The View From Princeton

Market Commentary ♦ September 2012

A Rally is a Rally is a Rally

Viewpoints among large diverse groups always disperse. Interestingly, the summer seems to have brought a proportional increase in the numbers expecting generally better stock valuations. Undoubtedly, the rally mauled and devoured the "sell in May and stay away" slogan. So, how would you describe the summer's rally, and what would you expect hereon?? From all that we read and hear, descriptions and expectations disperse very broadly, and cluster around the extremes of a negative "watch out" and a perceived prologue to an enduring uptrend following the election results of November 6 — notwithstanding the worrisome problematical Federal budgetary "fiscal cliff" as evident for early 2013. Ordinarily, dispersion of views is a healthy circumstance for facilitating the functioning of markets.

The stock market advance appears to have different character according to the base from which it is measured. If from the year's beginning, the advance appears nicely sized. If from the high point of March, it is nothing. If from the sinkhole bottom of May, it appears steep and strong. From each base point, there is some demonstration of fundamentals winning over emotions. The May sinkhole was brought on by an imaginary recessionary double dip, which we have experienced quadruple times. Now, prospectively, a "financial cliff" could provide another double dip chimera, which would be the quintriple time. It is all about volatility, such as in commodity markets after ten days of no rain "if there is no rain soon the crops will be ruined", or after a week of rain, "if the rain does not stop, the crops will be ruined". For the benefit of traders, there is volatility sometimes for volatility's sake. Investors, as distinct from traders, are advised to normalize forecasts: That is, mark the drama of the agora to reality, or to entertainment; then, get on with a firmer grip on reality. Pay attention primarily to affairs of worthy vigorous enterprises whose shares are attractively priced.

Worry derived from this "cliff" is already reflected in the market, so to speak, as a sobering influence. That reduces the possibility that such a budgetary contretemps could arrive with a sudden impact. Moreover, there is time and much prospect for change from now until then, which is by way of saying that while worry can happen any time, appraisal needs to await the circumstances prevailing coincident to implementation. Change and conditions seem likely then to be more resilient than now, that might well level this "cliff" into arable land.

The base has been prepared (nearing completion) for a decades-long advance in equity prices, which, in turn, will be the exemplification of the utmost effective aspect of monetary policy. That is the so-called augmentative wealth effect. This is arriving so partially it might be said belatedly, and is arriving after the Fed's recently announced additional stimulus in the purchasing of instruments based upon residential lending mortgages. This, too, seems late, and not now necessary. The economy is lagging because the recession imposed heavily upon state and local government's budgets and employment rolls, upon residential housing (owing to prior excessive financial support), and upon excessive expansion in the financial industry (which still must be tamed and trimmed into its rightful function as a service industry). Do not expect expansion in this industry any time soon, as both markets and governments exert constraining influences upon excessively self-serving practices.

We have encountered remarks calling the recurrent stock price advances a “stealth” rally, not to be trusted, and others describe it as a “take-your-profits-while-you-can” rally. Though it would be surprising if the advance could persist uninterrupted by a buildup in the dueling and grueling election process, we would remain focused on prospects for the months and years following the election, noting the supporting evidence is how very well major enterprises are proceeding in America, and elsewhere in well-ordered nations. These enterprises have more than sufficient financial resources — and can support opportunistic options as well.

To our clients, this thesis is not new; indeed, it has endured for three years, and validated in the American scene, having incorporated the helpful influences that emanate beyond America’s borders. The forces of growth vary importantly from that commonly extracted from national social data, and the analyses of so many economists who rely upon the experiences and schooling of years past, now obsolete and overwhelmed by the concerted influences of change everywhere. In order to keep this memorandum short for the sake of the writer, editors, and readers, we append an earlier (March 12, 2012) communiqué that gives further detail (something we have never done before).

With enduring cordiality and with earnest effort, our best wishes.

Hugh Fitzpatrick | Ken Berents | Jim Fitzpatrick

Attachment: The View From Princeton — March 2012

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Market Commentary ♦ March 2012

The stock market has spoken. The message is not to put worries aside. There are so many concerns that truly linger. Simply, the material aspects of the marketplace are overpowering the reluctance of concerns. This is a demonstration of strength, worries notwithstanding. Perceptions (or misconceptions, as in 2011) can rule for intervals though reality eventually prevails. Shares are not generally overpriced; high quality bonds are. Such low interest rates create a proclivity toward secure dividends from shares and toward other alternates. So, we are hearing the stock market sing, as the early robins, spring is near; take your chances without your snow tires or chains.

