June 2012

A Conversation with Michaels

"Being right when the market expects the outcome that you're right about is meaningless."

-Michael Aronstein

This month I participated in an excellent call with Michael Aronstein and Michael Shaoul of Marketfield Asset Management. In my opinion, they are two of the best macro thinkers on the planet and it is always interesting to hear their take on the world.

As investors are painfully aware, the return on U.S. stocks for the last twelve years has been terrible. Commodities and emerging markets have done relatively well during this time. The Michaels analysis of the world has determined that the U.S. is now in a long term bull market and emerging markets and commodities will generally be in a long term or secular down trend.

They cite ultra low interest rates as a driver for raw material investing that will bring on a flood of supply over the coming years that will outweigh the world's ability to consume these resources. One example of this is that the "oil rig count has soared from a low of 178 in June 2009 to a 20 year record of 1382." According to Baker Hughes, the 2008 record rig count was 442 rigs and they have expanded by 212% in just 42 months.

If the Michaels are right, this is actually wonderful news for consumers in the United States. That would mean energy prices will be trending lower and you would want to invest in companies that will benefit from lower input costs and in general stay away from resource stocks and economies that depend on the natural resources sector. I must admit that I am not aware of a major prognosticator that shares this view.

If you watch the main stream news or read basic finance material, the main message has been that the Asian economies have cheaper labor costs, better educated people, and they work harder than the lazy Americans. The main things I read about the emerging markets are about when (the if is not even mentioned) the emerging economies will eat our lunch. Investors have been conditioned for about ten years to think that prices can only rise and that emerging economies can only grow to the sky. Marketfield Asset Management recognizes that most people extrapolate the recent past into the future and that is why the majority is very wrong at major turns in the economies.

They also note how most headlines are concerned about Greece and the European Union right now and continue to wait for the main stream media to recognize that one of the reasons global stock markets are dropping is the dramatic slowdown that we are seeing in the BRIC (Brazil, Russia, India, and China) economies.

Michael Shaoul pointed out that a “typical bear market takes place over 24-36 months and is composed of three distinct phases.” The first phase has strong economic and corporate data, but since the stock market is a discounting mechanism, you start to see lagging equity prices. This phase also sees liquidity dry up and central banks often reduce interest rates to stimulate (re-inflate) the economy. Shoaul compared Brazil's phase one (summer 2011) to the U.S.'s phase one of late 2000 through mid 2001.

The money printing and lower interest rates in phase one often give asset classes a bounce and you then enter phase two. In this phase, corporate and local data shows marked deterioration and asset prices go even lower. In emerging markets, you often see the currency depreciate as foreign investors take their money back home or to safer markets. Phase two brings even more Keynesian intervention. Shaoul cited Brazil’s Finance Minister, Guido Mantega’s decision to relax the reserve requirement recently for auto loans as an example of government easing in phase two. In late 2001, the US congress passed the Bush tax cuts to try and revive the economy. Investors are often too optimist that stimulus measures will have an immediate impact on the economy and asset prices. Phase two will eventually get to a selling exhaustion that will cause a sharp rally. Marketfield thinks Brazil is still in the middle of phase two.

The U.S. economy entered phase three in Mid 2002 and they think Brazil will enter phase three in late 2012 to mid 2013. In this phase the economic data is downright horrible, investors have experienced steep losses, and sentiment is extremely negative. By this phase, companies have made massive adjustments and stimulus has had time start to work. Stocks don’t have to drop much further in this stage and could spend a long time building a base. Marketfield thinks Brazil will enter this phase in about a year. The chart below could be the path the Brazilian market takes over the next year and a half.

The current Brazilian Bovespa lined up with the S&P 500 from '99 to '02. Courtesy of Michael Shaoul, Marketfield.

The Michaels think that by the time phase three is over in Brazil, the SELIC (their Federal Funds Rate) could be as low as five percent. After the call, on April 30, Brazil dropped the SELIC to 8.5%. In my experience (Damon speaking) by the time a group of conservative central planners on a committee can all agree that it is time to drop the national interest rate, the economy is already in significant decline. I remember in late 2007 when Bernanke started to lower the Fed funds rate. This produced a sharp rally until October that in hindsight turned out to be a really great warning sign for the U.S. economy. Many of the emerging market central banks have slashed their interest rates since 2011 to try and compensate for the weakness in their economies.

Marketfield expects that later this year "the man on the street" will finally have clued into the fact that these economies are in severe decline and emerging markets will be a hated asset class. They are already surprised at how many people have over-stayed their welcome in losing emerging market investments. U.S. Dollar investors have already seen ALL of their gains since July of 2009 wiped out in the Brazilian stock market!

