

THE VIEW FROM PRINCETON

Market Commentary ♦ January 2015

VIEWS FROM STANDING ON THE HEIGHTS OF THE AVERAGES, LOOKING BACK TO THE LONG ASCENT AND FORWARD TO THE PROMISED LAND

Standing on the heights inescapably gives reason for circumspection and appraisal of the terrain. Repetitively, share-price advances wrote more deeply into the record book of higher highs. Yet, duration is only one of the important distinguishing features that sets this long advance to be different from all others. Throughout this longest of uptrends, attitudes of doubt, discontent, and even denials of reality seem to have been enduring background influences. This added to the clutter of anxieties that paradoxically imparted soberness to the market, and sustained relatively cheap valuations of the center ground of the stock market.

The shares of “household” familiar names of enterprises that comprise the center of the market are conservatively valued. On the flanks, optimism has carried some share prices to extraordinary valuations, giving support to wary commentary of an overvalued market. In contradistinction, we feel such to be a distraction that misses the more comprehensive universe as well as an appraisal of how investors might properly direct their financial marketable assets. Interpretive views, as always, gain worthiness if persons know on what they are standing (as shown in the averages), and better if one understands what these averages comprise, and of what one is holding vis-à-vis the logical promises.

Throughout this sustained advance, we have recurrently made the point that these steps upward increased the probability of another one, though successive advances might not be so large as those precedent, owing to the valuation itself had already elevated. Gains still beget more gains, beyond that of fostering fears of heights. So, it seems that 2015 inherits from 2014 the probability that irrepressible advances still tend to increase the likelihood of yet another step upward, notwithstanding the passing waves of pessimism, doubt, discontent and denials which seem to have become diminutive. Judging from conversations in the media, clouds and bears have apparently been receding.

The differentiating features of this advance should have made it clear that this one was significantly different for investors, and did not submit logically to a comparison to cycles beforehand through the lifetimes of those living. What we should have learned from its unique features might have sponsored a useful analysis of the differences — not the judgmental process of a juxtapositioning of this advance vis-à-vis others, nor the surmised future against the quiet past.

It seems useful to cite some of these differences as we wonder why so many observers and economists spent their time, efforts, and expressed opinions comparing this advance to the others:

1. The extent of the financial debacle was so general, so deeply severe, so steep, and so powerful that business everywhere was impacted. If the extent of the rise is measured from the pits of the 2008 market bottom, instead of measured from the preceding levels of the market (as in 2004-2007), the five years of advance would lose a significant part of the measured gains.

2. There was an abundance of liquidity throughout, even though use sometimes was constrained by governmental alarms over the profligate and licentious use of financing, of residential properties, especially, and of fund managers in financial capitals here, in London, and elsewhere.
3. Among American industries, and including a few around the world, the strong mighty international companies did not experience much of a recession at all. In short, these seem stronger and surely more adaptable than governments, having previously comprised a central force of growth for some years. Managements of these mighty companies should be credited for giving the leadership that they did. And, as we have pointed out a number of times, beginning a decade or so ago, there was a total reversal in corporate use of credit as drawn from capital markets. All of our lifetimes, industry has been categorically second to residential financing in use of credit. For the last decade, these mighty companies have sent money into the capital markets by way of satisfactory product pricing, continued growth, and developing huge cash accounts. These hordes of capital, one way or another, return money (net) to the capital markets. We cited the importance of this throughout recent years, but surprisingly have seen no other references for its long-term or generalized effects. This is essential to contemporary understanding. A huge circulatory national pattern for the flows of money has come from profitability of major corporations into their cash tills, and resides until used in the instruments of financial markets. This is the principle reason we expect the inevitable rise in interest rates to impose or constrain only gently.

