EPIC
Investment Management, Inc.

Issue 7 November 2011

Market Sentiments

Is it over yet? Has the bear market -- or was it a sharp correction? -- run its course? We never know until after the fact, as there is no crystal ball. So we look to history and common trading patterns for clues. Yet we also know that every market cycle creates its own unique character. No two downturns are identical.

Still, the evidence suggests that the worst of the downturn, whatever we call it, is over. After dropping 19% from its late April peak, the market has recovered over half its loss. Moreover, the bond market is regaining some sense of normalcy, as investors exit the safe haven of Treasurys and re-commit to quality and high yield corporates. Even the US economy has shown a glimmer of hope, with third quarter GDP growth coming in stronger than expected.

Let's look at the initial question from a different angle. Are there signs the downturn has reached its peak intensity? Is the stock liquidation subsiding? Has the biggest wave of selling run its course?

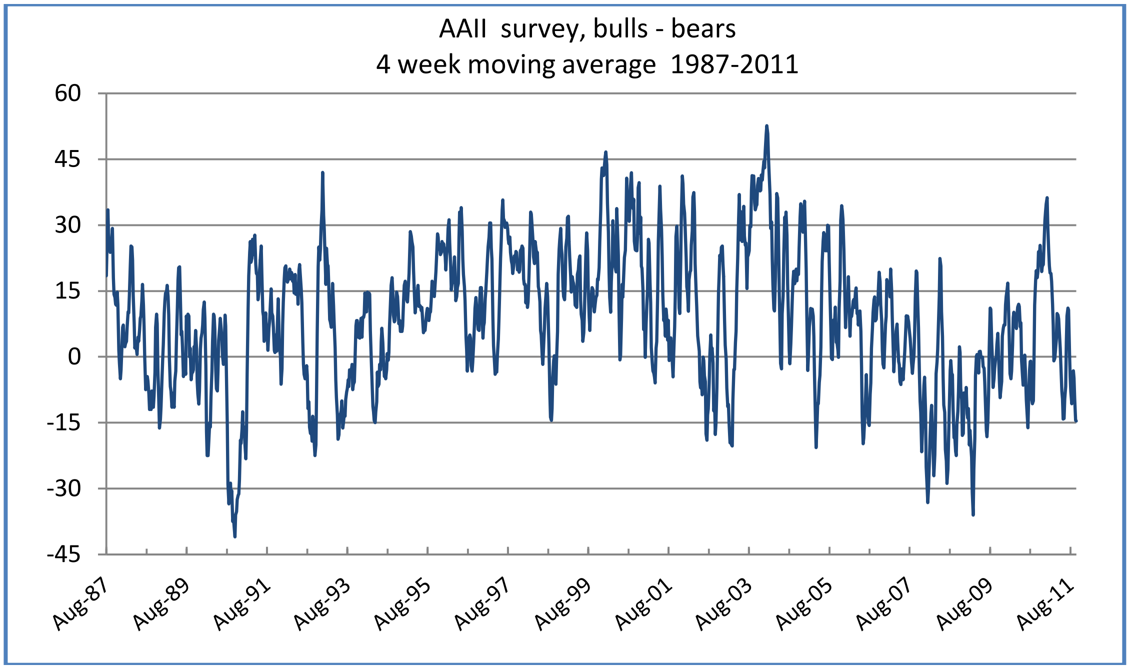
At this point the answer is yes. And if it is finally safe to go back in the water, then investor sentiment will have been our first and strongest clue. Measured objectively, we have rarely seen sentiment at such extremely bearish levels. As a reminder, investor sentiment is taken as a contrarian indicator -- when the masses are bullish, prudent investors should worry about market tops; when bearish moods prevail, we should look for signs of a bottom. And bearish moods have definitely prevailed.

