

“Confidence Game”
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Investment Strategy by Jeffrey Saut

“Confidence” is defined as, “faith or belief that one will act in a right, proper, or effective way.” But, confidence can be fleeting. As Fed Governor Kevin Warsh stated:

“Confidence can be fleeting. Confidence can beget complacency. If, in liquid times, investors in structured products become complacent, they may not understand fully the value of the underlying assets. High levels of confidence, perhaps even complacency, were also observable in the behavior of many financial intermediaries. Many hedge funds, growing in size and scope, invested in less-liquid assets in search of higher expected returns. Many commercial banks increased sponsorship of structured investment vehicles to invest in long-term securities, often financing them off-balance-sheet with short-term commercial paper. Those financial intermediaries that recognized the risks of extrapolating high levels of liquidity indefinitely were threatened with eroding market share and less-impressive profit profiles. They may have hoped that robust trading markets would allow them to exit positions ahead of a crowded trade. But, to paraphrase an old Wall Street saw, they don’t ring a bell when the markets are at the top or at the bottom.”

Since the Ides of March, triggered by the collapse of Bear Stearns, confidence has clearly been waning. In September that waning turned into a “confidence crash” when the Treasury Department nationalized Mac and Mae. As stated in previous missives, it wasn’t that these GSEs didn’t need to be bailed out, they did, but it was the structure of said bailout that caused a confidence collapse. Indeed, in previous bailouts the government has left an equity stub for shareholders, allowing them to participate in the survival, and eventual recovery, of the company (think: Chrysler, Lockheed, etc.). This time, however, the equity holders were wiped-out after being told by Secretary Paulson that everything would be okay with Fannie (FNM/\$1.34) and Freddie (FRE/\$1.49), as well as their preferred shares. Ladies and gentlemen, the structure of this bailout is historic, as well as a game changer, causing international investors to ask us:

“Why would ANY rational investor commit capital to a situation whereby if things didn’t go the right way the government might come in and totally wipe you out?!”

Clearly a valid question and one we can’t answer. A few weeks later another unanswerable question was raised when the Federal Reserve decided to let one of its primary dealers, namely Lehman (LEHMQ/\$0.17), go bankrupt. At the time the “spin” was that at \$80 – \$90 billion the cost of rescuing Lehman was just too large. But, during that same week the government bailed out American International Group (AIG/\$3.86) to the tune of \$85 billion; AIG was not even a primary Treasury dealer! The Lehman collapse triggered a sequence of credit market events that caused certain money market funds to suspend redemptions and/or redeem funds at less than 100 cents on the dollar. When the media trumpeted the money market machinations, it sparked a “run” on select banks, causing a domino effect that toppled a number of banks.

With the confidence crisis now in full regale, the politicians sprung into action spurred by the \$700 billion Paulson Plan. The original rescue plan was written on three pages. It was subsequently rewritten by the House of Representatives to some 100 pages. Still, if the plan would have been passed last Monday, our sense is the DJIA would be 1000 to 2000 points higher than where it now resides. However, our elected nimnods couldn’t rise to the status of “statesmen,” but rather played politics and defeated the bill, leading to last Monday’s 777-point Dow Dive. Shocked by that loss of more than \$1 trillion in stock market capitalization, the politicians quickly reconsidered their decision as rumors swirled of a newly crafted rescue plan. Those rumors drove a 485-point Dow Wow on Tuesday. That plan materialized on Thursday with a 400-page rescue plan loaded with more than \$100 billion of self-aggrandizing ornaments (i.e. pork barrel “earmarks”) for rum distillers, movie producers, wooden arrow manufactures, stock-car racers, etc., causing most of the electorate to lose total confidence in our politicians amid cries, “Our elected ignoramus should be ashamed!”



With confidence in our financial institutions, our economy, and now our politicians in total shreds, we told accounts on Wednesday/Thursday that even if the re-crafted rescue plan was passed there would likely be only a brief rally in the equity markets followed by a subsequent sell-off. In fact, we suggested that once the markets get to this stage, they don't usually end without a "pornographic plunge" type of hour. Regrettably, we got the brief rally when the rescue plan passed on Friday, followed the sell-off, and this morning it looks as if we will get the "pornographic plunge." Verily, what a difference a week makes, for if the original rescue plan had been passed, our sense is the equity markets would be substantially higher than where they currently are. Yet in this business what you see is what you get and trading accounts should have been "stopped out" of remaining trading positions in last Monday's meltdown, as noted in Tuesday's verbal strategy comments. Clearly, we were wrong that the "lows" of two weeks ago (9/18/08) would prove to be "the lows" for the year. That error rests on the fact that we were also wrong in our assumption the initial rescue package would pass because it HAD to pass.

So where does this leave us? Well, last Monday's "melt" (DJIA -777) turned out to be yet another 90% Downside Day (total point and volume was skewed 90% to the downside), while Tuesday's triumph (DJIA +485) didn't qualify as a 90% Upside Day. Moreover by the end of the week, out of the 98 sub-sectors in the S&P 500's sector analysis, only one was positive on the week, namely the Nondurable Household Sector, on which we have been bullish. In the past such negative sector metrics have been associated with tradable stock market "lows." Further, our proprietary oversold indicator is now more oversold than it has been in decades. Additionally, according to our "day count" thesis, we are now at day 24 in the downside skein. Historically, such skeins typically do not last more than 17 to 25 sessions before they exhaust themselves on the downside. Traders, therefore, should take heart that we are near a downside inflection point, unless this is indeed a "crash" (which we doubt). Another metric worth watching, since this is a "lending crisis," is the Libor to Overnight Index Swap-spread (Libor/OIS-spread), which tagged an historic 276 basis points "wide" late last week. Any narrowing in this spread should be viewed as a positive since it would imply banks are beginning to lend to each other again.

The call for this week: Well, we arrived at the office at 5:30 a.m. only to see the S&P 500 reopening futures down 33 points amid news out of Europe of an expanding banking/credit crisis. This morning's swoon comes on the back of Friday's Flop, which turned out to be yet another Dow Theory "sell signal" like the one we wrote about last November. Meanwhile, the three-month Libor/OIS-spread is at 295 bp "wide" and with the U.S., as well as Europe, going into a recession the environment is pretty dour. However, things "felt" equally dour post 9/11/01, yet the S&P 500 (SPX/1099.23) bottomed and rallied 24% over the following three months. Consequently, once again I think we are approaching a downside inflection point; and, trading accounts should conduct themselves accordingly. More conservative accounts might wish to consider some of the closed-end funds eviscerated by this month's hedge fund liquidation like: BlackRock Strategic Dividend (BDT/\$9.95); BlackRock Enhanced Dividend Achievers (BDJ/\$8.89); and Eaton Vance Tax-Advantaged Global Dividend Income (ETG/\$13.79), all of which have blue-chip portfolios with yields; and, all of which are selling at substantial discounts to net asset value (NAV). Clearly, these recommendations are like buying the indices at a substantial discount, as well as in keeping with our dividend theme. As for this week, it's kiss and tell time.

IF you have questions relating to the market or to your specific investments please contact Tim Eyerman or Brian Mezey.

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