Investing on the Edge of the Fiscal Cliff

For investors, 2012 has been a year so far of disasters that did not occur. The Euro did not implode; Greece was not unceremoniously dumped out; Israel has not attacked Iran; and other perhaps even less likely mishaps did not occur. Consequently, it's been a good year for equity investors if you had the long term view or short term intestinal fortitude to remain invested.

But it seems to me that the next looming disaster, the "fiscal cliff" may not be so easily avoided. Corporations are increasingly voicing concern about slowing demand. Anecdotal evidence is that uncertainty related to the election and its immediate aftermath are causing many spending decisions to be put on hold. And it seems 3Q corporate profits, whether they were surprisingly good or not have included downward revisions to guidance more often than in the past.

Meanwhile, conventional wisdom is that after the election legislators in Washington will arrive at a compromise that avoids the worst of the immediate drag on the economy from higher taxes and spending cuts that current law dictates. The idea behind this structure was that it would force Congress to address the issue rather than submit to the blunt instrument of sequestration. Although many people seem optimistic that a solution will be found, I don't think it's so simple.

First of all, the election is intended to clarify popular opinion with respect to each party's preferred solution (i.e. will we solve the problem with more cuts and less tax hikes or vice versa). And yet, the most likely electoral result is that Obama wins, the House remains Republican and the Senate is controlled by neither party (where a 60-vote filibusterproof majority is required to push through contentious legislation). Don't be confused by the various national polls – Intrade (where people bet money on the outcome) shows Obama with a 62% probability of winning (versus 38% for Romney). It may well come down to Ohio, and Romney's improvement in national opinion polls isn't nearly as important as what the people of Ohio think. Romney is not ahead in Ohio.

So there's a reasonable chance that the Lame Duck session of Congress that will meet following the election (for only 12 scheduled days until January) will be approximately the same group to be sworn in to power early next year. This is the same group of legislators who almost took us over the precipice in the Summer of 2011 with the debt ceiling mess. The notion that the losing party will respect the popular mandate and make more of the concessions necessary to avoid the cliff seems fanciful. More likely is that the Republicans will claim that a weak Presidential candidate not truly loved by the rank and file failed to capitalize on the widespread unhappiness with Obama. Moreover, they'll have little incentive to compromise because it's not their economy. A 2013 recession might be the best way to start the fight for 2014 mid-term elections, from the Republicans point of view.

But whether you accept that analysis or not, consider that neither side will want to settle things until the last possible minute, for fear of foregoing the best available deal usually obtained through brinkmanship. Two or three extra weeks of bargaining in hope of a better political outcome will seem worth the possible short term economic damage.

They'll work something out in the end. There's little choice. But my bet is that between now and December 31 there will be moments when there's reason to doubt that optimistic outcome, and in any event the economic damage caused by uncertainty is being inflicted every day.

How to invest through that period? We continue to own equities we like, but have trimmed positions in names that we believe are highly cyclical and hold some cash in case we are able to invest in one or two businesses at better prices than are available today. In our Deep Value Equity strategy one of our biggest positions is Berkshire Hathaway (BRK-A) which is attractively priced and not likely to cause too much concern even in the dark days of late December. We also have a big position in Microsoft (MSFT) – the release of Windows 8 looks underwhelming but its valuation and monopoly-like positions limit the downside in our opinion. The Gold Miners ETF (GDX) is a bet on central bank reflation and it's been handily outperforming the S&P500 of late. And Corrections Corp (CXW) should reveal more about their REIT conversion in a couple of weeks.

Buoyant Natural Gas Lifts Stocks

Natural gas is +6% today, in part no doubt because stocks are being rebuilt at slightly faster than over the past five years, according to the Energy Information Agency (EIA). Of course a mild winter like last year will lead to another excess of supply, although the continued switching from coal to gas in energy production is leading to a permanently higher level of underlying demand.