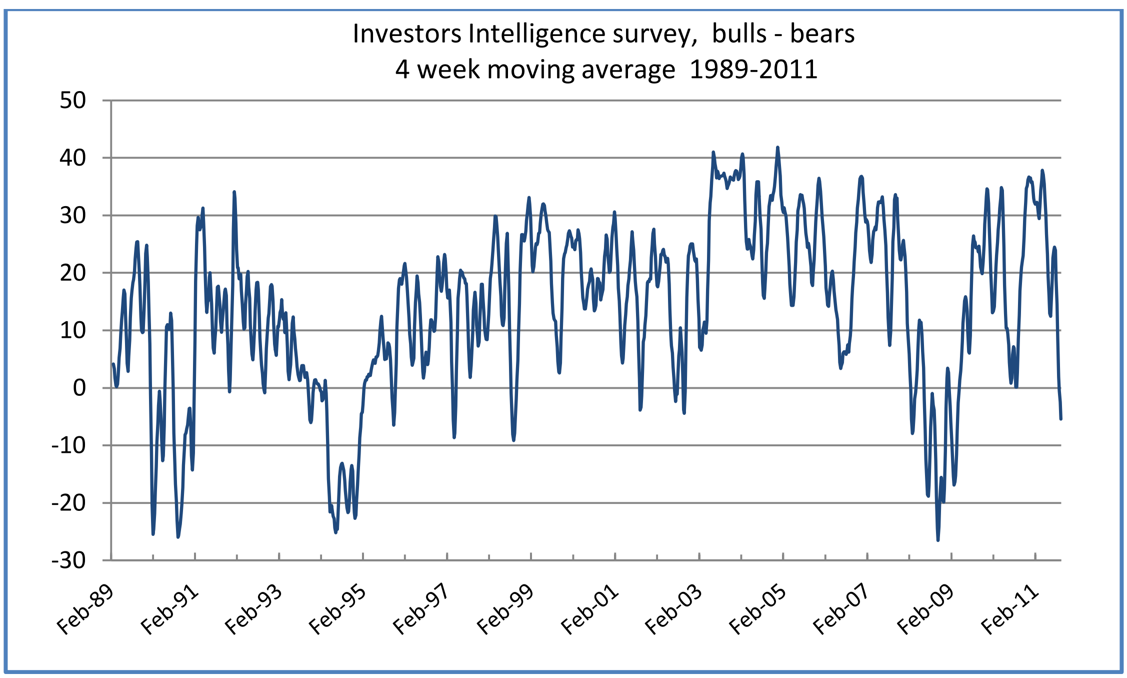
On the following pages we review five sentiment measures we track on a weekly basis. For the most part, the graphs are self-explanatory; yet they are also a bit deceiving. Because of the extreme levels reached in 2008-2009, it appears that sentiment could move substantially lower. The possibility is indisputable. Lightning could strike twice. But we don't count on it.

So we make a secondary calculation, not shown on the charts. In all five cases, we calculate a percentile ranking of recent levels, compared with the entire data series as far back as possible. What we find is that two of the sentiment measures are ranked within ten percent of their historic bottom(or top). In the other three cases, they are ranked within three percent. Sentiment is not at an all-time low, but it is very close.

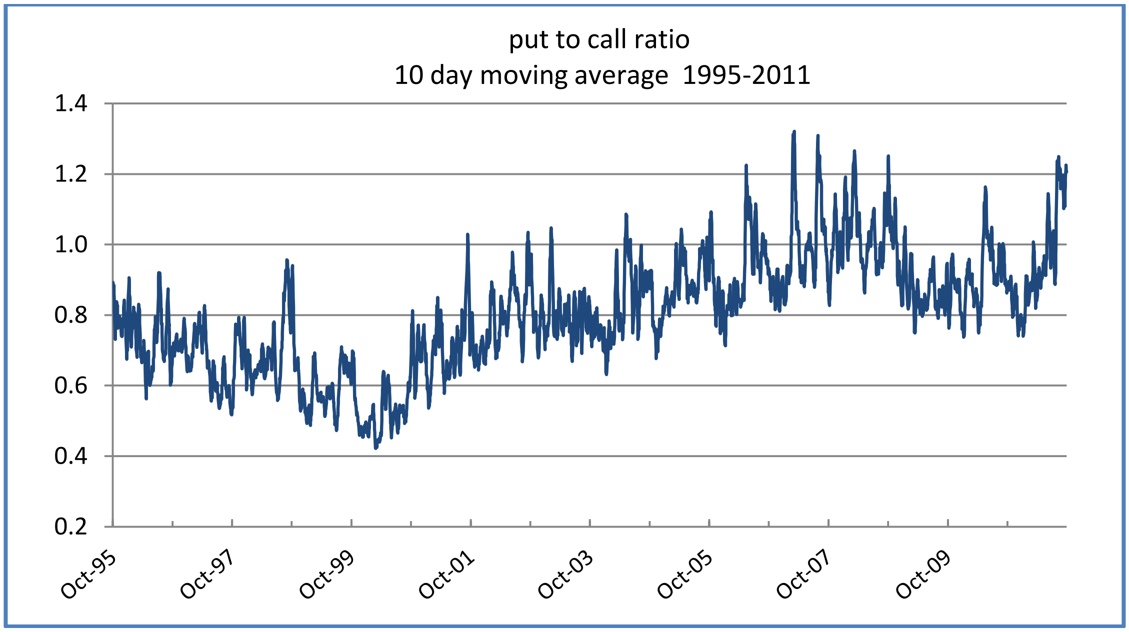
204 37th Avenue North #334   Saint Petersburg, FL 33704
www.EpicInvest.us

