Year End 2004

As the year 2004 rolls to close, I want to first wish everyone a happy and healthy New Year. The financial markets saw most of the trends of 2003 continue, albeit at a muted pace. In an unusual occurrence, the broad stock market averages posted returns right in line with the consensus forecast, gaining roughly high single digit percentages. The Dow Jones Industrial Average rallied roughly 4%, while the S&P 500 and Nasdaq Composite added about 9% each.

This was not in my forecast, as I had entered the year expecting broad market declines on the heels of a weaker dollar. In fact, the dollar did decline, to the tune of about 10% against a trade-weighted basket of foreign currencies, but this was once again viewed as a bullish development by the financial media.

So half of my forecast was correct. The dollar was in fact quite weak, and foreign currencies and precious metals benefited from this trend. However, the other half of my forecast was wrong. The broad stock market averages rallied strong in the fourth quarter in the face of a weak currency, reversing prior losses and posting gains on the year.

I had expected the correlated markets of 2003 to reverse course as the excess liquidity became saturated. This, however, did not happen, and we continue to see price gains along all asset classes in the face of a weakening dollar. To give just one example of these correlations which one would not normally expect, we saw the price of oil rise 32% during 2004, yet transportation stocks also rose, roughly 17%.

To my eyes, the most bullish development to the markets in 2004 was (and for the time being remains) the corporate bond market. As we entered 2004, the Federal Reserve maintained their policy of accommodation by holding the Fed Funds Futures rates at a half-century low of 1%. As investors reached for yield, corporate bond spreads (relative to treasuries) declined to 250 basis points. To give you a point of reference, spreads were as high as 800 basis points during 2002, which means that one was getting paid roughly 8% points more in yield to take the risk of owning corporate debt instead of treasury debt at that time. That level has narrowed to a mere 2.5% extra yield currently.

This is bullish in that it has allowed corporations to access additional capital much more cheaply than had been available previously. Many corporations have used this capital gained from additional debt to either increase their dividends or to implement stock repurchase plans. These developments are traditionally bullish, and have aided the stock market.

As you might expect, there are trade-offs to all business decisions. In a vacuum, I would view the increase in dividends and additional stock buybacks as unequivocally bullish. However, we currently see these otherwise bullish developments at the expense of increased debt and leverage. As these funds are not coming from excess profits and savings, it greatly increases the risks associated with such trends, as leverage is a double-edged sword.

But it is what it is. So long as the corporate bond market allows companies to continue to leverage their capital, it will remain a positive development in the short run. In the long run, it borrows from the future while simultaneously increasing the risk involved in the stock market.

This scenario is similar to the Internet and telecom sectors of the late 1990's. If you recall, at that time, corporate profits in many cases were non-existent. However, this was not deemed to be a problem because once a company needed more money, they simply tapped the debt markets. By the summer of 2000, this financing window slammed shut due to saturation, and there were no longer funds available for many of these companies to continue their operations.

It is difficult to articulate this point strongly enough. This development in the corporate bond market continues to be bullish as investor psychology continues to allow it. However, should that psychology change, and therefore crimp the corporate bond market, it immediately would change to being extremely bearish as companies would no longer be able to fund these types of operations solely through taking on additional debt. This is what caused the Internet and telecom collapse in 2000, and increases the risk of doing the same in the broad markets today.

As a throwback to that period, Global Crossing, which went bankrupt during that period for these same reasons, and subsequently re-emerged, recently stated that they had only a few weeks left before they ran out of capital again. Despite this fact, they were able to tap the debt markets a couple weeks ago for the first time since their bankruptcy. More disturbing, is that, despite proving yet again that their business plan remains flawed, they were able to do so for less than 700 basis points. This equates to less than 7% debt, which is far and away much cheaper than a "distressed" company would normally be allowed funding.

To further illustrate the point, I want to also share a name from the past that you may recall. In the late 1990's, Cendant's stock price declined roughly 70% after being forced to make a non-cash earnings restatement for about $140 million due to fraud. One might expect that an earnings restatement due to fraud would cause investors to drastically alter their view of a company. However, bullish psychology currently reigns supreme. So much so, that the recent announcement by Fannie Mae that they would need to make a similar non-cash earnings restatement, due to fraud, of $9 billion (cutting their perceived earnings over the previous 3 years by more than a third), actually saw a warm reception by the markets. Despite the company being found to be severely under-capitalized and perpetuating this fraud for a number of years, the stock rose about 4% the following day.