As a result, many natural gas names including Range Resources (RRC) and Comstock Resources (CRK), both of which we own in our Deep Value Equity strategy, are higher today. In addition, Bernstein Research initiated coverage on RRC with a buy recommendation. RRC claims potential resources of up to 60 TCF (Trillion Cubic Feet), enough to supply the U.S. for almost three years. The capex requirements to exploit a fraction of this are beyond RRC's current capability which is why we think ultimately they'll be acquired by a far larger company. However, BHP Billiton bought Petrohawk last year for $12.1BN and just recently had to take a $3.3Bn writedown on assets predominantly including natural gas. So other potential acquirers may be cautious about overpaying for assets in what is likely to remain a well supplied domestic natural gas market for the foreseeable future.

Nonetheless, a price closer to $4 per MCF rather than $3 seems likely over the long run given where the fully-loaded marginal cost of production is, and low cost producers such as RRC should be able to continue their production growth under those circumstances.

The Hedge Fund Debate

Last night's event organized by Catalyst Financial Partners was a great success. I was paired in a debate with an old friend Peter Fell, with whom I traded interest rate swaps back in the 80s when we were both at Manufacturers Hanover Trust (Manny Hanny). The question posed was "The Eroding Profitabilty of Hedge Funds". Peter (now with Kenmar) gamely took what I felt to be the much harder side (i.e. defending the hedge fund industry) and it was capably moderated by Brenda Mauro of Trident Fund Services. Peter was not distracted by the autographed copy of my book that I shamelessly thrust into his hands moments before we began, and while there may be varying opinions on the future of hedge funds most would agree that investors will need better terms and results if the industry is to prosper.

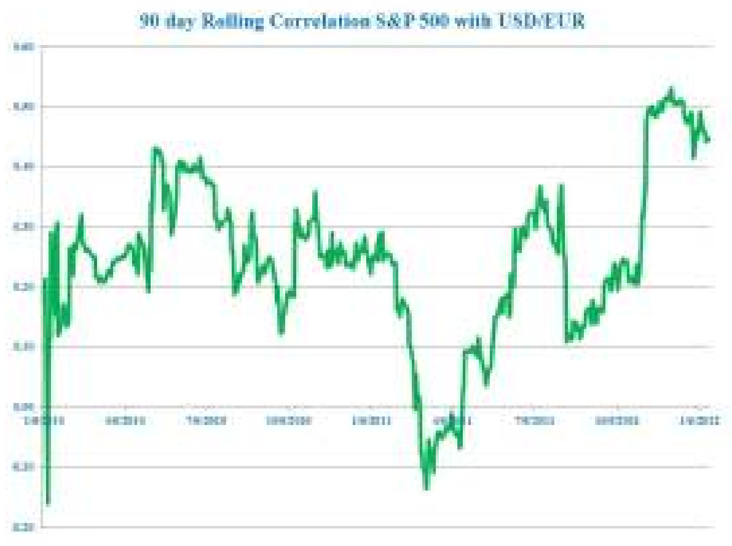
Today KPMG released a report on hedge funds in partnership with AIMA, the UK-based hedge fund lobbying group. They evidently felt moved to set the record straight after the relentless battering hedge funds have received in the financial media of late. I am grateful that they have made such an effort – it's given me something to write about.

Long Equities and Short The Euro Still Works

The Euro has been a good hedge on a portfolio of long stock recently. Equities are attractively valued for a long-term investment; the equity risk premium remains high. But who can think about investing in stocks for the long run and shunning bonds when the Euro sovereign debt crisis rolls on. For us, the solution was to short the Euro as a hedge against long equity positions. The correlation between the two rose during 4Q11, not surprisingly since Europe was driving short-term market moves.

But the ECB's Long Term Repo Operation committed them to support the banks and, by extension the Euro sovereign governments (barring possibly Greece, which is heading down its own path). Since Europe's banks are the biggest holders of European sovereign debt, the ECB has in effect become a lender of last resort to its governments. The removal of the Sword of Damocles hanging over markets has been replaced with a more plausible path to a lower Euro. Europe is in recession, the GDP differential between it and the U.S. is likely to exceed 3% this year, and the next move in rates from the ECB is likely down. Meanwhile, the U.S. economy continues to produce steady if unspectacular growth.

