PRIVATE ASSET GROUP LLC

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The Stock Market Is Going up, Are We out Of the Woods?

The media is focused on the Fed and their monetary policy and the Obama administration and their economic stimulus, but can the government fix the financial crisis?

The answer is they can't. The Fed and the lawmakers don't fix anything. Through monetary policy and fiscal stimulus they provide the economic conditions that are the back drop for the economy to improve. (The same people who set the economic conditions for the crisis with low interest rates, over leveraged banks and rampant disregard for oversight on mortgages) So who will fix the economy? You and I of course, we are the consumers. The consumer is a huge part of the economy and we can't have growth when the consumer is not spending. The consumer has long made up approximately 70% of the economy. Consumers are not spending, are losing jobs and the economy is in slow growth mode. So how can stocks go up?

The stock market and economy are two different things. The stock market is a barometer of how companies are doing dealing with the economy, but the stock market is not the economy. Companies can make money in a bad economy by shrinking, cost cutting and reducing staff. The weak companies go out of business or restructure and other companies become profitable and their stocks rise. Very Darwinian! We call it survivorship bias. Some companies are growing their businesses by taking over the market share of the companies that are disappearing. What we have is the economy shrinking, but strong companies getting stronger. It is fine in the beginning to lay people off and increase your profits, but if people don't have money they will eventually stop buying your products. The companies become more profitable but they shrink at the top line until people get back to work and spend, or companies find new consumers to sell their products to. (Think China) In the short run companies can grow in a shrinking economy - in the long run shrinking will restrict corporate growth.

So how do you and I "the consumers" fix the economy? It takes time because people will have to retrain for new jobs, start new businesses and generally find different ways to make money. We are industrious. We want things and a better life, so we go out and make changes and make it happen. It takes time for all of this, so the woods may be deeper than people think.

To create the right economic conditions the challenge now is for the Fed and the government to keep things balanced. Not too much stimulus and easy money so that we have a return of inflation before the consumer can heal their balance sheets. On the other hand if they jump back into raising rates or hold back the stimulus then we will shut down the economy again. The fed and government must keep a balance and allow the consumer to get back on their feet. Businesses will grow and then the consumer will get back to work. If the economy is kept in balance it may happen sooner but if the fed or administration fails, it will take longer. The stock market will tell us about the health of the companies we track, the economy will tell us about the consumer getting back on track. I don't think anybody believes the government will get it just right, but remember we have had many financial panics around the world in the past and we have survived.

You should start hearing more talk about helping the consumer. The Fed and the administration have done a good job at saving the banks and the "too big to fail companies" but small business and the consumer have been left to struggle. I know that there are programs in place for people out of work and food stamps, but small businesses need some serious help. Small businesses employ a good portion of the consumers and they need to get a lift. There will be some battles between the factions that want to stop the bailouts and the people who understand we need them. I believe the government needs to do more in the short run if they want to avoid a long term mess. We need programs that are short term in nature and very generous if we want the stimulus to replace the consumer and jump start new small businesses. If the government stretches it out then Margaret Thatcher's observation will be tested. She said "**They [socialists] always run out of other people's money".** In other words, you can't practice socialism for too long because nobody will keep paying the bill.

The majority of the rally over the last six months has come from the bottom quartile (25%) of stocks. In other words the worst stocks made the biggest come back. This leaves us with a great deal of uncertainty in the stock market for the near future, so let's focus on things that make some sense now and over the next couple years.

Macro plays

The US dollar. The markets seem tied to the dollar and as the dollar declines, stocks go up. This makes some sense for a while, as the dollar gets cheaper our goods and assets get cheaper for foreigners to buy. The hope is that they will buy more and our companies will be more competitive and make more money. The downside is that foreigners may not want to buy US assets if they think the dollar will continue down, because they lose money holding US dollars. While we are trained to think that a strong dollar is good for the US, the reality is a weaker dollar will make foreign goods more expensive and our goods less expensive overseas. Over the short run it is good for US business and bad for foreign goods. I believe we want to stay on that downtrend in the dollar and own foreign assets or currency.

Interest rates are at all time lows (looking back 50 years). This will create an opportunity as the Fed and administration comes to grips with the massive easing and stimulus packages. While it is always difficult to tell when interest rates will turn (market timing is art not science), it is time to get prepared to take advantage of higher rates.   It may not happen next year, but rates will move up. I'm setting up to trade rates around the world because other countries may raise rates first and faster.

We are also looking to buy short term fixed income and work on the ladders for the portfolios. Now is a difficult time to find any good fixed income at the short end of the curve, but it's the best we can do for now. Remember, buying longer term bonds will cause some problems when rates move up.

Energy is another area of opportunity. While everybody is talking about alternative energy, it is difficult to see that taking a bigger market share over the short run. Oil always seems to move down and shut down the alternative energies progress. Look at natural gas as a big potential for the future and prices are relatively low right now.

Water is the final asset that I want to cover this quarter. We all know that water is becoming more of a problem not only in Nevada and the US but in many other parts of the World as well. Water efficient products will have a lasting impact on the situation.

Current positions –

We are only long gold after exiting the India fund last quarter. Foreign assets and tech are rotating to a leadership position, but the long term trends remain down for most assets.

Call about different assets for the macro plays. There are many ways to take advantage of them.

I realize that it is hard to wait during this downturn, but use the time to reset your portfolios. Lower your exposure to equities and invest in laddered short rates and stay liquid. There are also alternative investments that make sense and look at the macro plays in sectors that you think will drive business even if the economy is slow. The stock market is rallying short term, but remains in a long term down trend. The survivors will become the leaders. I believe patience will be rewarded.

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