I could go on, but the point remains that bullish psychology remains prominent, and at extreme levels. Despite lackluster employment, a weakening dollar, increasing deficits and expanding debt levels, and sub-par growth to show for these increasing imbalances, investor psychology is stronger than any period since 1987. It is even stronger than the raging bull market of 1999, to give you some perspective of the danger of such extreme optimism. There is simply no way to tell just how far or how extreme these trends can persist, but so long as they do persist, the risk to the financial markets will continue to increase.

Which gets me to my forecast for 2005 and beyond. While I do not know how long these already extreme imbalances can persist, I can surmise that while it continues, it will come at a cost. That cost is the value of the U.S. dollar. Should the markets continue higher, I remain of the belief that it can only do so in the face of a diminished value in the currency from which those assets are priced. This is simple economics 101. If the basis of currency declines (i.e. inflationary pressures), by definition, the nominal price value of those assets denominated in that currency are likely to rise. This means that should the dollar's weakness continue in conjunction with record high investor sentiment, we may well see the nominal price of all asset classes rise. The price of oil *and* transportation stocks may well both go up together. The price of gold *and* the broad stock market averages may also rise simultaneously. While this trend continues, all U.S. priced assets may increase in price at the expense of the value of the U.S. dollar.

For this reason, I remain bullish on precious metals and foreign currencies. If investor psychology persists to ever-increasing levels, I anticipate that precious metals and foreign currencies will still outpace the gains in the stock market.

I was wrong in my forecast that 2004 would see a shift in this "all one market" phenomenon. However, I remain steadfast in the belief that this cannot last forever. And in the face of the current extreme in investor psychology, it is most likely, in my opinion, for investor psychology to dampen from the current record extremes.

Any one of a number of catalysts could cause this shift. To name just a few of such catalysts, it could come from the realization that a rapidly declining dollar dramatically decreases the value of the assets we own on a global purchasing power basis, or it could come from foreigners no longer wanting to support our burgeoning deficits. If employment remains lackluster, it could come from a decline in spending by consumers. Also, a continued rise in interest rates may hinder cash-out refinancing by consumers which would also hinder spending. The same effect, regardless of interest rates, could also come from additional regulations due to Fannie Mae's troubles, as described earlier.

The list of catalysts goes on, but it is futile to try to predict such an event, other than to recognize the relative probability that many such catalysts lie in the forefront of possibilities. However, the result, should such a change occur, remains the same. We would likely see either a slowing or a decline in the economy, causing the broad averages to decline from their current near-extreme valuations. Furthermore, an increase in the pace of a declining dollar may become exacerbated should foreigners flee from their massive holdings of treasury securities. This may also cause interest rates to rise, either perpetuating or causing some of the previously mentioned catalysts.

With a plethora of working parts within this macro-economic puzzle, one investment stands out in all such likely outcomes: precious metals. In the debate between such inflationary or deflationary scenarios, real wealth accumulation, which is nobody's obligation but rather a pure asset, stands to benefit in either scenario. The "wild-card" in all this is how investor psychology affects the U.S. dollar and the broad stock market averages.

For these reasons, and as a result of not knowing exactly how long the current trends will persist, I continue to recommend a combination of precious metals and foreign currency investments. For those who wish to also hedge against the shift in investor psychology, a portion of assets in investments that capitalize on a weak stock market should also be implemented. Obviously, each investor has unique circumstances from which these allocations should be made, but I continue to believe that a mix of these assets will outperform the broad stock market averages over the coming years.

I look forward to speaking with you in the New Year to either re-affirm the financial market strategies we have implemented, or to revise them to fit more in line with any renewed goals or perspectives you may have.

Until then, I want to wish you again a fantastic and prosperous New Year. May 2005 be everything you hope it to be.

Sincerely,

Shane Hoover
Hoover Capital, L.L.C.
shanehoover@hoovercapital.net