

# Market Outlook

## October 2010

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### Looking On the Bright Side of Life

Investors have been in high spirits since the dark days of summer. Back then, we had oil gushing uncontrollably into the Gulf of Mexico, the burst of economic growth from early 2010 had slowed noticeably, and talk of the “inevitable” double-dip recession were pouring from the keyboards of market pundits everywhere. Indeed, stock markets have rallied some 10-15% from the end of August, with barely any profit-taking along the way. The worries of mid-year seem to have evaporated like a Hollywood marriage, and bond and stock investors alike can be heard, metaphorically at least, whistling that old 1930s tune “Happy Days Are Here Again.”

Anyone acting on the advice of market seers who warned about the typically dismal months of September and October were left holding the bag, and scrambling to catch up to the market’s rally as performance in these months proved to be anything but poor. In fact, September’s performance was the best for that particular month in 71 years. Similar to summer’s negative justifications, today pundits are rationalizing the market’s vibrant rise with predictions of a better economy to come. Prosperity, it seems, is just around the corner, so why not look on the bright side of life, and pile into the stock market?

Probably the biggest rationalization for investors has come from the Federal Reserve. The Fed, which had been dithering over whether to provide additional stimulus to the economy, essentially gave the green light to such efforts in recent weeks as the level of job creation has fallen far short of what is needed to provide a self-sustaining cycle of demand for the U.S. In summary, they have signaled their intent to engage in a second round of “quantitative easing,” or QE, as a way to spur growth. This involves the purchase of Treasury bonds and other fixed-income securities (including mortgage-backed securities) in order to put cash in the hands of the public. This, in turn, is expected (hoped) to boost demand as that cash is spent on goods and services.

In the short run, investors should get their wish, as the Fed’s liquidity efforts are likely to boost GDP numbers and keep interest rates at practically zero. Longer term, though, such an approach could prove a Pyrrhic victory, especially if today’s efforts at “reflation” result in “inflation” becoming a problem later on this decade.

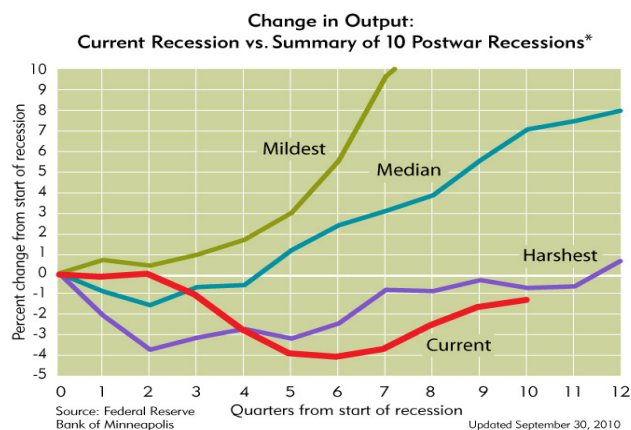
### Psychology Today

To really understand today’s financial markets, one must rely not only on traditional financial analysis, but on a heavy dose of psychology as well. This is true at both the household and the institutional levels.

At the household level, despite the best efforts of policymakers, demand remains sluggish. With high levels of unemployment, worries about real estate values, and the inability of either Republicans or Democrats to come up with a credible “fix” for our myriad problems, it is no surprise that households are conserving their cash rather than spending. In many ways this is a rational psychological response. Families have seen their retirement funds dwindle in the wake of two stock bear markets over the past 10 years, and the value of their homes (a major source of retirement cash) fall for the first time in our collective memories. It would be alarming if they didn’t adapt by reducing their debt exposure and boosting their level of savings. This *adaptation* to profoundly changing circumstances is what should happen, as “pain relief” is a major catalyst for behavioral changes. While beneficial in the long run, it will continue to be a source of short run frustration for policymakers expecting consumers to respond the way they have in the previous three decades. It’s a new psychological environment for households.

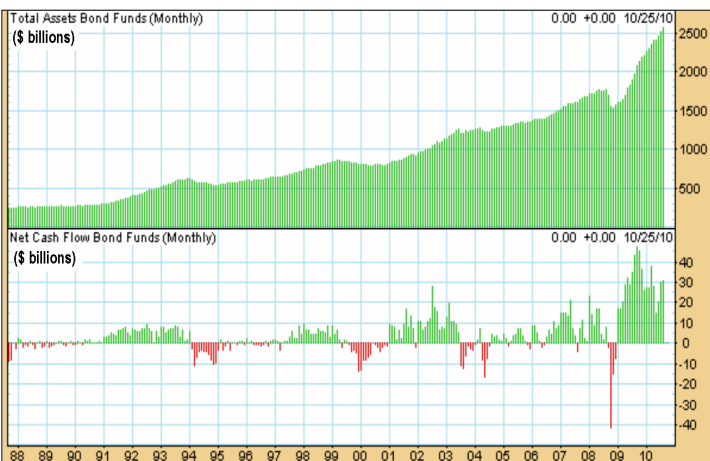
### Bonds Away

The financial markets have had differing reactions from a psychological point of view. Bond markets have rallied as tepid and erratic growth have erased all fears of inflation, and brought talk of deflation into the mainstream press. Short-term interest rates are effectively zero, and longer-term rates are not far above these levels. Psychologically, the bond market is ruled by fear of a further slowdown, or even a mini-depression. This is a logical response to circumstances, as seen in the charts below. The first, from the Minneapolis Fed, compares this recession to all previous post-WW II recessions. Today’s economy is clearly the worst of the lot, so the pessimistic psychology of bond investors is understandable.



