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The Bates Motel and the Storm Sail Flying

I'm not particularly fond of thriller movies, probably because I still remember so vividly how frightened I was by the "shower scene" in Alfred Hitchcock's famous movie "Psycho" which I saw when I was 18 years old. There was Janet Leigh, enjoying a warm refreshing shower in the Bates Motel, when suddenly Tony Perkins, dressed like his dead mother, rips back the curtain and slashes Janet to death as you watch the blood running down the drain. If you are a fan of thriller movies, you know that the quiet mood and music just prior to the violent scene gives away a sense that something is not quite right and you ready yourself for something dramatic getting ready to happen.

Well, it seems to me that the smoothly rising stock market since the 12 year lows were achieved last March 9th, is a bit like the soothing music and refreshing shower in the Bates Motel. The international economy is under serious stress, unemployment is rising, consumer spending is down dramatically, profits of almost all companies are way down, consumer credit is very hard to get, the real estate market is in the tank, and yet the stock market has been rising almost consistently for over 5 months. This seems clearly suspicious and way out of what one would expect. How can this be??

There are a few clues, however, which may well explain this phenomenon of poor economic and corporate performance and a rising stock market. One big clue is that for the most part, trading volumes on the exchanges has been pretty lack luster and unremarkable. There's an old saying in this business that in market movements, volume equals validity. Basically we are not seeing serious commitments by large institutional investors which would be evident with high and rising trading volumes. Moreover the trading patterns are characteristic of computer program driven trades. The volumes and movements we are seeing pretty much reflect the action of hedge funds and big bank trading desks, which really act like hedge funds (think Goldman Sachs), playing a game of chicken with each other throughout the trading day. Thus what we really have is a trader's market. Traders is a relatively respectable term used in this industry for what otherwise might be called gamblers.

Another important clue is the unusual relationship we are seeing between the exchange rate value of the dollar and the movement in the markets. Ordinarily, when the markets are rising, foreigners want to participate and thus must buy dollars to invest in the U.S. markets. Their actions would normally promote a rising value of the dollar, which is in fact the usual relationship of the dollar to the stock markets. Instead a clear pattern opposite to this has become the rule this summer. Whenever the dollar declines, the market rises. Whenever the dollar firms up a bit, the markets decline. While the markets are up about 50% from their lowest low in March, in the same time, the value of the dollar has dropped over 12%. This means that a dollar today only buys 88 cents worth of the international goods and services it could only five months ago.

Combining these two clues yields a plausible explanation for what has been going on. One of the most popular strategies for hedge funds and bank trading desks is called "the carry trade". Simply stated, the carry trade strategy borrows money in a currency with the lowest possible short term interest rate and invests in assets, such as common stocks and bonds, which have a higher rate of return. The difference, known as the carry, can be very profitable as long as interest rates for the borrowers remain low.

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(1942 -)

For a long time, Japan provided the source of funds for the big carry trades because throughout most of the last two decades, the Bank of Japan has been trying to battle their chronic deflation with very low interest rates. Now, however, our own Federal Reserve Board has lowered short term rates in the U.S. to near zero in their efforts to help make bank lending, which is a form of carry trade for banks, very profitable. In doing so, the Fed hopes the banks will be able to grow their way out of the financial bind they created for themselves with their risky investment practices in the mortgage backed securities markets.

The problem is that for the most part, banks are not lending aggressively into the consumer economy. If you've tried to refinance your mortgage lately, you know what I mean. Instead of flowing into the consumer economy, these funds have been flowing into the securities markets via the carry trade strategies of hedge funds and bank trading desks. As these traders deploy borrowed funds in their strategies, the supply of dollars rises without a comparable increase in real economic output. This leads to a decline in the value of the dollar.

Traders are not long term investors. Their focus is entirely on the short term and they'll flip their strategy in a heart beat. Thus a trader's market is always vulnerable to violent changes in direction should the players ever sense the game is up. So far, Federal Reserve Board Chairman Bernanke has soothed their concerns with assertions that the low interest rate environment will continue for a while longer. Yet with growing Federal budget deficits, higher interest rates most probably lie ahead. When interest rates do rise, the carry trade in dollars will cease to be attractive, securities will be sold to raise cash to pay down the traders' debts and the markets will likely reverse themselves pretty dramatically.

How does this environment affect our investment strategy at Eagle Wealth Management? When the weather is threatening, prudent sailors break out the smaller storm sails. This allows them to make steady progress, although slower than someone with full sails flying, but always in a position to haul down the storm sails quickly if the weather turns violent. In violent conditions, those flying full sails are likely to have their masts torn loose and fall permanently behind. So, acknowledging that the markets are running and storm clouds are evident, we have been adding cautiously to our stock market allocations (our storm sails) to take advantage of the market's direction without being so committed that we can't react prudently should the market make a serious reversal.

Keeping the mast intact is a key to success in sailing and likewise protecting your capital is a key to our strategy in managing your money. Sailors watch the barometer to detect the onset of adverse weather and we'll be watching the dollar/ stock market relationship to detect any dangerous change in the investment environment, too.

Warm Regards

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