QUARTERLY COMMENTARY
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The Investor's Dilemma: Bet With The Government Or Rely On Fundamentals?

Although stock market volume has declined markedly from its level earlier in the year, price volatility has increased. Stocks plummeted in the second quarter by 11.4% then soared in the third by 11.3%. A similar pattern unfolded within the third quarter as well, as a very strong September followed an extremely weak August. Those violent fluctuations left the S&P 500 up for the year by 3.9% through the end of the September quarter.

For reasons we have been voicing consistently over the past dozen years, severe economic dangers provide the background for these sharp securities market moves. In such an environment we have strongly counseled against the traditional buy-and-hold investment approach. Our preferred value-based strategic allocation approach worked against us over this past year, as both stocks and bonds have rewarded risk-taking. Quite a different picture emerges, however, over most longer periods of time. Even including the recent underperformance, Marathon's portfolios have outperformed stocks over two, three, four, five, six, nine and ten years. We underperformed the average equity return by just 2/100 of one percent over seven years and by 2.9% over the eight-year span. For the century-to-date, our portfolios have outperformed common stocks by more than 5% per year. Very few portfolio managers in the country can point to such a record of strength and consistency.

Stocks started their current rally at the beginning of September. One particularly strong Friday performance was attributed largely to pre-opening comments made on CNBC by successful hedge fund manager David Tepper, who spelled out his bullish case as follows: Equities are a good bet because either 1) the economy gets better and stocks rise or 2) the economy stays weak, the Fed intervenes again with QE2 and stocks rise. Hardly a fundamentally strong case for investment, his argument is instead a justification for speculation that hungry hedge funds and return-starved investors have seized upon. It is a bet that government stimulus, past and proposed, will succeed--at least for the market.

On a fundamental basis, corporate earnings continue to grow from the extremely depressed levels of the 2008-09 recession, although they are still not back to pre-recession highs. While we continue in a jobless recovery, businesses have aggressively cut fat and increased productivity, so profits have grown.

The fuel for continued corporate earnings growth, however, is running low. Economic progress has stalled despite the largest stimulus efforts in history. We remain in the worst unemployment situation since the Great Depression. And housing makes new negative headlines weekly, with prices dipping again coupled with a huge backlog of probable foreclosures. As we have frequently pointed out, our economy is highly unlikely to experience a sustained recovery until consumers regain confidence and increase spending. Such a recovery remains unlikely with housing and employment in distress.

Federal Reserve Chairman Ben Bernanke sees the bleak picture clearly and has, therefore, pledged another massive infusion of new money. At the very least, QE2 is an admission that the "shock and awe" of the greatest rescue effort in history was insufficient to push the economy into a sustainable upward trajectory. This is likely testimony to the vast extent of our economic problems.

Not all agree with the wisdom of additional quantitative easing. Ex-Fed official Robert Heller contends that the nation is in a liquidity trap, in which injecting additional funds will have no appreciable effect. Former Federal Reserve consultant and Shadow Open Market Committee member Allan Meltzer maintains that the Fed is ignoring the deleterious long-term consequences of their expansionary actions. The negative effect on savers and the retired is already apparent. Fed monetary policy and bond purchases in the open market have pushed interest rates to negligible levels on fixed income securities, so important to risk-averse retirees. Furthermore, the monumental build-up of debt has done potentially huge damage to the financial condition of future generations.

Beyond potential danger from additional quantitative easing, there is a serious question regarding its likely effectiveness. A recent poll of Wall Street professionals revealed an expectation that QE2 would have very little positive effect on either the economy or the stock market.

QE1 put a floor under a plunging stock market and an economy that many commentators argue was headed for the next Great Depression. The massive stimulus program is winding down, however, and with the economy still so unstable, the Fed has deemed QE2 necessary.

Many countries around the world are not eager to participate in a second round of stimulus. Many European nations in fact are leaning toward austerity and fiscal integrity.

In evaluating the potential for Fed success with this new effort, it's important to remember that many on the current Fed, including Chairman Bernanke, were the experts that promulgated the monetary policy which led to the real estate bubble and the later stock market collapse from 2007 to 2009. Do we have reason to believe that they are any wiser today? Or are they simply desperate in their search for any solution that might work today, regardless of longer term consequences?

Of course, quantitative easing is merely a euphemism for printing money. Will other nations around the world simply sit back and let us try to print our way out of the current crisis by debasing our currency? Or will they fight back, leading to a currency war? Brazilian Finance Minister Guido Mantega has declared that war already under way.

I wrote at greater length about the potential for a currency war in my October 22 blog post at www.ThomasJFeeney.com.

The effect on the world economy of a currency war is highly problematic. History argues that protectionism and trade wars would be likely results, with potentially serious consequences for world equity markets. The sheer size and volume of trading on the currency markets creates an unstable condition when countries with disparate interests contest. The potential for huge financial accidents is significant.

Investors are faced with an intense dilemma: whether to jump on assets that have been moving up – stocks, bonds and gold – in response to government stimulus and Fed rescue efforts, or to protect assets which could decline severely if those rescue efforts fail. The proposed degree of government stimulus and monetary creation is a massive undertaking, which could push asset prices higher if the government wins its bet. Investors are left to speculate on whether or not the monetary authorities can print us into prosperity.

Notwithstanding unprecedented money creation and more to come, if consumers remain cautious and continue to unwind debt levels, stocks could fail again as they did from 2000 to 2003 and from 2007 to 2009. Contrary to Wall Street propaganda, stocks are expensive by traditional measures of valuation. And the debt problems underlying the economy have been papered over, not solved.

Bond yields are near historic lows. The Federal Reserve has been a huge direct buyer of bonds and may buy more. A major question is how long China and Japan, our largest creditors, will allow us to debase the dollar, yet still hold and buy our bonds. A reversal of that pattern for either financial or political reasons could push interest rates much higher, doing severe damage to bond portfolios, as happened for four consecutive decades from 1941 to 1981 in the last rising interest rate cycle.

Anyone can choose to speculate on a favorable outcome, but could be hurt badly if the Fed loses its gamble. It is critically important to recognize, however, that a buy and hold approach to either stocks or bonds in this environment is not investment, but pure speculation. This is an especially critical recognition for individual or institutional investors who could not easily replace lost assets if the Fed loses its bet.

We prefer to stay in sync with securities fundamentals rather than speculating on the success of the Fed's efforts. We will continue to maximize return on secure, short-term investments while looking for strategic opportunities in stocks, bonds, gold or foreign currencies on sufficient price retreats, as we have done successfully throughout the first difficult decade of the twenty-first century.

Thomas J. Feeney
President
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