Despite their ultra negative view of emerging markets and commodity prices, the Michaels do still think the U.S. and Northern European economies will continue to grow over the next year. They think investors should focus on domestic consumer companies, regional banks, and stocks related to the U.S. and German housing sector. After a decade of U.S. investors sending money overseas, they expect much of that capital to be reinvested into the strong and growing U.S. economy.

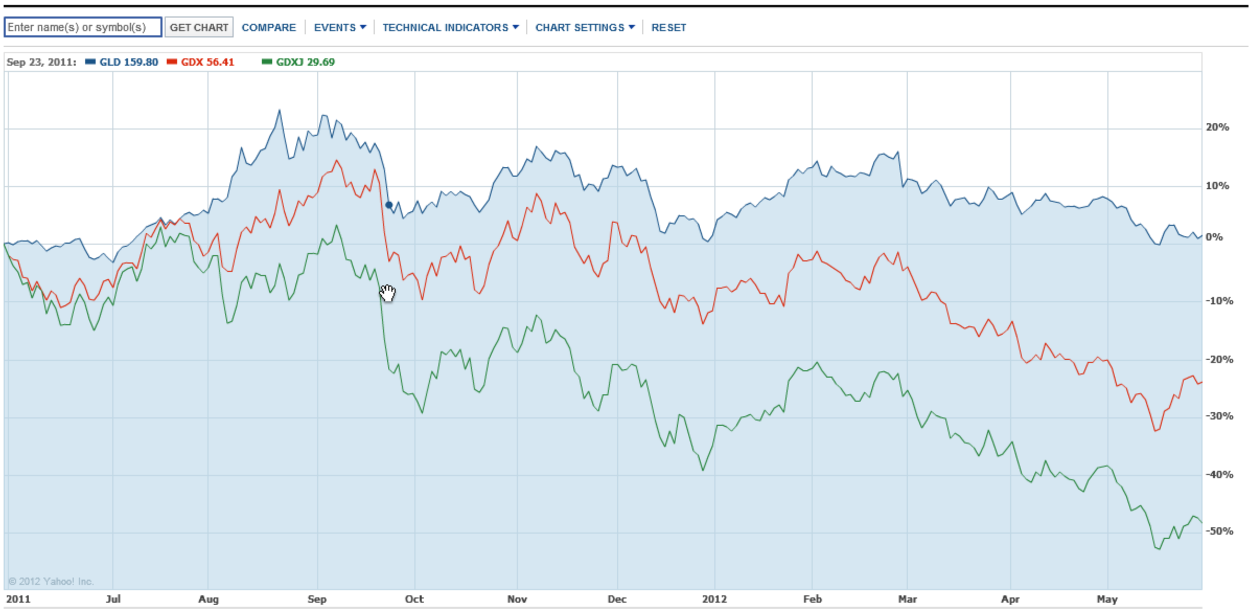
I asked Aronstein if he thought 2011 saw a long term peak in precious metal prices. He thinks that prices have risen too far already and sees supply overwhelming demand. He thinks you can't use central bank buying as a good indicator because central bankers are horrible investors (think England selling their gold at the dead low price in 2001). He expects countries to begin selling gold to pay off their debts. In his opinion sentiment for gold has already reached an extreme and he cited the reality show "Gold Rush" as an example of the mania for precious metals. I disagree with their thesis on precious metals in the "Markets" section below.

The last thing I gleaned from the call was Aronstein's view on the sovereign debt crisis. He said when it comes to sovereign debt, don't think of it as debt. Think of it as another line item in the budget. Most governments have made more promises than they can possibly pay. At some point governments will be forced to rethink all of their obligations. They will find a way to reduce Social Security, Medicare, and bond interest. Rates on US bonds and German Bunds may stay between zero and four percent for ten years because investors may continue to sell bonds of perceived weaker-countries and reinvest them in perceived safer-countries' bonds.

Like I said in the beginning, the Michaels are not afraid of making controversial calls. In this environment of "China is going to take over the world, we are running out of natural resources, and every human should short U.S. Government bonds," it may pay to take the contrarian view. In investing it is OK to be wrong. It is not OK to be wrong AND stubborn. The above is a summary of how Marketfield currently sees the world and they will be quick to change their mind if they see evidence that their current thesis is incorrect.

Markets

The recent correction in gold has been a scary experience for investors. Gold has had several drops during the last eleven years of its bull market; including a 30% dip in 2008. This latest correction has been particularly painful because it has occurred during relative strength in U.S. stock prices. The relentless selling in gold mining stocks has made the gold correction look tame. The chart below shows the price of the ETFs, GLD as a proxy for gold, GDX as a proxy for the large gold miners, and GDXJ as a proxy for the junior gold miners over the last year. As you can see gold is slightly up, the majors are down around 25%, and the juniors are down almost 50%.



