THE VIEW FROM PRINCETON

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SEPTEMBER SHALL HAVE A LONG RESIDENCE IN INVESTORS' MINDS

As summer seasonally slipped into September, investors were confronted with a vast scene that was tumultuous and perplexing, to say the least. This was exemplified in public commentaries. Emotional responses, recurrently messaged by ominous peals of thunder, seem to have ranged erratically from the sort of credence attributed to fabled Chicken Little, who judged from one acorn fall that the sky was falling, to the parody of Rudyard Kipling's famous *"If"*: If you can keep your head while others all about you are losing theirs, LOOK AROUND, JACK, YOU MIGHT NOT KNOW WHAT IS GOING ON. September could scarcely be filled with more contradictions and perplexing attitudes. Being perplexed and anxious does not shrink regard for a person's logic and capabilities; however, such states of mind are not helpful in managing financial assets for the benefit of the owners. The riddle is that in the recent timeframe, trouble and uncertainties elsewhere have prompted an inflow of financial capital into dollar-denominated assets, giving support to prices of tradable financial instruments.

We categorically list some of these disparate events and responses thereto, along with some of the provoking anomalies.

1. **Whew!** What a massive show of kinetic anticipation in long lines of persons to purchase, as soon as available, Apple's new phones. This was an unprecedented scene.
2. **Rah-Rah!** For the upstaging of the long lines of Apple enthusiasts. Alibaba (headquartered beyond America's boundaries) chooses the New York Stock Exchange for its first issuance of marketable shares. The largest valuation ever for an initial offering, priced at $68 per share equal to a bit over 21 times trailing twelve months of revenues, and 22 times current run rate. The price imputes a market worth of Alibaba of $217 billion. On the first day of trading, the share price advanced nearly 40%.
3. **Mon Dieu!** For the strife that centers in the Ukraine. What else could one say?
4. **God Help Us!** The fractious animosities explosively critical in Syria and Iraq has drawn America deeper in the insuperable violence.
5. **Oh No!** The polls in Scotland showed the separatist sentiment gaining in Scotland to the point of making the referendum on separation too close to call. This threw a specter of uncertainty, which thereafter (should the separatists had won) would have had the potential to reverberate worldwide into counterproductive realignments of currencies, and, in turn, a multiplicity of effects on capital markets and trade. The uncertainty as to what might happen had already weakened the pound (Sterling) and strengthened the dollar, as an easily ready alternative.

For weeks, expectations for the financial world seemed suspended between the influential (though erroneous) Scottish poll and the irreconcilable Arabic strife drawn along traditional and "tribal" lines.

Both developments force all concerned to think in "what if" terms, and to ponder pathways toward reconciliation for the U.K., and how to keep hope alive (however pale it might be) for an eventual triumph of reason and well being over fractious traditions. There are sufficient examples natively derived to nourish hope, led by younger Arab persons who aspire to become a larger part of the modern world.

Difficulties elsewhere had the apparent effect in the recent timeframe of sending financial capital to America, adding to the dollar's strength and the abundance of dollar liquidity. Money naturally flows towards what best serves it, and from uncertainty toward assurance. This seems to be a partial explanation of why American markets appear unperturbed, as the stock market averages move repetitively higher from the heights already attained. These heights seem to increase the fears and visceral congestion of bears, and, oppositely, give added animus to the bulls derived from the equanimity and irrepressible resilience of the stock market.

Thus, observer opinions seem to migrate to an unusual degree toward extreme opposite viewpoints. Should, however, analyses draw rightful guides from persisting money flows toward the capital markets (sourced from native American circumstances enduring after the present fear-driven bulge from beyond subsides) the bulls can enjoy fun and games for another few innings at the very least, and bears must subsist on much leaner diets, to which they seem to have grown accustomed.