The first two sentiment measures are opinion polls -- surveys of individual investors and investment newsletters. These polls typically show more people bullish than bearish, sensible since stocks rise more often than they fall and the net result over time is a strong positive return. Recent surveys, while not at extreme levels reached in the prior bear market, still show a dearth of bulls, and are in the bottom ten percent ranking of historic results.

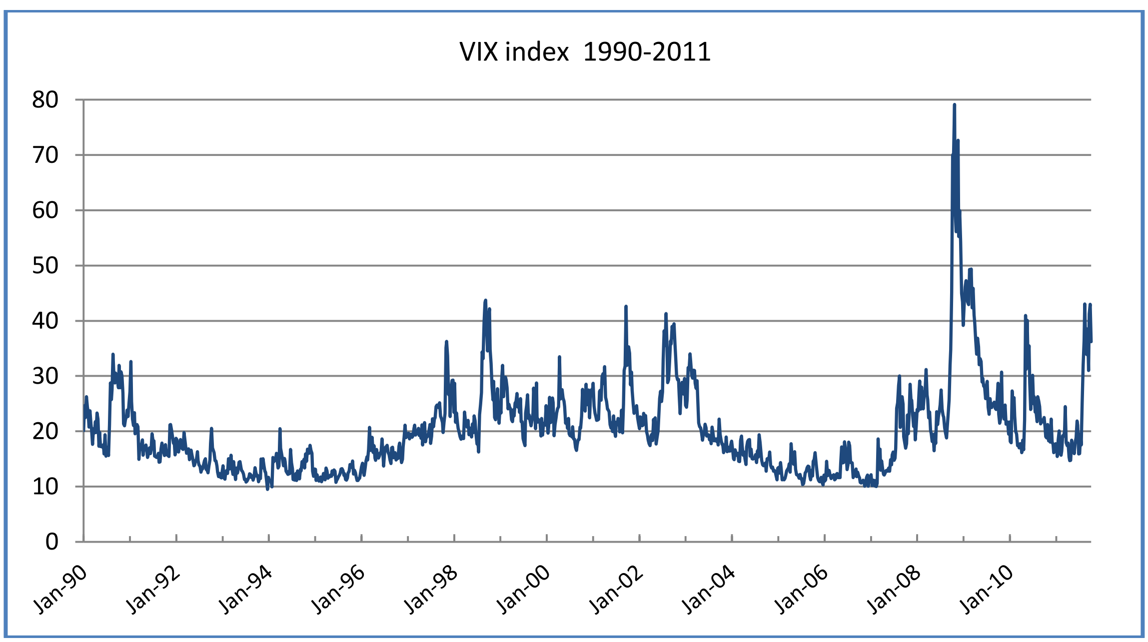




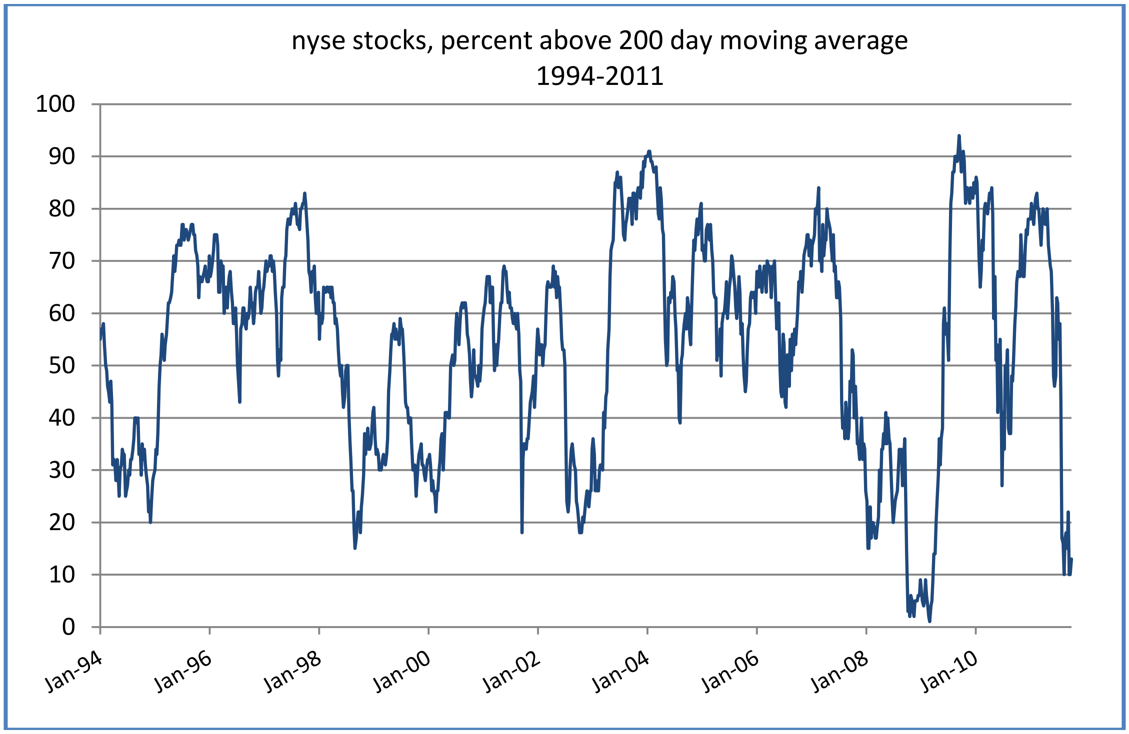
The next three measures are more convincing. First is the put-to-call ratio, a measure of option activity on equities and equity indices. The basic idea is that when investors become bearish, they buy more put options than call options. It's simple enough, and hard to argue with the premise. Heavy put option buying has pushed this ratio to the top one percent ranking in its history.



'The VIX' is shorthand for The Chicago Board Options Exchange Volatility Index, a measure of implied volatility priced into S&P 500 index options. It is not a pure measure of sentiment, but rather of expected market volatility. Nevertheless, it serves to highlight extremes that may indicate panic selling. While the index is nowhere near the outlier levels reached in late 2008, the VIX rose to within the top two percent ranking of historic data.



Our fifth gauge of market sentiment measures the number of stocks trading above their 200-day moving average, and expresses the tally on a percentage basis. In bull markets a majority of stocks trade above their moving averages, reflecting prices moving higher and higher. The reverse occurs in bear markets, as a selling contagion hits all but a few select stocks. This measure reached trough levels only exceeded in one other downturn -- the bear market during the financial crisis of 2008-2009.



When we add it all up, does sentiment tell us the market has bottomed? Market turns are always a tough call, and bold predictions are a fool's game. Sentiment alone does not a bottom make. Yet valuations are also favorable, and the economy may sidestep a recession. That may be as good as it gets for now, and it may be good enough.

Fees, Taxes, and Limited Power of Government

It's Washington. It's supposed to be dysfunctional. But still.
Let's start with some background information. Every time we swipe our debit card to make a purchase, a fee is transferred from the retailer to the bank. This means on some transactions a retailer keeps less money from a debit card purchase than from a credit card purchase; just as both are less efficient than a cash purchase. Simple enough.