Gold (blue) has dramatically outperformed the Majors (red) and the Junior Miners (green). Source: Yahoo!

I have wrongly favored the mining stocks as a leveraged play on the price of bullion rising and I can't explain the large difference in performance of the metal to the miners. Gold recently hit a ten month low and the HUI Gold Bugs Index has dropped to a 27 month low! In May of 2012 the HUI index dropped to 373. It was at this same level in July of 2007 while gold was around $700. Since mid 2007, gold has more than doubled to $1562 at the time of this writing and the miners continue to break hearts. The value in this sector doesn't make sense to me. There are a handful of stocks that are trading very close to the cash on their balance sheet. In some cases investors could come in and vote to give away their gold mine and redistribute the cash to each share holder proportionately and still make money based on the ridiculously low prices. On several metrics these companies are very cheap and at some point I expect the price of the miners to make a massive readjustment relative to the price of gold.

The debate on whether gold is a good investment or not continues. "Mr. Too Big to Fail" and Obama-handler, Warren Buffet, is a well known critic of gold. Last year he said:

> I will say this about gold. If you took all the gold in the world, it would roughly make a cube 67 feet on a side…Now for that same cube of gold, it would be worth at today's market

> prices about $7 trillion dollars – that's probably about a third of the value of all the stocks in the United States…For $7 trillion dollars…you could have all the farmland in the United States, you could have about seven Exxon Mobils**,** and you could have a trillion dollars of walking-around money…And if you offered me the choice of looking at some 67 foot cube of gold and looking at it all day, and you know me touching it and fondling it occasionally…Call me crazy, but I'll take the farmland and the Exxon Mobils.[1]

This May, Buffet's number-two, Charlie Munger, went a step further when he said, "gold is a great thing to sew onto your garments if you're a Jewish family in Vienna in 1939 but civilized people don't buy gold - they invest in productive businesses." Wow. Well call me uncivilized. I was happy to see that famed hedge fund manager, David Einhorn, decided to jump into the debate and refute Buffett in his recent investor letter:

> The debate around currencies, cash, and cash equivalents continues. Over the last few years, we have come to doubt whether cash will serve as a good store of value. If you wrapped up all the $100 bills in circulation, it would form a cube about 74 feet per side. If you stacked the money seven feet high, you could store it in a warehouse roughly the size of a football field. The value of all that cash would be about a trillion dollars. In a hundred years, that money will have produced nothing. In a thousand years, it is likely that the cash will either be worthless or worth very little. It will not pay you interest or dividends and it won't grow earnings, though you could burn it for heat. You'd have to pay someone to guard it. You could fondle the money. Alternatively, you could take every U.S. note in circulation, lay them end to end, and cover the entire 116 square miles of Omaha, Nebraska. Of course, if you managed to assemble all that money into your own private stash, the Federal Reserve could simply order more to be printed for the rest of us.

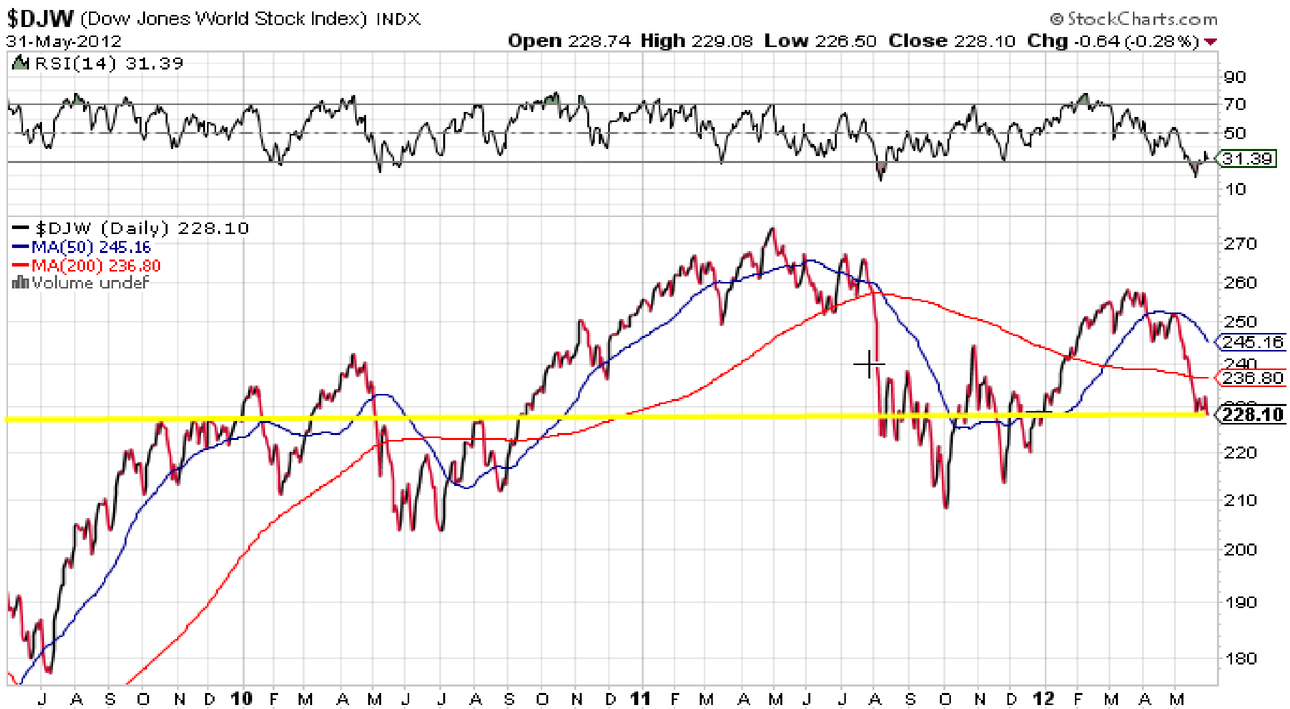
I could be wrong, but I still don't see the kind of mania that would kill the secular bull market in gold. Most Americans have never touched a gold coin and can't name a single company that mines gold out of the ground. According to Bloomberg, the U.S. treasury owns $4.12 of gold for every dollar in the M2 money supply. At gold's secular peak in 1980 it was almost $10 of gold for every dollar in the M2 money supply.[2] In April, Turkey raised its gold reserves by 29.7 metric tons and Ukraine, Mexico, and Kazakhstan also boosted their gold reserve according to the IMF.[3] What other currency are these central banks going to buy? The dollar, the Euro?

