

The Bubble In Negativity

I don't need to tell you that what we've experienced in the last two months has been a series of financial calamities and mistakes of titanic proportions. Much of the blame should be cast on the era of deregulation and gross disparities of income in our country. The only way to have afforded a home when prices were stratospheric and wages were flat was to leverage up. The concept of the "Ownership Society" has fallen upon itself due to a lack of common sense and broad based wealth creation that cut across race, demographics and class.

There will be extensive implications in our social fabric, economic and political assumptions and stock market ramifications that going forward will be difficult but largely positive. Great positive change doesn't come without a cost. The election of Barack Obama is likely a major step in the right direction as his economic team will likely be better equipped, more competent and with better focus on the U.S. domestic economy:

"Going for him too is a broad sense that the President-elect faces are so deep, from war and peace to economic dislocation, that voters will be patient, give him time, and be grateful for any progress. Modest improvements will be seen as small triumphs." Peggy Noonan, WSJ

Clearly the next four years should be focused on getting our own house in order. Where I once thought that an Obama victory might be a market depressive, I believe it will likely be market positive.

We've witnessed a purging process unlike anything seen in our lifetimes and probably will never see again. My work on investor sentiment was largely ineffective. However the bulk of the damage has probably already been completed as the climactic action of the sell off on October 10th when the S&P 500 sank to 840 has been retested but has not been broken. Subsequent retests of 840 have occurred on much less volume and fewer stocks making new lows, a sign of selling exhaustion. Clearly, I was wrong in not anticipating that the "*Black Swan*" (from the book by Nassim Nicholas Taleb where highly unlikely, extreme events have devastating consequences) would be realized and create such devastating losses in financial assets.

Worldwide government monetary support has largely been positive. Not every policy executed by the government in the TARP program will succeed, but by and large it will likely succeed. This is contrary to the actions of governments during the Great Depression where rivalries and protectionism prevented coordinated solutions. World governments now are working together in creating the necessary solutions. The impact of worldwide monetary stimulus has only recently been effecting improvement in the financial system. Equities may remain weak but LIBOR and credit markets continue to show improvement.

At present negativism reigns supreme in the world, which is not surprising considering economies are on the decent and unemployment is on the ascent. The failures of Washington Mutual, Wachovia, Bear Stearns, Lehman Bros., Fannie Mae and Freddie Mac easily enough to shake anyone's belief in our financial system. Hedge fund liquidations have also exacerbated the situation as their compensation structure inhibits patience: (Most hedge funds charge 2% of assets and 20% of new profits. Due to their severe declines they have virtually no chance of ever seeing the 20% of net profit bonus hence they liquidate assets and can reform in 2009 with a fresh

chance of starting at zero when future prospects are much brighter). My guess is that eventually these monies will return to the markets albeit in non hedge fund investments.

The severe negativism in the world at present is probably one reason why the SP 500 has remained in a trading range above 840. In other words, if the continual onslaught of horrific economic news has not caused you to sell by this point, then you probably aren't going to be rattled to sell anytime soon. Negativism has become commonplace hence there is little money to be made from selling into the consensus. Stock markets are a discounting mechanism. They assess the coming weakness beforehand and are calibrating pricing to reflect dismal numbers for 2009. At some point in 2009 it is likely that the markets discounting mechanism will see a housing bottom in the future and the eventual economic turn. Markets are self-healing but they require time and patience to work through the process.

Market rallies can come from the strangest places under the darkest of clouds. The odds are very high that the action of October 10 will likely have been the climax of the greatest amount of selling pressure seen by this bear market. The headlines from that weekend foretold that the end of the western financial system was very much in doubt and without immediate an immediate solution, a new Great Depression was looming. Thanks to proposals by the EU, a solution was brought to the table by mid afternoon on Sunday the 12th. From October 12th onward, world government got into the act and no doubt will pull out every stop and solution imaginable. Never have the vested interests of so many people and economies been so uniform.

This does not mean the market is now set to stage a major rally, far from it. The U.S. stock market will likely move in baby steps and there is hope of an intermediate termed rally (4-6 weeks) beginning anytime soon. I would pay particular attention to the cabinet team proposals by President-elect Obama. President-elect Obama has a clear opportunity to appoint the best and the brightest to cabinet posts, men and women of extraordinary intelligence (thankfully intelligence will no longer be repressed in this administration) with great credibility and cross party experience. Could Boone Pickens be selected for Secretary of Energy?

The Intermediate Term - Obama will be given the benefit of the doubt as he makes his cabinet appointments. If Obama chooses a highly capable team to lead our economy out of the current morass we should consider that should rise in the prospects of new hope and optimism, a concept so out of place with the current administration.

Most major bear markets end with not a single bottom in place but multiple bottoms, some of which could exceed the initial low. The major bear markets of 1957, 1970, 1974, 1982 and 2003 rallied and then had a retest to the old market lows (840 in our case, hopefully) two or more months later. The average rally in the initial bounce was roughly six weeks. There have been several positive divergences in each successive trip to 840 on the SP500 in the past month, which indicate the selling is growing increasingly weaker. This is a good prelude to an intermediate term bottom and rally.

I believe that October 10th was the climax of high intensity selling that created a fear-based bottom in the stock market at 830-840 on the SP500. Just like a bouncing ball that will hit the floor several times before it becomes motionless, we're seeing successive bounces to or around 830/840 and each drop shows decreasing intensity and a smaller number of stocks and industry groups making new lows.

The next major move should be higher but any intermediate termed rally we see in the near future will likely fail in early 2009. Hence, I intend on being a seller across the board into the rally as the odds are good that it's not *The Rally*. The dip I'm anticipating in 2009 could be the final end

of the bear market and set the stage for a massive rally. We still have no idea as to the length and breadth of the recession, so any rally at this point will be ignorant of the future.

Contrarianism is essential for long-term investment success. Just as in big bull market investors feel that stock prices have reached a permanent lofty level, bear markets such as the present day perpetuate a false belief that our current dire crisis will never be solved and rallies are impossible. The rally that we all desire will come, it will likely be huge and one year returns could be on a scale we've never experienced. That rally will likely last 2-3 years and returns could easily exceed 100%.

I also want to thank our clients for sticking with RMHI. This has been a severely stressful time and I'm sure that down the road we'll look upon 2008 as year where all those bargains were to be had. Given time, markets do heal themselves and this time should be no different.

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