It’s still worth holding a short Euro with a long equities position. The tail risk, an unforeseen crisis in Europe, still makes it a worthwhile hedge even while the day-to-day relationship has become slightly more subdued. But they could just both be good investments in their own right. Equities are attractively priced and the threat of a European crisis is receding. The Euro area is in for a period of no-growth while banks recapitalize and governments impose austerity. Long equities and short Euro is not the pairs trade it was, but both look like attractive investments.



Disclosure: Author is Long SPY and Short FXE

Why The Mario Put is Bullish for Stocks

It’s taken many observers including me longer than it might to comprehend, but ECB chairman Mario Draghi has done something that should be very bullish for U.S. stocks. [Floyd Norris]() noted some of the ramifications in today’s New York Times. The

Long Term Repurchase Operation (LTRO) in effect is an extension of credit from the ECB to EU sovereigns.

How can this be, when Mr. Draghi said all along he would not lend directly to governments? Because of the symbiotic relationship that exists between EU governments and their banks. The banks own most of the debt. If the banks can't afford to roll over maturing bonds governments will default. If governments default banks will go with them. Both are locked together, and we believed that the ECB was holding off from proving needed sustenance while the politicians showed some evidence of imposing fiscal austerity. They (sort of) did at the last summit, and now the ECB has taken a path from which it will be difficult to turn.

Eurozone banks took down 489 billion Euros of three year loans at 1% this week. Whether they choose to buy sovereign debt or not is really not the point. They can, and now whenever the banks appear sufficiently shaky that they won't be able to finance what their sovereigns need, the ECB can be relied upon to provide it. There will no doubt be more brinkmanship and dire warnings about delaying needed economic reforms in the south, but the problem has always been the absence of a credible punishment to wavering countries. The Maastricht Treaty incorporated enormous fees (1% of a country's GDP) that were soon shown to be implausible when Germany and France were among the first to breach the 3% deficit/GDP criteria. Forcing a country to default is clearly unacceptable. The Eurozone's countries are all roped together, and the ECB recognizes that pushing one off the cliff endangers them all. The ECB is the lender of last resort to banks. It has become the lender of last resort to EU governments as well, and Germany as a guarantor of the ECB's balance sheet is now part of this solution.

This is not necessarily bullish for the Euro, although the tail risk of a disorderly collapse has been removed. But it is assuredly bullish for U.S. equities. By far the single biggest question mark hanging over stocks has been Europe, and now the roped-together have stepped away from the cliff. Equities are attractively priced compared with bonds and have been for some time. This may just be the development that nudges investors off the fence.

Dislocure: Author is long diversified equities equivalent to SPY, and is long EUO

Bond Buyers Drive with the Rear-View Mirror

Charles Evans, Federal Reserve Bank of Chicago President, was on CNBC yesterday and nicely illustrated why bond yields could stay low for a considerable time. At times sounding as if he was running in a Democratic primary campaign, Evans commented repeatedly on the pain out there in the economy and the chronic unemployment. Interestingly he maintains that the "natural" rate of unemployment remains at 6% even while the numbers of long-term unemployed remains high. The Pew Research Center recently reported that nearly 32% of those out of work haven't worked for a year – over time leading to an atrophying of skills, reduced employability and ultimately less excess capacity in the labor force as the jobs market moves on. It is no doubt a terrible human tragedy – if only Washington could stumble on the right policies to fix it. But the familiar partisan gridlock remains.

Therefore, since low interest rates are the time-honored solution to economic distress, we face more of the same. It is a recurring irony of recessions that while excessive exuberance and debt generally precede if not cause a slump, much pain is also borne by those whose affairs were managed altogether more prudently. So it is that bond investors today are paying for the sins of their more profligate neighbors through miniscule interest rates that erode the purchasing power of their savings. The over-indebted are helped with a transfer of real wealth from the frugal. Managing your own affairs carefully carries less reward than it might.

