

Welcome to the Jungle

October 27, 2008 Newsletter

*Welcome to the jungle
We got fun 'n' games
We got everything you want
Honey we know the names
We are the people that can find
Whatever you may need
If you got the money honey
We got your disease*

Welcome to the Jungle—Guns and Roses.

[Welcome to the Jungle Video](#)

Welcome to the Financial Jungle

Last December, I wrote a piece, entitled [I Don't Know](#), detailing what I expected for the financial markets in 2008. I usually have a fairly strong opinion, but last December I really didn't know what to say about the future. My reasoning remains that to use historical precedent as a roadmap for these currently unprecedented times is a big mistake. I have a keen appreciation for history, however because the build-up of debt has been so unique, using only history as a guideline is a mistake. Instead, I firmly believe that what follows an unprecedented buildup of debt plus the creation of esoteric financial instruments and poor lending habits would lead to an unwind of historical proportions.

I believe that when historians and investors look back on the unwinding of the most dangerous financial experiment of all time, this will be considered a historical guide for the future.

Welcome to the financial jungle, a place where we have a vague idea of what can happen

given historical precedent, but must wait for the unwinding or leverage and risk to end. The unwinding is unpleasant to watch even for those of us that have been expecting an unruly market. It seems that we have now entered a period where survival is key and the goal is just to exit this painful period with the majority of our capital intact. It is at that point that we can pounce as a predator would in a jungle and emerge the victor.

I feel for those that have lost capital while reaching for opportunity, but I continue to believe and position client assets with the mantra of, "I would rather lose opportunity than capital." Despite the fact that tens of trillions of dollars of financial assets have evaporated this year, I continue to search for when it will be time to enter the jungle and attempt to emerge the victor. I do have some ideas, or educated guesses, on what could happen, but that is all we have to rely on with markets that are so violently volatile.

Welcome to the Jungle.

Are Stocks Cheap??—The True Conundrum

Conundrum — A paradoxical, insoluble, or difficult problem

-American Heritage Dictionary.

Given what we have witnessed the past 18 months or so, I would have to say that "conundrum" may be the best word to sum up where we stand now in the equity and credit markets. Stocks seem "cheap" (so cheap, in fact, that a famous ex-Wall Street Strategist declared stocks the cheapest EVER on Friday). Without acrimony, I have been hearing

that stocks are cheap for the past 400 points of downward move in the S&P. Declaring any asset class as “cheap” during what may be the most devastating financial/economic/credit unwind is a dangerous business in my view.

If all you care about is price, then stocks are cheaper than they were. Consider this—stocks began this decline as historically expensive, considering most any reasonable valuation measure, but then a nasty thing happened. The global economy began to experience a coordinated de-leveraging, earnings began to fall worldwide, unemployment began to soar, and Governments around the globe were all forced to bail out companies, industries and individuals... All at a time when risk aversion has climbed to new heights. How on Earth can anyone tell me that given these facts, stocks are cheap?

At the expense of missing a potential imminent move upward in the equity market, I ask the question openly and am dying for an answer - “If you have no clue how far the unwind will go, have no reasonable expectations of earnings per share, how can you tell me stocks are cheap?” I don’t believe that anyone can. Markets can become “oversold” and due for a bounce, and as a technician, I respect these bounces.

Bloomberg World Equity Index Price/Earnings Ratios

World Equity Index Ratios				97) WEI	98) EMEQ	
Measure	Price/Earnings			Price/	Curr Yr	Nxt Yr
1) North/Latin America		Price	Net Chg	Earnings	Est.	Est.
4) INDU	DOW JONES INDUS.	8378.95	-312.30	10.46	9.95	10.44
5) SPX	S&P 500 INDEX	876.77	-31.34	19.13	11.00	9.35
6) CCMP	NASDAQ COMPOSITE	1552.03	-51.88	26.04	14.91	11.54
7) SPTSX	S&P/TSX COMPOSIT	9294.09	-37.26	10.72	9.11	8.07
8) MEXBOL	MEXICO BOLSA IND	16978.84	-820.15	8.02	8.51	7.73
2) Europe/Africa/Middle East						
9) SX5E	DJ EURO STOXX 50	2333.28	-118.75	6.94	7.20	6.60
10) UKX	FTSE 100 INDEX	3883.36	-204.47	7.05	6.66	6.51
11) CAC	CAC 40 INDEX	3193.79	-117.08	8.17	7.22	6.87
12) DAX	DAX INDEX	4295.67	-224.03	8.22	8.17	6.99
13) IBEX	IBEX 35 INDEX	8353.20	-458.00	6.71	7.38	6.94
14) SPMIB	S&P/MIB INDEX	19879.00	-1182.00	6.50	6.93	6.47
15) AEX	AEX-Index	245.92	-11.93	4.22	5.26	5.30
16) SMI	SWISS MARKET IND	5675.09	-218.64	34.91	15.98	9.41
3) Asia/Pacific						
17) NKY	NIKKEI 225	7649.08	-811.90	9.20	10.36	9.39
18) HSI	HANG SENG INDEX	12618.38	-1142.11	7.70	8.62	7.68
19) SHCOMP	SHANGHAI SE COMP	1839.62	-35.94	14.25	13.04	10.70
20) AS51	S&P/ASX 200 INDE	3869.40	-105.00	10.41	8.63	7.89
21) FSSTI	STRAITS TIMES IN	1600.28	-145.39	5.08	7.78	7.41

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But don’t forget, BEAR MARKETS GET OVERSOLD AND STAY OVERSOLD.

