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STORM AHEAD?

08/05/2013	Value	YTD %
Dow Jones Industrial Avg	15658.43	19.5%
Vanguard 500 Index	157.79	21.25%
Vanguard Total Bond Index	10.67	-2.35%

The VLMAP is now somewhere between 40% and 35%. According to several sources, this is one of the lowest readings in history, similar to readings recorded just before the 1987 crash and the 2008 Financial Panic.

This tells us that another correction greater than 20% is probable. The possibility of a SUBSTANTIAL stock market correction is now looming.

Of course, if earnings come up from underneath this valuation and support it, we will see a sideways market, and nothing more. So I can't predict a stock market correction with 100% certainty. It's also a real possibility that the stock market will keep going up for months.

If earnings support such growth, then a sideways move will follow. But if earnings do not support a continued upwards trend, as is likely, then we will probably experience a down market similar to 1987, 2000, or 2008-2009.

To put it another way, the economy has grown 2% in the past year while the stock market has gone up 20%.

There is a reasonable likelihood, but by no means a 100% probability, that a recession will ensue following any crash which might take place. What will trigger the downturn, if it happens at all?

Last week I spoke with Jeff Auxier, manager of the Auxier Fund. He points out that the Federal Reserve's easy-money policy has resulted in historically low interest rates. Due to this policy, Treasury bonds have reached a 200 year valuation high. Imagine that: a 200 year high! This is the Mother of All Financial Bubbles. It doesn't necessarily have to end horrifically, but it's certainly unlikely to continue into eternity.

Jeff sees the possibility of a stock market decline originating with the end of the Federal Reserve's stimulus program later this year or perhaps from this fall's Congressional debate over debt ceiling limits.

At present, the Federal Reserve is pumping $85 billion per month into the global economy. To put such a massive artificial stimulus into perspective, consider that 85 billion seconds ago, it was 682 BC, and civilization was just emerging in Egypt, Samaria, Israel, Central America, and China. A few billion here and a few billion there, and pretty soon you are talking about serious money.

Such a move will probably cause rising interest rates, which will slow the economy down and curtail the housing markets. According to last Wednesday's GDP numbers, the economy is growing at a sub 3% annual growth rate, so there's not a lot of room for a financial market downturn.

If interest rates rise, we're likely to see a recession as well. Unemployment in places such as Greece and Spain is already approaching 30%. Even counting the growing number of part-time jobs, our local unemployment rate is about 14%. There's not a lot of economic reserve built into the system, so a small disruption could possibly trigger an economic slowdown.

On the other hand, this situation could be similar to 1987, where the October stock market caused an immediate flight to quality and interest rates stabilized. Very slowly rising rates might cause an initial shock, without really damaging a growing economy. Also gradually rising rates could create higher revenues for fixed-income pensioners and for financial institutions.

It's not all bad. And my statistical analysis could easily be wrong. Clearly, most investors deeply disagree with me, or the stock market would not be continuing its upwards rise.

The VLMAP statistic has always been right, as far as I can determine. It often signals years too early on both extremes, as it did in 1997, in 2006, and probably in 2012. Eventually, though, it's always been right.

With that in mind, it's appropriate to get ready for a storm. Our portfolios are mostly configured for tough times already, with relatively low risk allocations which have caused our portfolios to lag in 2012 and in 2013.

We need to keep in mind that the stock market may easily keep going up for a time. We have to resign ourselves to "Groundhog Day": waiting and waiting for a meaningful event while we grow our understanding. If we do this, the probability of greater future gains is high.

And there's always the possibility that the statistics and I are wrong. While I have to admit that prospect, I also have to remember that it's simply better to be safe, and it's plainly better to keep ourselves rich first rather than expose ourselves to potentially ruinous risk. So I am trying to keep us relatively safe; however, I'm NOT selling us out of the stock market because this could go on for years.

If our scenario is right, then rising interest rates will happen first, and these will initially damage the bond markets, possibly seriously. I'm gradually trimming away our bond mutual funds that hold longer term bonds or mortgages, and replacing these with bond funds with more creative, flexible mandates, and which might better cope with an interest rate shock. Future portfolio changes in our bond allocation are probably in store for us.

In short, we should prepare for some unexpected and perhaps frightening changes. When investors are shrieking and running, we'll be buying. Steel yourself to endure as markets rise without buying more, and prepare emotionally to buy when others sell.

Patience pays. Diversification pays. The basics work. Let's stay the course. ■