A consequence is that dividend yields on a number of blue chip stocks are higher than the yields on their own bonds. This used to be far more common in the early 20th century when bond coupons were regarded much more favorably than uncertain dividends, and you can't rule out that this state of affairs could persist for many months. It maybe even turn out that this yield advantage of stocks is appropriate for the risk, if we endure a period of protracted slow growth or recession that sees no dividend growth. High dividend yields can indicate corporate stress. Transocean's stock (RIG) currently yields 6.4%, but the market recognizes some risk this will be cut, either through continued poor execution by management or following a larger than expected settlement with BP on last year's Macondo spill. On the other hand, Johnson & Johnson (JNJ) stock yields 3.5%, comfortably above its twelve year bond yield of 2.6%. JNJ is not a stressed company and has raised its dividend annually for 49 years. They're likely to earn close to $5 per share this year and consensus expectations are for 5% EPS growth in 2012. There are numerous other examples in this article for instance. Pepsi (PEP) and Kimberly-Clark (KMB) probably belong in the same category – companies whose stock is highly likely to outperform its own debt.

Falling and low bond yields have so far not dulled retail investors' appetite. Strong returns on fixed income in recent years, for those who buy securities because "the chart looks good" reduce their return potential as assuredly as night follows day. The most you can earn on JNJ 6.75% corporate bonds maturing 11/15/2023 and yielding 2.6% is, well, 2.6%. That doesn't even cover inflation, never mind taxes for the eager, momentum-driven buyer. If that return beats stocks over the next ten years it's unlikely that most types of corporate risk (credit or equity) will have been comfortable places to be. Is it possible the buyers are actually expecting still lower yields and therefore some capital appreciation? Ben Bernanke has surely demonstrated that yields can always go lower. But if you like JNJ bonds at 2.6%, surely treasury bills for a couple of years at 0% with the retained option to invest on better terms later on must be a viable alternative? With a modified duration of just under 9, if the yield rose to 2.9% the capital loss would eliminate the coupon income. A portfolio of reliably growing, dividend paying stocks either in combination with a beta-neutral hedge or cash is far more attractive than high-grade bonds.

Disclosure: Author is Long RIG, JNJ, KMB, PEP

Reining in the Rating Agencies

Through the ongoing and mind-numbing complexity of the European sovereign debt crisis, the bureaucrats in Brussels can be relied upon to introduce some absurdity into their deliberations. The latest is a report in the FT that under certain circumstances the EU will suspend the ability of rating agencies to evaluate sovereign credits. Now it's true that markets are generally too reliant on credit ratings issued by S&P, Moody's and Fitch. The basic business model of charging the issuer for the rating is fraught with conflict, as catastrophically revealed during the sub-prime crisis. However, alternative models are hard to identify – increased competition among rating agencies would likely cause a “race to the bottom” in which issuers would flock to those with the most forgiving standards. And charging investors, the actual users of the ratings, is regarded by many as unworkable.

But the downgrade of U.S. debt that occurred in the Summer highlighted the absurdity of the rating agencies evaluating sovereign debt. Unlike a corporate issuer where a detailed financial analysis encompasses most of the necessary work, sovereign credit analysis incorporates a political judgment as well. The U.S. downgrade in the Summer illustrates the rating agencies straying beyond their expertise. U.S. creditworthiness is based to a large degree on a willingness to repay debt, and an opinion on which is as much political as it is financial. The rating agencies have no more insight on the politics than many other informed observers, and as such their opinions ought to be irrelevant except for the fact that so much bond investing is rules-based driven by the ratings that these agencies issue. Many bond investors are required to hold issues with minimum ratings from the three Nationally Recognized Statistical Rating Organizations (NRSROs), otherwise known as S&P, Moody’s and Fitch. But really, since sovereign issuers have the ability to tax, their credit ratings are by nature not simply financial. The ratings frankly shouldn’t carry any more weight than other sell-side research on bonds.

As sensible as it might seem to ditch the legal support for NRSRO-issued sovereign credit ratings, the EU bureaucrats in Brussels have revealed their own muddled thinking in the latest proposal. No doubt France’s impending loss of its AAA rating, a possibility the French regard with horror but which financial markets have already moved past, is the catalyst. The FT reports that under proposed EU regulations ratings will be suspended *during times of financial stress.* So good ratings are fine, but bad ones are not. And presumably the EU's credit experts will anticipate trouble by suspending ratings prior to a downgrade, therefore providing an eloquent and informed signal to investors that perhaps those bonds are not quite as safe as previously thought.

In the U.S. we can be grateful that we don't subsidize such entertaining idiocy with our tax dollars. It must be more frustrating for those sitting in Europe.