Meanwhile, the negatives surrounding the markets kept share prices cheap. For instance, all but three of our Firm's top twenty holdings are cheaper on the matrices of data that are normally used to value enterprise shares. These are cheaper than they were in 2007 — or 2004 to include ten years of growth and strength not capitalized in their share prices. This gives the big lie to those who say this market is overvalued; contrariwise, choosing such shares serves as risk minimization. Many shares seem overvalued on the flanks, or at least incautiously valued pertaining to possibilities for the now unseen competitive product developments. This seems to apply to share prices among 3-D printing, a few new Internet-based enterprises, and in a number of biotechnology companies. Such lofty share prices are cautionary signals, to be sure, but they miss or occlude the central aspect of this market; that is, the visceral center is solid.

Not to be overlooked are the grievously sad events beyond Europe's eastern border and the Mediterranean. For investors, circumstances there comprise wildcards with no predictable outcome. This has frightened many. Sanctions on Russia have constrained Germany and other nations of Europe — not surprising in that Russia is a leading commercial partner. There should have been no doubt — that should have been one of the easiest of all matters to surmise. While the European markets have not been able to withstand this without giving ground, the American market benefitted because the concerns for many led to major amounts of money flowing inward to America, encouraged also in their search for safety by the relatively strong dollar. Our partner, Steve Reynolds, reminded us of the "Iron Lady" of Britain, Margaret Thatcher, once referring to a like market phenomenon as the "TINA" market, an acronym for "There Is No Alternative." For those who sought solidity and assurance in the disposition of their financial assets, these events in the short run have benefitted our stock market, while they have subdued commerce nearly everywhere to some degree — especially slowing the European recovery move. This is a trouble not to be taken lightly, and gives bears yet another inning of worry.

All things considered, the American economy is doing just fine. Retail sales in November and December were significantly up from preceding comparisons. Many observers gave credit to the falling pricing of oil as having brought this benefit to consumers. For the short term, we see it just oppositely. This drop in the oil price is negative on employment, exploration, and alternate fuels; so it works against the GNP, it works against incomes in the short run, and in the long run it will be a huge benefit to nearly everyone. Our interpretations are opposite for the sequence of the influences, as a matter of time intervals.

We see an economy gaining traction, which will broaden the background support to the capital markets. We see sporadic rallies and further drops in the price of oil. Even that which has taken place is immensely important, and effects will become more general. This benefits everyone like a gigantic tax decrease if you are not in the business of supplying energy.

For those, especially in the oil industry, exploration, secondary and tertiary recovery, in transport and holdings, these are negative in the short run and should show up in GNP figures. Peripherally, the effects are calamitous for many alternate sources of energy (such as ethanol, sun at extended altitudes, and wind) that must contend with increased stern measurement of economic feasibility, even including new building or expansion of wind farm sites. Through coming months, nearly every industry and household will benefit from lower energy costs.

A positive note of a magnitude that will have influence far beyond the specific industry is rooted in the necessity to rebuild infrastructure, especially for transportation. Expenditures for roads, bridges and airports must increase from here. This will bring a new demand for credit, yet easily financed. The Federal government can guarantee the issues of state or local governments, or states can guarantee the issuance of debt from their local communities, and use of revenues can be set on a toll basis in some cases. Many of these projects could stand alone financially and economically. The social costs of the waste of time in present circumstances is a multiple of the cost of financing. The arithmetic is compelling. Attitudes are compelling. That is all anyone should need, combined with a look out of your motor vehicle or airplane window.

For recent months, the American economy has been bolstered by the rise in nominal household wealth, as the value of their houses has stopped falling (even rising in some areas) and as the value of their investments in marketable financial assets have moved upward. This is manifestly the power of fulfillment in monetary policy beyond most other manifestations for an economy such as America's has become in these recent decades.

As usual, this is no time for risk minimization through diversification, which always gives more numerous exposures while attenuating the dollar amount of risk in any one item. Focus nearly always works better than diversification. In the vast array of opportunity for risk attenuation, there is a very large playing field for investors between diversification by rote and "had-a-hunch-bet-a-bunch" on which vigorous and strong enterprises play that allow choice and focus. The right managements and the right industries should fulfill reasonable expectations and hopes.

With enduring good wishes,



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WELCOME 2015!