Market Dynamics

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Performance Management System

"Don't Fight The Fed."

Portfolios heavy with under-performing stocks almost never outperform the market.
Ignat's Law

"It is a basis assumption of this book that the processes of the stock market are more psychological that arithmetical. This produces the well-known tendency of stock prices as a whole to go to extremes in either direction, as optimism or pessimism holds sway."

Security Analysis
by
Graham, Dodd and Cottle

A collection of recent newsletters is available on the web site.

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The advice not to fight the Fed was laid out years ago by Marty Zweig. It has been proven over and over again in the many years I have been in the investment business. FRB monetary policy can often be a primary determinant of the behavior of financial markets

The economic history of the United States is replete with noteworthy examples of fluctuations in liquidity and the money supply and their impact on the economy and the financial markets, especially the stock market. A few recent examples are FRB policy leading up to the crash of 1987 and monetary policy in the aftermath of the '87 crash. Monetary policy during the Peso crisis of late 1994 and the subsequent bullish move in the stock market. The FRB moved decisively during the LTCM crisis of 1998 and the stimulation of the growth of liquidity ahead of the anticipated Y2K problems led to a blow off in the stock market. The withdrawal of that build up of liquidity in 2000 and 2001 probably led in large part to the bear market of 2002.

Liquidity problems began to surface again in early 2007, not so much the result of FRB monetary policy as much as a speculative and overly aggressive expansion of lending to the housing market and lax regulatory oversight of Wall Street and certain Government Sponsored Enterprises. Also the period from 2003 to 2007 was the "heyday" of the lightly regulated hedge fund industry which thrived on the combined strategies of short-term speculation and leverage in everything from securities and derivatives to all types of commodities.

It was not necessary for the FRB to tighten credit to restrain these excesses, natural corrective market forces began to appear in the summer of 2007 and they have become more powerful as the markets moved into 2008. These forces have led to a bear market in stocks, many corporate failures, the demise of at least two GSE's and a severe adjustment in housing prices. This has led to what one writer termed a "revulsion of credit" and severe liquidity problems in the financial system worldwide.

This gets us up to the present time in the evolution of this financial cycle. The most important development in several years has been the decisive move recently by the FRB to aggressively provide liquidity to the financial system. This step-up in monetary ease has occurred during the past two weeks. The FRB seems to have "pulled out all the stops" in its strategy to provide liquidity and stop the credit crunch that has proved to be so damaging to the nation's economy.

This can best be seen by the recent huge jump in bank reserves in the banking system. This jump in liquidity is almost unprecedented. The best source for statistics on the banking system and the money supply can be found at the St. Louis FRB web site at www.stlouisfrb.org—look for publications and select "U.S. Financial Data."

This writer expects the aggressive moves by the FRB to provide liquidity will remove the tightening grip of the credit crunch on the financial system and allow the system to return to a more normal state. Not so coincidentally, the chokehold of the credit crunch on the stock market will be removed and the stock market should enter a more positive trend soon.

It has been my experience that many investors are still transfixed by the bad experiences of the bear market and the more positive outlook provided by these liquidity flows will be widely doubted. This is common at major turning points in the stock market. This is what I call the "rear-view" mirror effect.

A well respected investment research firm reported that as of last week, the percent of investment advisors bullish had fallen to only 33% and the percent bearish had risen to 47%. This is such a lopsided tilt in the bearish direction that any surprise will almost certainly be positive.

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