A Check List for 2012

Follow, if you please, through a brief application of our "Check List" for selection for strategic investing.

1. Foremost, we appraise the risk as perceived in the total environment – political, economic, and monetary, worldwide. Politics are discordant and fractious, aggravated by unacceptably slow growth in America and in Europe. Money is plentiful at extraordinarily low costs. If slow growth should (unlikely) become a recession, with such a plentitude of low cost money, this would be a first.

2. Viewing the world industry-by-industry, it is readily evident that many major industries have enduring dynamic factors driving expansion. We would cite:

   - Energy (all forms, fossil and alternatively derived)
   - Agriculture
   - Electronics (especially facilities for communications, data processing, storage and accessing)
   - Life Sciences and Human Care
   - Travel and Entertainment
   - Education

   All of these industries are vigorous and have such massive scales that these prevail over weaknesses in other industries, and withstand the gloom of attitudes and the acrid chatter and clatter of politics. For investors, these major industries abound in opportunities.

3. Most importantly, we evaluate enterprises one-by-one according to products, the competitive nature of their markets, their business models, and sufficiency of staff to meet prospective realizations.

4. Valuation, valuation, valuation! — ever of critical importance.

As in the year past, money will continue to be abundant as supplied by (1) central banks here and in many other advanced nations, (2) the huge accumulations of cash by prosperous corporations, (3) major oil exporting sovereign states, and (4) American households, which have (in totality) been sending more money back to financial entities from their mortgage repayments than these are obtaining with new applications. The latter has not happened since World War II; that is, households (which are categorically the largest users of credit by far) are returning money into the financial system. When central banks eventually determine to let interest rates rise naturally as the economic pace advances, rates will not rise rapidly until households begin to borrow as customarily.

After the Check List has been satisfied (all things considered), the managements chosen accomplish the gains. In short, we choose the managements; they do the hard work. Does not this sound like a good business to be in? Yet, after giving management due credit, we work most diligently 24/7 in order to play our part in the success of investing in behalf of clients. Such a check list can prove to be a useful guide toward success when coping, as now, with a recalcitrant, incoherent environment.

The recent flow of data has verified our reiterated perceptions that the American recovery phase has long since moved into a growth phase that is persisting (though not well rounded). The forces of expansion are prevailing over the lagging parts of the American society. There is a question thrown across prosperity's pathway by the automobile industry, which has played such a significant (even surprising) role in the American recovery. Noteworthily, Chrysler has risen from its coffin to lead the top Three for percentage increases. You have only to look through your windshield as you drive to see the number of Dodge Chargers on the road. Chrysler 300's seem to be doing rather well, also in terms of frequency, to say nothing of Chrysler's perennial position in vans and pickups. Ford and General Motors have new winsome designs and configurations throughout their product lines. So, the Three are now strong. But we think the pace of the past cannot be maintained, given the competitive aspects that might bring profitability under challenge, and act as slowing elements in this growth of the American economy. Worldwide manufacturing capability of automobiles is excessive, or so it seems, unless deliveries to Asia and the southern hemisphere nations that are growing very rapidly now make up for this excess. Though money will be plentiful, it is possible for automobile deliveries to satiate demands for short periods.

On the other hand, regarding a newer phenomena (which some economists have not caught on to as yet), communication volumes never drop. Use is insatiable. Usage begets usage as mobile telephones and other devices and system facilities all are enhanced, and thus support and encourage additional usage. This ongoing expansion in electronics communications supports an emphasis in the deployment of client money deployed. This phenomena is so indestructibly great, it is difficult to get your arms around the breadth, the vigor, and the influence throughout societies that this aspect of communications provides to the world growth pattern and to the world growing closer together. It is a phenomenon that is reminiscent of the introduction of electric energy earlier in the industrial revolution;

and, it is for everybody everywhere with not much cost to the user. Clearly, this is one of the world's great driving forces, giving assistance to all other driving forces in turn.

So, amid a world that just will not behave according to comity of spirit nor to orderly conduct, politics have become so fractionated and so fractious, while commerce has rarely been so vigorous. It is necessary to look at the world in terms of the huge, prosperous, and competent multinational enterprises. These cords bind the world beyond any others. Start with the oil industry. There is a cartel of four (Exxon-Mobil, Chevron, British Petroleum, Shell, or five if you include Total of France) that command a major portion of the industry. The world has never seen so grand a cartel. The tide toward bigness in other major industries has been primarily supported by new worldwide markets, while facilitated by an abundance of money, and by financial entities that have been quite willing to support mergers to obtain strong leadership, especially in the new technology-driven industries.

