



PLIMSOLL MARK CAPITAL

Call of the Sirens

Earlier this year, central banks from around the world came together in an unprecedented way and rescued the financial system from collapse by making available massive amounts of monetary based liquidity. We are now experiencing the unintended consequence of all this new money creation – liquidity driven financial markets. In our opinion, liquidity driven markets are the most speculative and dangerous because they often go on longer and reach higher levels than anyone would anticipate creating an increasingly large bubble. When and what causes them to end cannot be known in advance but a pin does indeed lie in wait for every bubble. At which point, investors are again reminded that speculation is most dangerous when it looks the easiest.

*Liquidity driven markets are also seductive as the upward momentum attracts more and more participants into the game. In Homer's epic *The Odyssey*, Ulysses longed to hear the Sirens' beautiful voices even though he knew that doing so would render him incapable of rational thought. He had his crew bind him to the ship's mast to prevent him from jumping into the water and to protect him from the call of the Sirens. Like Ulysses, investors would now do well to reflect on their own financial goals and objectives, ignoring the call of the Sirens, and seek balance in their portfolios.*

3rd Quarter Market Summary

The past quarter saw record returns in many world markets, with most equity indices rising about 20% or so. Their dramatic rise from very depressed levels reinforces the notion that markets have a habit of doing whatever will make you feel the most uncomfortable. The precipitous fall and subsequent rise of most financial markets over the past year has certainly caused them to live up to that reputation.

The three main forces behind the rally are easy to identify. The first is simple relief – relief that the world avoided falling off the economic precipice. The second is government stimulus – imagine a large hose spraying unprecedented liquidity into the financial system with much of that liquidity finding its way into financial investments (like stocks and bonds) rather than into productive assets (like building new factories or shopping malls). The third factor is fundamental – economies all over the world are rebounding from a fall so great that a bounce was inevitable.

You will read in the newspapers that there is “a lot of money on the sidelines waiting to come into the market”, and that many investors have “missed the rally” and are waiting for the opportunity to put their “excess cash to work”. These comments are typical of a liquidity driven market. This is jargon for saying that the return on cash is so low that you might as well get your money out of cash and put it into the financial markets. As liquidity driven markets go up, they have the tendency to transform into their evil cousins – stock market bubbles. The problem for even the most thoughtful and nimble investors is that the dividing line between the benign and the malign is all but invisible.

A Decade of Bubbles

We have already persevered through two major stock market bubbles this decade. If you think back to the heady dot com days, you will recall investors were convinced that the economic rulebook had been rewritten and that

the “paradigm shift” promised by new internet technology rendered traditional stock market analysis redundant. The same narrative was true in the second bubble which was centred on US house prices. Sophisticated new financial instruments coupled with very low interest rates caused housing prices to explode upwards convincing both homeowners and investors that there were no risks involved with easy home mortgage credit.

Unfortunately, we were again reminded that the science of trying to predict when an unsustainable market cycle will end is not a science at all but merely guesswork. Investors who guess right are rewarded with excess returns and regarded as prescient, while those not lucky enough to get the timing right, are not.

Up, Up and Away

Now here we go again. The liquidity being pumped into the financial system has had the desired result of preventing a meltdown. To put this in perspective, the US monetary base has doubled since the financial crisis began just over a year ago – that’s 100% growth. Never before has the Fed created so much liquidity in such a short period of time and this liquidity must find a home. Since bank lending remains depressed and because the capital market’s appetite for securitized loans is non-existent, it is hard for the liquidity to spread into the real economy to support growth. Instead, it goes into the financial markets pumping up prices in equities, commodities and gold.

The liquidity pump continues to run in the US even though the underlying economic issues have not been addressed and new problems are being created. The primary ill effect of the increased liquidity is a decline in the US dollar. The more money that is created, the less it is worth, unless or until it is absorbed into real economic activity. Currently, the US government does not seem overly concerned about the declining value of the dollar. In fact, it will be politically difficult for the Fed to constrict money flow in the US with unemployment approaching double digit levels.

And it appears that the Fed will keep the monetary hose wide open until one of three things happens: (1) we have a genuine self-sustaining economic recovery; (2) investors panic as the build-up of public and private sector debt triggers a rise in long term bond yields; or (3) a declining dollar forces the Fed to respond with higher short rates.

Plimsoll Mark believes that the second or third outcome is much more likely than the first, particularly in the developed world. With stock and bond prices continuing to rise against the backdrop of what could be another potential fiscal crisis, the likely hangover could be painful for some. The timing, as with the two earlier bubbles in this decade, is uncertain. As the old Wall Street axiom goes, “these things work until they don’t”.

The Wealth Manager’s Dilemma

This brings us to the central problem for a wealth manager today. Do we go with the flow and jump into risky assets; arguing that what was just a vicious cycle a few months ago has turned virtuous? Or do we stick to our fundamental analytical approach and manage portfolios in such a way as to adjust for the risks we think are present? While this may seem like a theoretical choice, it really isn’t. Liquidity driven markets are seductive creatures. With rates of return on risk free assets like cash approaching zero, the temptations of the recent returns in the equity markets and of corporate bonds yielding 5% or 6% are hard to resist, especially when even thoughtful people like us think the equity market rally may go on a little longer.

The Plimsoll Mark Approach

Our basic framework hasn’t changed. We favor a balanced approach. We still believe that the recovery in devel-

oped countries will be anaemic primarily because the high level of household debt needs to be reduced and the planned level of government deficit spending is unrealistic.

While the overall economic environment causes us to be cautious, we continue to look around the world for bright spots. Our analysis pulls us towards Asia and other emerging markets like Brazil, where the economic problems are more cyclical than structural in nature. As equity markets are becoming truly global, better growth in the developing parts of the world will tend to “lift all ships” or at least keep some afloat longer. We believe that equities of companies benefiting from emerging market economies offer the best potential for growth and investors should have readily available cash in reserve to invest in them during the next market setback.

A properly balanced portfolio also must recognize the risk to wealth of a declining dollar. Protection here lies in a portfolio holding international equities, shares of U.S. multinational companies, a basket of diversified commodities including energy, and in the traditional safe haven, gold. The latter is the asset in the eye of the liquidity storm, and gold offers one of the best hedges against further currency decline. Of course, it will also be one of the most vulnerable assets when this liquidity driven environment meets its likely demise.

Finally, keep in mind how far we have come in just six short months! In the spring there was serious concern about a global deflationary bust, and there was considerable doubt that government intervention would be effective. We were then surprised by the willingness and ability of the Fed and Treasury along with other central banks to provide the massive liquidity required to stabilize the financial system. Now, we are seeing the unintended consequence of that liquidity creation. While the results of this cascade of monetary induced liquidity are inevitable, the timing of the shifts are impossible to predict with any degree of accuracy - all the more reason to keep your feet on the ground and focus on long term investment goals while effectively managing portfolio risk.

Thus, the answer to the wealth manager’s dilemma is to remain balanced while tilting investments in the direction of purchasing power protection. And as markets continue to rise, risk management becomes more of an emphasis than the quest for quick profit.

Our very best,

The Plimsoll Mark Capital
Global Investment Committee:

- *Bill Hall (Maine)*
- *Jim Awad (NY)*
- *Tom Barry (NY)*
- *Steve Bates (London)*
- *Steve Canter (NY)*
- *William Garrett (London)*
- *Don Kurtz (NY)*
- *Bruce Lueck (NY)*