Andresen & Associates Inc.
P.O. Box 1434 Salinas, CA 93902-1434
Phone: (831) 758-1575 or 1-800-345-9644
Fax: (831) 758-1576
WWW.ANDRESENASSOC.COM

October 31, 2014

The Great Pumpkin Rises

Our last Andresen & Associates quarterly review, for September 30th, 2014, analyzed our current financial markets in detail, to reveal how we are now in a very unusual situation in the global economy.

Since the Financial Panic of 2008, we have enjoyed spectacular recoveries in both the stock and the bond markets, globally. The US financial markets have been particularly good investments. Now we find ourselves in a financial situation where continued economic growth will sustain the stock markets, but reduce the value of bonds. On the other hand, the bond markets are priced to suggest that the global economy will stagnate for the next several decades.

"The Great Pumpkin" currently on the rise is the consensus opinion that both the bond and stock markets will continue providing increases. However, historically, it is very unlikely that both the stock markets and the bond markets will continue to enjoy substantial gains. It is much more likely that one or both of these markets will experience a correction as the economy either booms or stagnates.

New data I've seen since I wrote the quarterly review details how the S&P 500 stock market index has literally increased at five times the rate of economic growth. This is an astounding divergence, only before experienced in the recoveries of the 1930's and 1940's. The stock markets of the world, especially the US markets, are far out in front of economic growth. Stock markets are usually leading economic indicators which go up in advance of genuine economic gains. However, they also commonly go to extremes of valuation. We can only conclude that stock market valuations have either priced in a superb economic recovery or they're nuts. We don't know which, really.

Since the time I wrote the quarterly review, we've all witnessed an astounding revelation of the forces driving the stock markets. In mid-October, equity markets began a valuation-based downturn which seemed entirely rational. At most, the S&P 500 was down perhaps 6%. However, the downturn was stopped in its tracks when James Bullard, President of the Federal Reserve Bank of St. Louis, was interviewed on Bloomberg Television and said,

"I think a reasonable response of the Fed in this situation would be to invoke the clause on the taper that said that the taper was data dependent. And we could go on pause on the taper at this juncture and wait until we see how the data shakes out into December."

This comment would be called "moral suasion" in my college economics class. In other words, Mr. Bullard said whatever was necessary to keep the stock markets elevated. He also sent us a strong message about the policies of the current Federal Reserve. Whereas in the past, our system was essentially capitalist, with free markets, there's a new game plan.

During the 2008 Financial Panic, the primary goal of the Fed and other agencies of government was to avoid a second Great Depression at all costs. Fed Chairman Ben Bernanke was tailor-made for the task: he is a devoted student of financial crashes.

Part of the government's initial response was to let the marketplace handle the financial shortfall. But the severe global economic effects of the collapse of Lehman Brothers on September 15th, 2008 shocked elites such as Henry Paulson and Ben Bernanke, and they revised their response by declaring large financial corporations "Too Big To Fail".

Thus, during both the Bush and Obama administrations, the Federal Government bailed out corporations which had made giant mistakes, such as AIG, and even supported banks that had in many ways caused the meltdown.

The economy has not recovered well, but it HAS recovered. And, in the ensuing years, the lesson of intervention has been learned. James Bullard's words are amazing to me as an investor, because what he is essentially saying is the Federal Reserve now believes that the entire economy is too big to fail, and market valuations don't matter. That's a game-changer, isn't it? Apparently, at least according to these words, we will not completely rely on market forces to shape the economy in the future.

What does this all mean? It means our statistical interpretations of the global economy are likely to be distorted, at least in the short-run. We can't determine if this is a good or a bad thing. As a result, I am continuing my diversified allocations of your portfolios, with a perception that my capacity to see what is happening is somewhat muddled.

And now for something almost completely different: since our most recent quarterly review, we've also received additional news about the rising disparity of wealth distribution. As you can see in **Graph 1** below, long term investing success appears to be a learned behavior. We are not entirely at the mercy of markets. Instead, our choices seem to create our investment outcomes.

Apparently the people who invested during the 2000 and 2008 stock market downturns, at the most fearful times, recovered quite nicely. The people who sold out their mutual fund stock holdings and never came back to the stock market became much poorer.

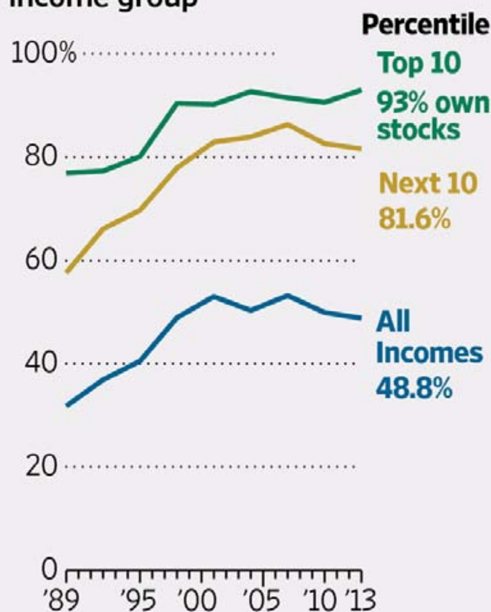
This graph suggests to me that some people tend to consistently make wiser long term financial decisions than others. The core ability appears to be the courage to disagree with the consensus: to buy when others are selling and to sell when others are buying.

That's why, when downturns in any financial markets inevitably emerge in the future, we'll be prudent buyers. As the graph demonstrates, that's the historically proven path to success.

Meanwhile, I feel we should be patient and watch to see what will inevitably happen next. It's time to wait, stay diversified, and watch the Great Pumpkin rise. ■

Scared of Stocks

The highest-income families are the only group more likely to own stocks than in the past. As stocks boomed, they gained a growing share of the nation's wealth.



*Either directly or indirectly through retirement accounts

Source: Federal Reserve

The Wall Street Journal

Graph 1

Wall St. Journal, October 27, 2014, "Bad Market Timing Fueled Wealth Gap"