The last page of this memorandum is identical to the last page (a postscript) to our communiqué of January 5. It makes the case for the importance of science in appraising the course of the world, and in facilitating investment decisions with definably clear, specific products, and attributes. This is a basic footnote to our Check List, and it supports assurance that the products in and of themselves are worthy for investing client funds.

As a bottom line for equity investors, all should recognize the <u>advantages</u> of the unacceptably slow growth in the American economy in the effect of constraining economic improvement that could otherwise sponsor indiscriminate exuberance. Also, this very slowness acts to keep share valuations reasonable (even cheaper) and interest rates low. Contemporaneously, both of these are vital factors. Of course, these are not exact offsets to other concerns and worries that pervade societies everywhere, especially from the Mediterranean eastward to the Indonesian archipelago, where social ferment is an unpredictable wild card for investors. However, these are not the regions where the world's societal wealth is a large part of the landscape, such as in Europe, in Russia, in North America, and as is rising so rapidly in Asia and in certain Latin American countries. And the inscrutable troubles from the Mediterranean eastward are not bearing so closely upon investment considerations as the factors that are herein presented, which are more relevant, and thus more forceful for decision making.

As a thought provoking footnote, remember the so-called yen-carry in the few years preceding 2008. The extremely low interest cost of the yen led to massive borrowings by Japanese and non-Japanese financial entities which had the effect of a lifting force in all major financial centers for financial instruments and other tradable assets. If nearly zero money costs for the fourth ranking currency in those recent years could have such an observable lifting effect, what could one surmise the effect will eventually be from nearly zero costs on the top four actively tradable currencies: the US dollar, the euro, sterling, and the yen (plus several other currencies as well). Give it time: The simple arithmetic will prevail. When money is cheapened, all other items that can be expressed in money are marked higher than these would otherwise be.

The Sciences as Driving and Guiding Forces

Why is "scientific" a centerpiece in our deliberations in behalf of client service? Why is so much of our distinctive value-add for clients derived from scientific factors?

Think: During the lifetimes of living persons, the industrial revolution of our textbooks exploded into

- the passenger airplane (not 1% of Americans had entered a plane by 1940)
- astonishingly advanced military and transport planes
- atomic energy defined, released, and harnessed
- the basics of physics and chemistry were redefined, and enabled therefrom
- the cathode ray tube imaging device (say television) was developed (largely in New Jersey)
- the transistor was created (in New Jersey)
- the computer was created (in the Delaware Valley)
- photo composition for printing (in New Jersey and Ohio)
- the charged-coupled device (image capture) was created (in New Jersey)
- cmos, and broad ongoing developments in solid state physics
- the laser was created (in New Jersey)
- fiber optics for communications, and for other applications
- electrostatic printing, scanning, and facsimile transmission were created from newly enabling understandings
- polio paralysis was conquered
- antibiotics were developed (first in New Jersey)
- DNA was defined (in the UK)
- antibodies were defined (in the UK)
- DNA was recombined (in San Francisco)
- radio frequency developed out of its infancy in communications into a multitude of applications, including very high-energy applications
- digitization allowed compression of binary impulses into extreme miniaturizations and transmission speeds.

Each of the above was world-moving in its import, influencing most aspects of our lives, and adding immeasurably to the wellbeing, and therefore wealth, of societies. This is only a partial list. Millions of other new products sprung therefrom, as discoveries propagated other discoveries.

As a subset, notwithstanding the contributions from the Delaware Valley, the Hudson Valley, and the UK, California stole the credit for creating the modern world under the catchy name of Silicon Valley. Where could you match that one for creativity?

Science drives value creation in specific terms and aspects, as nothing else does, allowing dependable analysis out of its very specificity, and owing also to the endurance of new knowledge of nature. This is why our Firm incorporates scientific achievement, as few others do, into product analysis, which, of course, builds into enterprise analysis, and product-pricing freedom for profitability. Proprietary products and profitable product pricing are the commonly used, worthy catchwords of investment analysis. The analyses require vast knowledge bases, the awareness of our limitations, and the ability to draw recurrently upon human resources beyond ourselves.

In a larger, societal scene, applied sciences drive value creation in:

- increased efficiencies – for everyone and every enterprise
- new products – for everyone and every enterprise
- new functionalities ever reforming personal and societal character and behavior

Accordingly, our understandings and responsiveness to the forces and influences therefrom are vital to our top-down as well as our bottom-up appraisals, which together guide all that we do in our enterprise analyses, and in providing our value added for clients.