The next chart shows how the public has taken this view to heart. It summarizes the total assets and cash flow into bond funds since 1988. Clearly, the fear of investors is palpable as bond fund popularity has broken all previous records. This

underscores the deep hesitancy investors have to take risk, and have bet heavily on the lethargic economy continuing for some time.



**Stocks: One Second or One Year?**

So why have stocks rallied in September and October, given the psychoanalysis above? I think a partial answer is driven by institutional investors, and can be found by looking at Social Proof and High Frequency Trading.

Social Proof describes the human tendency to look at the behavior of others in order to guide us during times of uncertainty. Being social animals, it’s natural to seek these clues out from the larger herd. This really only applies when we don’t “know” what to do, and today’s uncertain times have laid a strong foundation for Social Proof to heavily influence our actions.

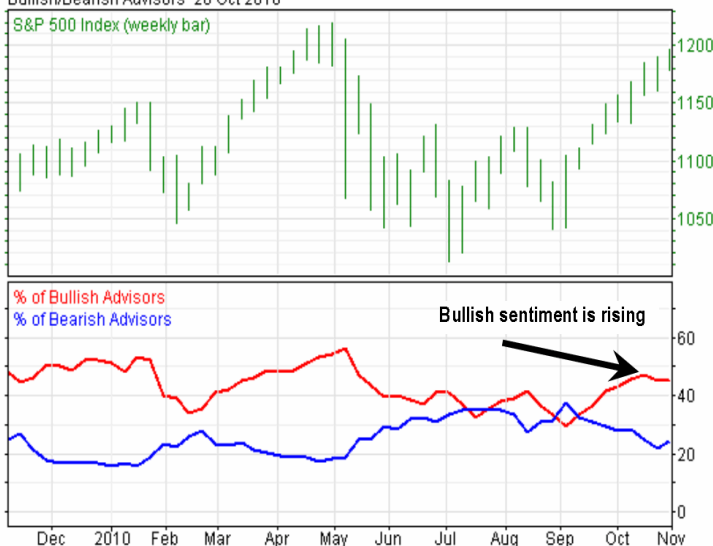
Given the extremes of economic distress and near-zero interest rates, the financial world is suffering from levels of uncertainty unseen in the post-war world. Thus, Social Proof has a heavier weight than ever before. Unsophisticated investors (including professionals) are looking at their peers for hints as to how to behave. This tends to exacerbate any nascent trend and run it up or down to an extreme. This past May, for instance, a garden variety correction rapidly snowballed into the “flash crash” as computers did what their human masters programmed them to do: mindlessly follow any trend (in that case, the trend *down*). Likewise, the rally of the last 60 days is the result of a tendency of investors to follow the trend, in this case, the trend *up*.

High Frequency Trading (HFT) is a tactic used by an increasing number of hedge funds that buys and sells positions within very short periods, sometime mere seconds. Uncertain of whether to hold for a year, they hold for one second instead. The intent is to capture very small gains, but to do it hundreds or thousands of times a day. The result is a mechanical reinforcement of the existing trend, up or down. Fuelled by uncertainty and fast computer power, HFT has gained a following by virtue of Social Proof: if others are doing it, why not join the crowd? An apt motto for these funds could be “*High Frequency Trading: It Beats Having to Think for a Living!*”

The combination of Social Proof and HFT means that economics and psychology are equally important in making decisions today. As such, we are urging caution to any investor wishing to jump on the bullish bandwagon. We have taken numerous profits in accounts, and have raised cash to levels last seen in April (before the summer correction) as we employ some contrarian tactics on behalf of clients.

Undoubtedly, one factor playing into the rally are gains the Republican party is likely to enjoy in the upcoming midterm elections. Wall Street tends to be a Republican-leaning place, so the prospect of wresting control of the House from the Democrats is no doubt causing some buying in advance of the November 2<sup>nd</sup> polls. But it may be a case of “buy the rumor, and sell the news” once the election results are in. There is a high level of expectation built in to Republican victories, and if they fall short, a good deal of recent stock gains could be erased.

Bullish/Bearish Advisors 26 Oct 2010



From a more quantifiable point of view, stocks are very “overbought” as of this writing, the opposite of what existed when the last Market Outlook was written in late June. Today, bullish sentiment is very high, which occurs near price highs; in June *bearish* sentiment was high, which occurs near bottoms. Today, insiders are *selling*; in midsummer they were *buying*. Summer’s *positive* divergences between price and breadth are beginning to show *negative* divergences today. Moreover, the seasonally poor months of September and October have turned out to be quite good for stocks, leading us to believe that the seasonally positive tendency of November is likely to be the opposite of its historical norm. All of these factors have had remarkable turns in about two months, underscoring how quickly psychology can change in today’s uncertain environment.

Our caution shouldn’t be viewed as a prediction of financial collapse or bear market, but a reflection of the ebb and flow of psychological influences on the market today. Until a secular bull market causes all stocks to rise, investors will have to be content with seeking out bull markets in individual securities, and taking profits as they present themselves.