Nuts

So what can you do to ease the stress of investing in such a volatile market?

I've got five suggestions.

1 – Just know that I'm on it. All day, every day. Should I see any data come out over the coming weeks and months that gets me truly alarmed about the future of our companies, the stock market, or the country, I will not hesitate to move some or all of the portfolio to cash. But this is not one of those times.

2 – Prepare yourself for media reports that will harp on whatever sells the most ads. In a weak recovery like this one, economic headlines won't be sunshine and puppy dogs every time – particularly when it comes to unemployment. Correspondingly…

3 – Don't get too carried away when things do turn positive, either. The biggest mistake you can make as an investor is to buy crappy companies near market peaks. Be cool.

4 – Consider making investments at regular intervals, rather than all at once. Among Tarpon investors with the highest returns to date are several people who contribute money regularly to their accounts every month. It's easy to set up, takes emotion out of the equation, and in times like these, will allow you to improve your long-term returns.

5 – If you're investing over a short time horizon that I don't already know about it, or if you may need money earlier than you might think, call or email me. The sooner you need to withdraw any money, the more stress market volatility will cause - whether you're invested in Tarpon or elsewhere. If I'm aware of any deadlines ahead of time, though, then we can take advantage of any big market upswings, or perhaps park some money in the lower-return but less-volatile Gecko Folio. Whatever works best. The point is just to make sure we're on the same page when we each say "long-term."

Please let me know if you have any questions. And hang in there. We're going to get through this just fine.

- Cale