“Nobody goes there anymore. It’s too crowded.”
– Yogi Berra

Growing up I was never mistaken for an optimist. Well, maybe except by my mother who was raised in the Bronx and brought up to be instinctively cautious, very common amongst her baby-boomer peers of Jewish, working class roots. Nevertheless, my childhood friends here in San Francisco used to joke that I’d seemingly find a way to rain on their parade, as I dissected popular beliefs trending within our group. Looking back now, I do not believe this was a fair assessment of my character, but we all know how boys like to dish it out.

Beginning in my pre-teen years I became interested in politics, markets, economics and history. Intuitively I probably thought that following these various disciplines would help me to understand people and my environment better. Answering the questions of what motivates individuals or groups and why some are better off than others continues to occupy my thoughts. I am fortunate in that I have a history buff for a father, who also happens to run an independent tax accounting and financial planning practice. So, on the one hand, I grew up watching “Wall Street Week” with Louis Rukeyser Friday evenings, and then later I’d have to work on book reports he assigned covering topics such as “Tippecanoe and Tyler Too,” as an exercise to improve my reading comprehension. To this day, I still do not get the meaning of that slogan or what my father sees in it. In addition to Dad, my two uncles have also had a profound effect on my thinking. Uncle Howard, who is politically progressive, studied anthropology and practices medicine, while Uncle Robert (sadly no longer with us) was politically conservative, had a mathematics background and worked on Wall Street in the 80’s and 90’s as a “quant.” Sharp as tacks, they were usually the smartest guys in the room… except of course when they were all in the room together. With all that education, reading, and sheer brainpower behind them,

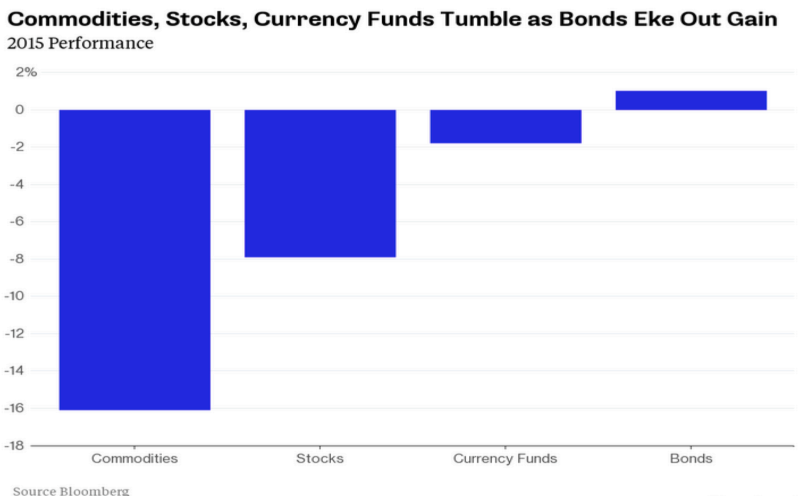

Figure 1

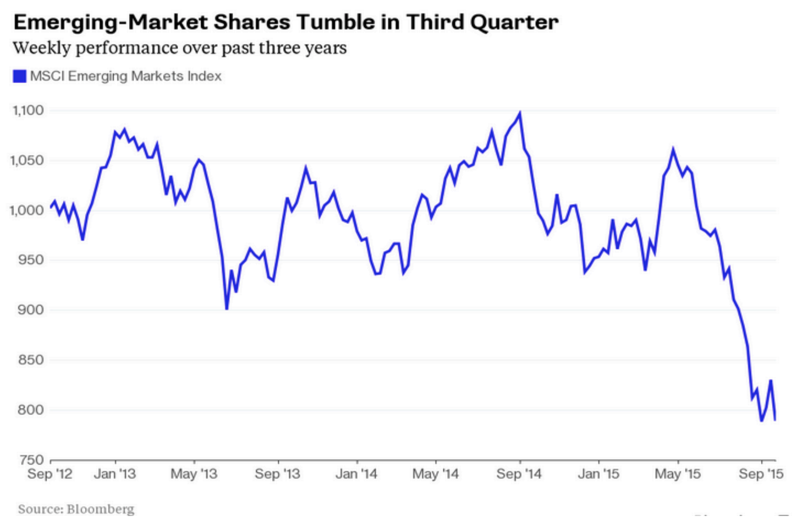

Figure 2

one would think that they would be in agreement on many things. But thinking back on all the discussions/arguments I observed over the years, they seemed to agree on very little.

A recipe for stressful family get-togethers some would say, but more than anything it was a great education and helped me to keep an open mind and consider all the angles on various subjects. I didn't know it then, but it was also great training for a career in the financial markets. You see, I have come to learn that outside the hard sciences there are very few universal truths in this world. It comes down to perception, perspective, or where one is positioned relative to others. This is what makes financial markets so interesting. Everyday we learn something new as we piece together and adjust this real-time puzzle.

