

**Broad Market Overview**

February 2004

When I started Hoover Capital, I immediately began thinking about a succinct article to write which could outline my views in an easy to understand manner. Unfortunately, with the investment climate as complex as it is at the current juncture, I am skeptical on the possibility of outlining a broad picture in a short space, as there are so many intricate matters that must be taken into account. This paper is an attempt to highlight some simple concepts that will affect investors in the coming years.

When it comes to investing, once everyone agrees on something is precisely the moment that the belief will be proven wrong. Although counterintuitive, it can be no other way.

I point out this simple fact, as it is the primary basis for understanding financial markets. Without a comprehension of the psychology inherent in finance, one is unlikely to be a successful investor. To paraphrase George Soros, one must fully understand both sides of the argument in order to know which side carries the fatal flaw. Once you identify the flaw, you will know which side is correct.

And that is how markets work. There are always two sides to every trade. Human psychology dictates that we want others to agree with our opinion. Unfortunately, finance is the only area that I know of in which everyone agreeing will lead to being proven wrong.

Let us assume that we believe XYZ Company is a fantastic company with huge potential. Shouldn't we invest in company XYZ's stock? How can we go wrong? Well, if we are first to the party, we likely cannot go wrong if our assumption is correct. As that potential becomes more commonly known, others will begin to agree with our assessment and commit capital in the same manner that we did. However, the last person to agree that XYZ's prospects, and therefore XYZ's stock, are set to soar, will be the last person to commit capital to the stock. That moment, the moment when the last available net capital flows to the stock are made, is precisely the moment that the stock will begin to decline. There will be no more money left to put into the stock, and as a result, only net outflows will be left. This will drive the stock down, even if the company achieves what everyone expected them to do.

This is the reason the markets are so difficult. We cannot merely presume that what we expect to happen will happen. We also need other people to come around to our viewpoint and vote with their dollars. Otherwise, we simply cannot make any money. It is a process that works in three stages: denial, migration, and panic. To complicate matters further, this process works at all degrees of trend and over various time frames.

For this reason, I simply do not get discouraged when others do not agree with my financial viewpoint. Neither should you. Financial profits occur as *more* people come to that same viewpoint, *and* are willing to commit (or remove) capital in that manner.

With that introduction, I will tell you that I am generally bearish on the prospects of the stock market. Simultaneously, I am bullish on precious metals and many foreign government bonds and currencies. While I certainly recognize that I hold a minority opinion on these matters, the following will outline why I hold these views, as well as why I believe others will agree with this assessment over time, resulting in financial profits should my assumptions come to fruition.

### The Facts:

- Stocks are more expensive relative to earnings than in any other period of time in history, with the sole exception of the peak in the markets a few years ago. While the future has yet to be written, stocks have never achieved a positive return over a 10-year period with price to earnings multiples anywhere near current levels.
- Debt in the U.S., relative to GDP, is higher than any economy in any period in history. Debt levels in the U.S. are well over 300% of GDP. To understand just how much debt we have, the two previous records occurred in the U.S. following the 1920's boom and in Japan following their 1980's boom, at 270% of GDP and about 268% of GDP, respectively. High debt levels, particularly in extreme situations, have always acted as a severe economic headwind once they reach a saturation level and are forced to be paid-off.
- Sentiment levels across almost all measures show record, or near record levels of optimism toward U.S. stocks. Almost every measure of market sentiment for stocks show extreme readings of optimism, indicating high levels of investors who have already voted with their dollars.
- The Federal Reserve has injected record levels of liquidity into our economic system. Almost every conventional tool available to the Fed has been used in an effort to stem an economic decline. Members of the Federal Reserve have even begun to speak of the "unconventional" tools they may try to use should the economy begin to deteriorate again.
- All periods of financial gains in equity markets have been characterized by a disinflationary economic environment (i.e. interest rates declining). With interest rates along all areas of the yield curve at historically low levels, continued disinflation is highly improbable.

Certainly there are a multitude of other positive and negative data points to throw into the mix, but I believe the facts above are most relevant to our current situation.

Effectively, we had a booming economy throughout the 80's and 90's predicated on the expansion of credit and the easy money and liquidity provided by the Federal Reserve. This led to an extremely strong economy during that period, which was aided in part, by a

disinflationary environment. However, the nirvana situation over those two decades resulted in major structural imbalances caused by excess capacity, huge debt burdens, and malinvestment in many industries.