Now follow the bouncing ball.
The Financial Reform Act of 2010, commonly known as 'Dodd-Frank', mandated reductions on these bank debit card fees. Basically our government decided the fees were too high, and after careful study, set arbitrary limits. Then things got interesting.

Our nation's largest retail bank, Bank of America, responded to the price cut by announcing a monthly fee on debit card users. Washington, especially the White House, seemed shocked. Apparently their limited acumen fails to grasp that a business facing reduced fees in one hand will try to raise fees in the other. Nor did Washington contemplate the law of unintended consequences -- for one, the consumer getting thrown into a scrum between retailers and banks, and for another, the banking system retrenching further every time its profits get pinched. The upshot is that a transaction system that was not 'broken' was nonetheless 'fixed', creating a chosen set of winners and losers. To calm things, the White House threw a hissy-fit, complaining that one bank of 7,000 cannot simply raise fees, risk customer defections, and earn whatever the market will bear. Really? But price fixing -- if the government is the fixer -- is okay. Really?

In short order, with no major banks following its lead, Bank of America backed down. But the bank still intends to cut 30,000 jobs over the next few years. This is the larger issue. Between 'Dodd-Frank' and the 'Volcker Rule' and jaw-boning from Washington and proposals for a financial transactions tax and a weak economy, the business model of large US banks is under attack. The financial services sector, once a growth engine for the US economy, is now spewing smoke. Smothering it with a wet blanket of government intervention will not make things better, and in the end we will all suffer for it.

Moving right along, the White House also proposed a millionaires surcharge, which seems like another hissy-fit. Details are sketchy, but it's something along the lines of 'tax the rich, feed the poor, til there are no..' well, you know the rest. The latest permutation is that a surtax of roughly five percent will be placed on incomes over $1 million. In which case, expect an abundance of incomes to be reported at $999,999. Really, it is not that difficult.

Across the aisle, candidate Herman Cain is gaining attention with his novel tax idea. His '9-9-9' plan -- a proposal to tax corporate profits at 9%, personal incomes at 9%, and institute a national sales tax at 9% -- is a bold and creative approach to US tax policy. It is perhaps the most innovative idea on tax policy in three decades. Let's give him an 'A' for courage and originality. All without a teleprompter. Imagine that.

Unfortunately the idea is a failure. For starters, the individual tax rate of 9% will inevitably be viewed by much of the nation -- populace and politicos alike -- as far too low. Imagine taxing millionaires at 9%? Not a chance. A single-digit flat rate simply will not fly. It goes against our sense of fairness, and our conditioning for a progressive system. If it were instituted, by year two there would be a movement toward staggered rates, working gradually higher. History is a guide. The US income tax began in 1913 with a top rate of only 7%. By 1917 it was 67%. Over time it reached 94%. Using Mr. Cain's template, the initial teaser rate will quickly be nudged up to low double-digits, the soft ceiling of 9% instead serving as a hard floor, while progressively higher rates will be added on for higher incomes.

Second, and more problematic is the 9% national sales tax. This idea creates two serious problems. First, it will encourage expansion of the underground economy, those people who neither register as legitimate businesses nor collect taxes for any government. When a tax can be avoided simply by leaving a transaction unrecorded, the incentive for underground activity only grows. In short order, measured economic activity will suffer; right along with it will be tax collections. Adjustments will follow -- rates rising across the board, honest Americans paying more than their fair share, subsidizing the tax cheats -- and all the wrong people will benefit.

Moreover, a national sales tax is a potential black hole for our economy. It is not a conservative idea, no matter who proposes it. It empowers the government to collect huge amounts of money, siphoning dollars from the private sector and sending them to Washington. At least with the income tax, we know what we pay and in some sense hold our politicians to answer for it. At the end of the year, who will know what they paid in sales taxes? That is a danger for individuals, and for the overall economy. In time, the 9% tax rate will be raised to mid-teens levels. Meanwhile, consumer spending will stagnate; after all, it is a tax on consumption. In the end, we will not be substituting one tax system for another. We would just layer on another form of taxation, a heavy layer at that. 'Feed the Beast' may be a political philosophy, but it is not a viable economic policy.

