Income Builder Weekly

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Road Map Out of the Recession

Forget the past and comparisons with it. Every recession/bubble has a different set of characteristics and a different "way out." That said, there are some sign posts we seek to give us a better sense that we have hit bottom in financial markets.

The 2001-02 recession was shallow and was already well on the way to remediation when the stock market bottomed in July 2002. The situation is quite different now - it's a more typical recession scenario, in that the market began going down long before the economy began tanking and, maybe, it is firming before the economy will be seen to improve. Forget the guesswork - let's get to the sign posts.

Already seen:

- Firming of corporate bonds (up notably from Nov-Dec lows)
- Copper price firming ("Dr. Cu has risen about 50% from the Dec. lows)
- Bank stocks recovering (maybe)
- Baltic Dry Freight Index recovering (on first bounce, good tentative sign)
- Stabilization of leading purchasing manager reports (last 2 months have seen flatness at a low level)
- Consumer discretionary stocks have staged a nice little recovery (foretelling that the U.S. consumer may be loosening up in the months to come?)

Milestones not yet reached:

- Coincident to lagging indicator ratio not positive for 3 months (good sign that upturn is 2-3 months away)
- Stock market only tentatively bottomed (no re-test yet)
- No confirmation of copper price stability
- No solid global stimulus out of the recession (some signs, but that's it)
- Most importantly, the U.S. housing market has not stabilized (though it may be dropping at a slower pace)

Comment and Implications for Your Portfolios

I am keying on the coincident/lagging indicator ratio to give me a solid sign that the recession is turning. But I also realize that markets will anticipate the turn. Thus, I look at the groups leading and lagging in markets. Leading the past month (even into the decline of mid-March) have been the techs and consumer discretionary (as opposed to staples like groceries). Both leading groups are economically sensitive and were early to fall. Company earnings are much more than expanding

revenue. Cost, too, must be considered. And costs have dropped enormously for these industries noted above. But the signs are tentative. We may be seeing an oversold bounce which will fade away like the rallies in April and May and November and December, but maybe not. We are especially keying on bank stocks. They probably bottomed in the March final capitulation-waterfall - maybe.

One thing for sure - don't look at job market figures. Though politically charging, they are a lagging indicator, in that job cuts lag an economic turndown and job additions lag the upturn. That's why I like the coincident (current) vs. lagging (past) indicator ratio. It does not rely on guesstimates of the future; it relies on comparisons of the present with the past, more or less. Our thanks to Dennis Gartman for this indicator. We have not had even one month of improvement. That said, financial markets themselves are leading indicators - looking some 6-9 months out (normally).

In short, there are buds of spring but we have to consult the groundhog of other indicators before we can be highly confident that the worst has passed. Unfortunately, once many people have certainty that the worst has passed, security prices are up 30% from the lows.

It is better to feel a little bit insecure when making a purchase than to feel completely secure. A completely secure person is, for sure, buying something at full value or greater. A mostly secure person (us these days) is still risk-averse and wary, but recognizes opportunity being greater than risk - for the first time in a few months.

Another thing; one can handicap the past with great vision. Handicapping the future, as we must do, is an inexact exercise at best. So how do we deal with insecurity?

One finds greater security at the company level, for we do not buy "The Market." We buy 20 or so securities. If we pay attention to the fundamentals of each security like hawks stalking prey, we will be able to speak about the entire portfolio with more confidence than if we were, say, buying the entire S&P 500. How could we possibly know 500 companies?

Conclusion

We are getting there, but are not quite "there." Maybe there is no "there" there? (Alice B. Toklas on Oakland).

Road Map to Improving Your Account Balances

Our "scalping" program is in full swing. In January we sold some O and PSEC at prices notably (about 20%) higher than they were when we bought them back not long ago. Simply put, by "scalping" (selling some to buy back later at a lower price) we increased your income on that tranche by 20%. We illustrated this point in an earlier bulletin, but we felt that repetition would not hurt.

Being a successful scalper means that we must be able to recognize relative high points and their opposite. We did just that, though PSEC continued about 15% lower before turning up and giving us a 10% profit as of Friday. The important thing is NOT the effect on the balance but the effect on your income. Fortunately, they march together in the scalping process. Thus, over time your account balance will improve even faster than markets will if we do our job right and well. The downside to the approach is more commissions and turnover. For that reason, we are restricting scalping to those accounts for which we've cut volume deals with Fidelity.

Thank you for investing with us.

Jim Pursley

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