Those who warn of a bubble in the market, and the inherent threat of overvaluations, were giving support to their attitude by these two extraordinary exhibits (Apple and Alibaba). These were demonstrations of hysteria (akin to euphoria, but not the same). In any event, this is a phenomena that will be referenced for many weeks. There is no question that the market represents a passion for things that are new and useful in a readily apparent way, especially if Internet based which allows relatively low incremental costs for incremental expansion of revenues. While these will be lasting in conversations, the take-home messages of greater worth seem to be the following:

I. America is evidently in the late stages of an easy-money monetary policy imposing upon interest rates, and in the providing of money in abundance. In past years, the effectiveness of such policies usually assumed the sequence of first boosting prices for the nearest thing to money (that is, the tradable financial instruments of worth), and thereafter, inflating the prices of actively traded materials — eventually including nearly everything. So those who worry about inflation have these two categories (shares and materials) as useful reference points. Contemporaneously, there is a scattering of overvaluations in biotechnology shares, in a few Internet-based enterprises, and in new product providers, especially in data transmission and in storage management.

II. Yet, the take-home message is that the inflation feared by many has not happened. The commodity picture is unlike anything commonly experienced for such late-phase effects. Instead of support at high levels, there is a downtrend in wheat, corn, soy beans, cotton, cocoa, coffee and other agricultural products. There are also downtrends in prices of copper, aluminum (recently stalled by capacity reductions), silver, and rare metals including platinum and gold. Contrawise, the prices of cattle have been rising, as have the prices of hogs. It is interesting that the corn/hog ratio has rarely been so favorable as it appears to be now. Supply has been constrained by a species-specific infection that especially hits young pigs. Government supervisory agents seem not so concerned because of the species-specific nature of the infection. The supply of cattle has been, in some geographies, constrained by draught. The complex of fossil fuels seems to have begun a prospective long downtrend, with implication beyond users of fuel to include alternate sourcing of energy and of ethanol.

III. Thus, one of the take-home messages is that the Federal Reserve System has a broad degree of freedom as it moves forward. Odds on, the chances are that the Fed will move toward neutrality within a few months and will let the normal forces act to take interest rates where rates might wander without the strong influence of governments.

IV. As this happens, interest rates will rise gently, and consistent with natural needs. Private use of credit is likely to be of moderate scale. State and local debt financing seems likely to increase for infrastructure building and repair. In total, credit use seems most unlikely to stress markets to the extent of sustaining rapid advances in interest rates. By category groupings, the two largest perennial uses of credit have been for the financing of residences and the needs of industry. The use of mortgages is most unlikely to approach the volumes seen before the financial debacle. The larger scheduled repayments will provide a much larger share of newly created mortgages. For industrial America, the change is nothing short of a radical reversal. Pricing of goods and services and enterprise efficiencies have been so satisfactory that corporations have huge hordes of cash to supply funds in large scale into the capital markets, directly and indirectly.

V. Most importantly of take-home messages, the American economy has re-established its sound footings and is assuring endurance of growth as contrasted with speed. The recurrent commentary that growth has been slow measures against obsolete business cycle theory developed out of the 1920s and 1930s, instead of measured (as always it should) against contemporary circumstances. Amid all of the distractions, contemporary capital flows are supportive to the American stock market, to the dollar, and to anyone in need of the use of external financing.

VI. Shares of large, vigorous, well-managed companies are largely cheap relative to their historical valuations, and cheap relative to much of current alternative investments. This is easy to verify. Check out the top twenty or fifty largest industrial companies of the Fortune 500. The massive blue chips show the center, or backbone, is not overvalued. However, American companies that are multi-national, commonly receive 40%-60% of their revenues overseas. Reported earnings will shrink from sluggishness of other economies, and as translated back into dollars. Such haircuts will be of considerable size. This will make their price/earnings ratios appear to be somewhat more fully valued.

Let others own the overvalued — so easily done when most fine company shares are not overvalued. Stay the course. Count on good managements to deliver good results. Traditionally, this is a good rule to live by.

With enduring good wishes,

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