THE VIEW FROM PRINCETON

Market Commentary ♦ May 1, 2010

April was delightful; wasn't it? Spring came late, but came broad and strong. The price advances gain in significance by following three successive quarters of more than customary appreciation. Furthermore, the experience affected millions of investors, which renders this to be of much significance in wealth creation and in attitudinal re-creation. The financial markets have become interactively responsive with commercial activity so that, again, each helps the other in supporting optimism and activity. That is the message of April. The financial markets have reached the stage of synergistically interacting with society, forming a base for more. Thus, the market withstood congressional investigation proceedings and an extension of anxieties regarding the creditworthiness of national governments among the smaller nations in the European monetary union.

We accept these stock market signals as being of lasting significance, for these show that the constraints of traumatic experiences in preceding years have continued to dissipate. Now, the inevitable effects of monetary policy have been made apparent. From the standpoint of stock market expectations, it is appropriate to put the (opposite) positive spin on the drag of unemployment, because the extent of unemployment will long incline national monetary policy deliberations toward encouraging the economy. The growth paths underway will take place well in several major sectors, while the financial industry (broadly defined) will be one of the lagging sectors, along with residential construction and automobile manufacturing. These are labor intensive industries, now with chronically high unemployment.

Meanwhile, liquidity is abundant — even still redundant — which acts to prevent the strictures and "slings and arrows" of disapprobation from restraining enterprise growth. With such an adequacy of financial means, expect one of the largest ever incidences of mergers and acquisitions as the months unfold. Acquisitions have been significant in the past year, and previously were major driving forces for stock prices in the latter 1990's, and during the years from 2003 through 2006. Expect these to amount to a major driving force again. The last issue of Business Week shows fifteen large companies in the information industry having cash tills of $316 billion dollars. That is enough to support strategic acquisitions in large volume, and this is only a minority portion of the industrial liquidity that is under the management of corporations whose duties require them to find adequate employ for such cash balances. A very significant portion is likely to be deployed in strategic acquisitions. Combined with this, the cash balances of investors sequestered from the market are still at an extraordinarily large ratio relative to the market valuation of all equity shares.

Circumstances by and large support optimism. Of course, we do not expect the market to continue without setbacks along the way. The SEC and the Congress delivered karate chops across the nose of Goldman Sachs that got the attention of everyone, and contributed to a significant day or so on the down side. After such persistent market advances, quick downbeats are to be expected. Illustratively, one cannot dance for long in the same direction without departing the ballroom floor. So it is with stock markets. Markets must fall back to stay in the game in reasonable ways after large advances.

The native, homespun wisdoms of one of America's athlete-philosophers, Yogi Berra, are fondly remembered and often quoted. Remember: Yogi remarked that, "The future ain't what it used to be." And he is also credited with positing, "You can learn a lot from listening." Such relevant advice was taken too lightly in recent years by the participants in Wall Street. Reliance upon algorithms and regression equations is always backward looking. There is no forward data available that is compiled and fed into a computer. Accordingly, so much of the synthetic instruments that drew their imputed values from price expectations is based on backward looking, and traded on the assumption that the future will be similar to the past. And with so many participants doing the same thing at the same time, an unbalancing vogue developed beyond anything the market has experienced. The unwinding will take longer still, having now entered the sociopolitical phase, and become highly dramatic.

Americans have begun to see TV shows that require attention from the halls of the Congress of the United States. Derivative financial instruments were handled with an extraordinary degree of perception by some senators (and quite the opposite by many others). To cut quickly to the essence, it is fair to say that the values of many of these arcane derivatives are not derived from assets themselves, as so often asserted. Rather, the values are based on the possibility of price changes in the assets that underlay the derivatives. As a standard answer to clients of this firm when they have inquired about participating in street-fabricated synthetic assets, we have asked a simple question, "Have you found one that was put together to serve clients, instead of having been put together to serve the creator of the synthetic instruments?" And usually, their response was, "Oh, I had not thought of that; thank you."

There are many aspects to the Goldman Sachs interrogations televised from the Senate Banking Committee headed by Senator Levin of Michigan. First, see this as part of a very high-profile cannonade to spur the Democratic Party march to the November midterm election. For effectiveness, this is an impressive choice, and has the potential, with sequels, to become a long-run show, competing for both soap-opera and prime-time space. As interrogations unfold, and encourage counter responses, the complicity of the Congress in the development of the financial excesses and debacles of recent years might also be revealed. This would be one of the unintended consequences. Senator Levin displayed diligent preparation regarding the essentials of arcane and occult instruments that are often beyond the comprehension of most professionals as well as uninvolved citizenry. Take his comprehension as evidence of serious intent, much beyond the superficiality of Senator Dodd's feckless censorious proposals.

As these revelations proceed, led by Congress and followed by incessant media coverage, Wall Street might lose large measures of its appropriative profitability. Lets hope change will follow guidelines of architectural design (rather than the lines of jungle warfare) toward ensuring the financial industry returns to a service industry for society, not a casino or rip-off industry as lack of supervision has allowed. In a free society the financial market is the most vital of all markets, which requires it to be balanced, decent, and free. Responsibility and accountability, too often eluded, were once supportively written fully into our national code and thereafter applied by the Securities and Exchange Commission. The precedent casts models for newly invigorated and empowered commissions to address a much changed world.

Very interesting and important change is developing form and force. Do not miss this, do not fight it; let it speak and listen. Banks could be made to become banks again, divesting risk-involved trading and leveraged activities. So-called private entities large enough to have market effects beyond that of immediate daily transactions might well lose their privacy, in the name of transparency. "Let the sun shine in," as a politician might phrase the intent for a non-sophisticated public.

However boisterous or unattractively self-serving this long-run episodic show might become, it will also be in essence a convergence of political motivations with imperative social needs. Accordingly, the long-run prospects seem assured for dénouement after dénouement of the culture of the fruits of greed, owing to American circumstances. Add to this the necessity to involve representatives from governments and financial industries of many nations in this contemporary 24/7 universal market place. As an exaggeration for emphasis sake, this expansive show has the potential for durability to place it as runner-up to "As the World Turns" that was born in the early days of television.

In strategic investing — which is the hallmark of this Firm — investors are encouraged to invest in the future as best it can be perceived, imagined, hoped for, and measured with the test of reality that is derived from relevant information and experience. The world is not (as always) what one might wish it to be, but does indeed seem to offer an uncommon abundance of opportunities drawn from, and supported by, human aspirations, innovations and social adaptabilities. All three are very basic enduring guides in concept that are also highly reliable, if one properly perceives these and has the patience to live with the distilled judgments — all of which could change, thus must be marked to reality on a daily basis.

So, April seems to have been a part of the prologue to a sustained growth phenomena that will gain and gain at a slower than accustomed pace, yet with an abundant complement of investment opportunities.

With all good and friendly wishes,

James Fitzpatrick

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