I will say this simply, even though I may be wrong. I believe that while stocks may look cheap, relative to what I believe lies ahead for the global economy, that there will be better entry points ahead, even despite the 40 percent bludgeoning that stocks have taken so far this year.

I have been told that stocks look cheap on a “trailing earnings” number and, to be frank, they do look cheap based on the last twelve months. Unfortunately that number is as useful as remembering what my golf handicap was in 1981. Perhaps more importantly, I would like to focus on Wall Street analysts estimates for earnings, because stocks around the globe look very cheap if you believe their earnings estimates. I, however, most definitely do not.

The graphic below, courtesy of Bloomberg LP, shows us the current and forward price/earnings estimates for many of the world’s major stock indices. If you believe the estimates, what we see are single digit price/earnings ratios.

Someone has to be wrong here, right? Either I am too pessimistic about the economy, unemployment increases, profit margin squeezes, or the analysts are correct with their estimates. We both can't be right.

So I decided to study how often Wall Street analysts and strategists had under-estimated realized earnings versus how many times they had over-estimated them. As it turns out, it is no surprise that the strategists and analysts are a very cheery, bullish sort. As an ex-broker, I can tell you that it is part of Wall Street to be bullish—to encourage folks to buy things. As an investment advisor, I am only interested in protecting client assets through tough patches so that we can “live to fight another day”, no matter how unpopular the view at the time.

All that matters to me are the GAAP (Generally Accepted Accounting Principles) earnings. The data below is courtesy of Ned Davis Research and is extracted from Standard & Poor's data. What we see is that for 2009 we can expect, if everything goes according to plan, that earnings will be approximately \$49 per share for the S & P 500. When we use Friday's close of 868, which is a far cry from the high near 1600 last year, we arrive at a price/earnings ratio of 17.8.

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S&P 500 12-Month Reported Earnings	
Dec 1994	30.60
Dec 1995	33.96
Dec 1996	38.73
Dec 1997	39.72
Dec 1998	37.70
Dec 1999	48.17
Dec 2000	50.00
Dec 2001	24.69
Dec 2002	27.59
Dec 2003	48.74
Dec 2004	58.55
Dec 2005	69.93
Dec 2006	81.51
Dec 2007	66.18
Dec 2008	54.51(E)
Dec 2009	48.52(E)

Risk Premium for Equities and the Credit Markets

One of the most important investment decision to be made, whether you are a retail investor, a large institutional investor, or hedge fund investor, is what asset is most appropriately priced relative to its risk. Academic types like to call this model the “Efficient Frontier”, a study as futile as I have ever seen. Come on now. If the world was *efficient* why wouldn't everyone just follow the same canned model? Why would many of us work so tirelessly? All we would have to do is plug some street analysts expectations into a computer and simply calculate our “efficient frontier”. This doesn't work for me when, in times like these half your money sometimes disappears.

At this point, the academics like to say that you just experienced an “outlier event”, or one that wasn't in their models. So much for models, right? Because, after all, once you have lost half your cash, simple arithmetic I can do on a cocktail napkin, tells me I have to double my money just to get back to breakeven. And trust me, anyone that says they can double your money in a year should have snake-oil for sale.

So where am I going with all of this? The first key to making money is to not lose your money. I may have been unpopularly bearish for a while now, something that frankly, I would have rather not been, but It is much easier to be a blissful perma-bull and just love stuff all the time... And to be honest, that sounds fun (if not dangerous).

I have seen the most complex of models from the highest end computers determining that stocks were cheap because they looked good versus riskless Treasuries as a function of some "Fed Model" or other such model.

But the truth is that I can buy GNMA pools around 6.25%. So what risk premium would I

have to receive to buy stocks with \$48 of earnings in the S & P 500? I would need to earn AT LEAST 400 basis points more per year of return, which equates to a price/earnings ratio of 10 or so. A P/E of 10 equates to a price level of approximately 500 on the S&P 500, which is precisely the point at which this Great Bull Market began in 1995 (see the chart below).

There will be bounces along the way, but until credit markets behave, and until we get to a positive part of the Presidential cycle, and until the Fed/ECB/Treasury, etc stop intervening (interrupting) in our markets, we shall remain on the defensive.

Loragithmic S & P 500 Since 1980



Welcome to the Jungle.

Bennet Seddaca,
President

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