For those who have followed my writings for some time, pointing these items out will not come as a surprise. I have been focusing on these issues for just over three years now. To some, the recent stock market rally off of the March 2003 lows indicate that these risks are no longer relevant. I disagree.

Economies and markets are living mechanisms. They inhale and exhale, cycle and shift. They don't go up in a straight line, and they don't go down in a straight line. Smaller cycles make up larger cycles, and larger cycles make up even larger cycles. As the economy has recovered from the nadir of the fall of 2002, this recovery was predicated on additional easy money and credit. Massive economic stimulus and an additional availability of credit to sub-par companies and consumers facilitated economic expansion over the last several quarters. What has not happened, however, is a readjustment of the major structural global imbalances facing the intricately tied world economy.

These imbalances have increased during this period. And while it does not necessarily make it today's business, it does increase the risks to a systemic shock due to the ever increasing debt and leverage building up in the system.

These risks, in conjunction with record high stock valuations and record optimism indicate to me that we are nearing the end, if we haven't already seen it, of the recent stock market rally. Valuations are not discounting these risks, and the record levels of optimism indicate that there are little capital flows left available to propel the markets higher. These factors combine to make me generally bearish on the U.S. stock market.

Yet, as I mentioned previously, it does not necessarily mean that it is today's business. Additional liquidity and stimulus may well continue to be pumped into the system. In fact, I expect this to happen. The Federal Reserve has indicated that they will continue to keep rates low for some time, and in so doing, they hope that the economy will become self-sustaining so that it will not fall back into recession once the stimulus is removed. Due to the gargantuan debt levels, I do not believe this to be possible. And as a result, I expect the Fed to continue to effectively print ever-increasing amounts of money in an attempt to re-inflate the economy.

This is the basis of my bullishness in precious metals and some foreign government bonds and currencies. The Fed is literally turning our currency into confetti. As they issue more credit and increase bond issuance at record levels, without the economic growth to support it, our trade imbalance and current account deficits continues to grow. Most everyone can understand that printing paper dollars with reckless abandon will make each of those paper dollars worth less, and simultaneously make any goods or services exchanged for such paper dollars increase in nominal value.

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And this is exactly what is happening. The reflation that the Fed wishes to impose is currently working. Everything that is U.S. dollar denominated is increasing in price, from stocks to bonds, real estate to commodities. Yet, while price is increasing, value is not. The result is a decline in the value of the U.S. dollar. This is perfectly reasonable, as it is obvious to everyone that if simply printing money actually created wealth, there would be no poverty or famine anywhere in the world.

The complex nature of currencies is much more multifaceted than the purposes of this overview. But these reasons indicate to me that precious metals should perform very well in the years to come should this continue. Not only are precious metals denominated in U.S. dollars (resulting in gains from this reflation process), they are nobody's obligation. They cannot be manufactured like paper dollar assets for a fraction of their printed value. Simply put, there is a finite amount of precious metals, and should this process continue, particularly should a crisis of confidence take hold as a result of the dollar's devaluation, the value of precious metals should increase substantially. Furthermore, any country that acts to constrict their money supply, or merely treat their currency less like confetti than we do in the U.S., should see a rise in their currency value relative to the U.S. dollar.

To summarize, even if stocks continue to perform well in the near term, I anticipate that it will happen as a result of our current currency policy in relation to our burgeoning deficits. Should this turn out to be the case, precious metals and foreign currencies should still do very well as their value will increase relative to the U.S. dollar. And U.S. stocks may continue to benefit, but I do not believe that investors in the U.S. markets are being compensated for such risks. With record optimism and record high valuations, should confidence in this reflation by the Fed begin to wane, there will be little to support equity prices.

As a result, the greatest risks to our economy and markets, is the potential for a crisis of confidence in our attempt to show nominal price increases. Although this is not an issue today, all the ingredients are in place for this to happen in the reasonably near future. I am of the opinion that investors are not being compensated for these historic risks in equities, and should act accordingly by shifting assets to those investments which should perform well with *or* without continued additional stimulus necessary to increase the nominal price. In either scenario, the outlook is bullish for many foreign currencies and the precious metals.

As always, should you want more information about Hoover Capital, or have any questions or comments, please do not hesitate to let me know. Your feedback is appreciated.

Sincerely,

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