To be great in this business requires independent thought. But, thinking independently has the potential to get us into trouble as inevitably something unpopular or taboo will be expressed. As an investment manager, independent ideas tend to be unpopular with the bosses and investors, especially if they don't pan out early on. They are more likely to get you fired before you receive that "Atta Boy" affirmation. I have found that for the most part, it is difficult to maintain independent thought within a large organization as too many people are just trying to cover their backsides and ultimately keep their jobs to pay the bills.

How does this all relate to the markets? Best to answer that one with a quote from Howard Marks of Oaktree Capital Management taken off a recent quarterly letter in which Charlie Munger of Berkshire Hathaway expressed, "It's not supposed to be easy. Anyone who finds it easy is stupid." So, there it is. Following the crowd is easy, but is also likely to cost money over the long term.

To date, the market has been hanging on every word out of the Fed trying to anticipate when the first rate hike will occur. How's that working out? Other commentators have pointed out that historically the Fed has been a poor predictor of growth, inflation, asset prices/bubbles, etc. What they would like to do (normalize short term rates) seems to be different from what they will do (status quo). As a result, I have been reading/hearing more about the credibility and the politicization of the Fed. The below note posted by Peter Boockvar of the Lindsey Group was published on "The Ticker District" blog after the Fed's rate decision and later highlighted by John Mauldin of Mauldin Economics. I think it does a good job of capturing this point.

Figure 3

Figure 4

"The Fed punted AGAIN and thus are inviting us to the daily obsession of when they eventually will hike for another 6 weeks. While the economic commentary on the US was not much different than the last statement, they added "recent global economic and financial developments may restrain economic activity somewhat and are likely to put further downward pressure on inflation in the near term." They see the risks to the outlook for economic activity and the labor market as nearly balanced but are "monitoring developments abroad." Jeff Lacker is the only one that stood out from the crowd with a dissent and the desire to raise 25 bps. Bottom line, the problem now is not when the Fed will raise rates or not, it is the paralyzing discussion about when they will eventually raise rates. We get to do this all over again as the Committee continues to day trade every data point not only in the US but now globally. They are the center of uncertainty and the multitude of excuses over the past few years has reached a tipping point that I don't believe the stock market will continue to embrace. China has been slowing for 5 years and commodity prices have been falling for 4 years, and the Fed has now discovered them as risks to their outlook. Are we going to now price in the greater chance of a rate hike if China's PMI's start to improve, if retail sales tail higher. The Fed is implicitly acknowledging again that their policy action over the past 5 years of putting the US economy on a sustainable growth path has been a failure and now if their international concerns become more pronounced, they will also admit to the world that they have no tools to deal with it. I think today's decision was a bad one. The dollar rally should be over and I'm bullish on precious metals (again) as I don't understand at all what the bear case is anymore. Other commodities should benefit too from the weak dollar. For stocks, while we still have another 1 ½ hrs, it's looking like we've already had the no rate hike rally. Therefore be cautious, the Fed did more damage to its credibility today. Lastly and sorry to speak from my soap box to those who don't care to hear it but, I'm sorry to the retirees that have saved their whole lives. I'm sorry to the generation of young people that don't know what the benefits of saving is. I'm sorry to the free markets that best allocate capital. I'm sorry to pension funds that can't grow assets to match their liabilities. I'm sorry to the successful companies that are competing against those that are only still alive because of cheap credit. I'm sorry to the US banking system who has been hoping for higher interest rates for years. I'm sorry to those industries that have seen a pile of capital (aka, energy sector) enter their industry and have been or will see the consequences of too much capacity. I'm sorry to investors who continue to be bullied into making decisions they wouldn't have made otherwise. I'm sorry for the bubbles that continue to be blown. Again, I'm sorry to those who don't want to hear this."

Lastly, I'll conclude with a few charts that have gotten my attention recently. Figure 1 and 2 come from a recent Bloomberg article and illustrate what a difficult year it has been for many investors. Figure 3 is a chart of the stock market volatility index (VIX), which has undeniably had a huge spike up and should at least cause investors to think twice about increasing any risk exposure at the moment. Figure 4 is a chart of gold going back to 2006, and I thought with the major central banks (U.S., China, Japan, Europe) all either easing, or maintaining easy policy, it made sense for those that are under-allocated to revisit a larger position in the yellow metal, as central bank creditability could become a greater factor than it has in the recent past. In a nutshell, the market is whipping around due to uncertainty, lack of confidence, and a decrease in liquidity. All of the above should be warning signs for those looking to make returns through collecting a market risk premium.

Sincerely,

Justin Kobe, CFA
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