Anecdotally, many of the world's best investors continue to recommend owning some gold. My non-comprehensive list includes Dr. Marc Faber (www.gloomboomdoom.com), Felix Zulauf (www.zuam.ch), David Einhorn (Greenlight Capital), John Paulson (Paulson and Co.), Bill Fleckenstein (Fleckenstein Capital), George Soros, PIMCO, Eric Mindich (Eton Park Capital) and Eric Sprott (Sprott Asset). Lastly in a rare interview with *Barrons*, Ray Dalio of Bridgewater Associates (arguably the best investor of our time) was asked "Are you still a fan of gold?" He replied:

[1] http://wallstcheatsheet.com/economy/heres-what-warren-buffett-says-about-gold-and-commodities.html/
[2] http://www.bloomberg.com/news/2012-05-30/dollar-s-gold-backing-drops-with-metal-s-price-chart-of-the-day.html
[3] http://www.bloomberg.com/news/2012-05-24/gold-poised-to-rebound-as-china-optimism-offsets-europe-concern.html

Longer term, yes. It could temporarily be a bumpy ride because Europeans will have to sell gold in order to raise funds because they are squeezed. Most people should have in the vicinity of 10% of their assets in gold, not only because I think it will be a good investment longer term, but because I think it is a very effective diversifier against the other 90%.[4]

The last two and a half years have been extremely difficult for investors. Below is a chart of the Dow Jones World Stock Index. It is a good proxy for how global (including U.S. stocks) have performed. As you can see we are now back to the same level as October of 2009.



The last three years of the Dow Jones World Index. All volatility and no return. Source: StockCharts.com

That is right. Buying and holding this index has produced precisely zero return in 31 months! On top of the poor returns investors have had to cope with massive swings in their portfolios. I actually believe the terrible stock market performance to be good news. The U.S. stock market experienced a roughly 16-year bear market that culminated with a bottom in 1980. The sentiment at the time was not fear of stocks but more of apathy towards investing in stocks. After 12 crummy years for U.S. stocks I am starting to sense that people are giving up on the idea that you can make money in the stock market and have lost interest. I don't think I have heard of anyone quitting their job since 1999 to become a day trader.

The last bear market's apathy culminated with the famous 1979 cover of *Business Week* titled "The Death of Equities." I am not sure that we have reached the same level of apathy to cause a new secular bull market yet (Marketfield does) but I feel like we are getting close. Beginning in 1965, the Dow Jones Industrial Average bounced off the 1,000 level five times. Investors became conditioned to believe that the Dow could not make a sustainable move above this level. When the

[4] Ward, Sandra (2012, May 19) Dalio's World. *Barron's,* Cover Story.

Dow finally crossed 1,000 again in 1982 nobody believed that it was on its way to 11,700 by the year 2000. The 18-year secular bull market in stocks made many people fabulously wealthy. If history repeats itself somewhere between now and 2016 will begin a new secular bull market for stocks and investing will become easy again. I long for the day!

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