Speaking of viable economic policy, the economic crisis and lingering hardships have caused far too much confusion about the role of government in our economy. Social policy is a separate issue -- we should provide Welfare, Medicare, Medicaid and other social services. But these are social policies, not economic policies. When it comes to economics, government power is extremely limited, more so than most people imagine.

What can government do? It can create jobs. Really. We can hire half the people to dig ditches in the morning, the other half to fill them in the evening. This can go on forever. Don't like getting your hands dirty? We can use idle factories to build small explosives, transport them to the coasts, load them in bombers and drop them in the ocean, far from harm's way. Wasteful you say? We could drop them on people, buildings, villages. The major difference is that there would be fewer people, buildings and villages, and most of the world would hate us. Ridiculous? Try this one: Let's rip up roads and sidewalks, replace them with roads and sidewalks, and call it a 'shovel ready' infrastructure project.

The Brooklyn Bridge was a real infrastructure project. So too the Golden Gate Bridge and Hoover Dam. Harnessing the power of a raging river is infrastructure. Facilitating the movement of people, goods, and increasingly of information, is also infrastructure. Digging holes for the sake of filling them with dirt, concrete or asphalt is not. But it does create jobs.

Second, government can create money. All it needs is a printing press, ink and paper. In fact, in the modern world, it can be done at the press of a button. Just as we pay our bills from a computer, sending electronic signals across the country, so too the government can 'print' money.

Again, this can go on forever. Of course the more money we print, the less valuable it becomes. Just ask 1920s Germany or 2000s Zimbabwe. Fiat currency is only worth what people believe it is worth, one reason that gold has outlasted any fiat paper currency by millennia.

So if government can create jobs, and government can create money, what is the problem?

The problem is, government cannot create wealth. All government can do is transfer wealth from one group to another via taxes, borrowing and spending. Individuals create wealth, and no, it is not a fixed pie. Wealth transfer is a fixed pie, wealth creation is a growing pie. When it comes to economics -- the allocation of scarce resources and creation of wealth -- government should recognize its limitations, set a few ground rules, and get out of the way.

Sources:
Bloomberg
Tax Foundation

Tidbits..

IMF cuts global GDP growth forecast to 4% for 2011, 2012.
Still moving in the wrong direction, and 4% sounds pretty high right now.

After 2 years and 14 summits, European leaders reach shaky agreement on credit crisis remedy.
Catastrophe avoided until.. well, don't blink.

White House proposes new jobs/spending/tax plan, version 4.0?
'Insanity: doing the same thing over and over again and expecting different results.'

US poverty rate at highest level since 1993.
Middle class incomes, inflation-adjusted, fall to 1996 levels.
In bifurcated economy, the US is losing its middle class muscle.

2011 Restaurant Bankruptcies: Friendly Ice Cream, Sbarro, Real Mex Restaurants.
Further fallout from middle class retrenchment.

US justice department opposes wireless industry mega merger of AT&T and T-Mobile.
Once in a while, the government gets it right.

Federal Reserve begins 'operation twist', targets lower yields on long-maturity debt.
Moving financial markets, but not so the job market.

'Re-shoring' -- the return of manufacturing jobs to US soil -- enters lexicon.
Let's see if it works out better than 'hope and change'.

Boeing delivers first 787 Dreamliner, three years and billions of dollars behind schedule.
Better late than never, or was never the wiser choice?

M&A activity awakens:
United Technologies to acquire Goodrich for $18 billion.
Google to purchase Motorola Mobility for $13 billion.
Kinder Morgan to purchase El Paso Corp. for $35 billion.

US economy grows at 2.5% rate in third quarter, best pace in a year.
Hard to believe given all the dire headlines.

MF Global Holdings, Wall Street broker and commodities trader, collapses into bankruptcy.
The perils of mixing hubris with leverage.

Heads roll:
Hewlett Packard ousts CEO Leo Apotheker after only 11 months, names former eBay chief Meg Whitman as successor.
UBS replaces CEO Oswald Gruebel after revealing rogue trader lost firm $2.3 billion.
Yahoo dumps CEO Carol Bartz after.. well, it's Yahoo, they don't need a reason to be dysfunctional.