

## **The Other Side of the Street April 26, 2009**

### **Overview Comments**

Hi all,

I am trying this new format, which is designed to both pass on short and long term thoughts as well as observations on the various markets. I will also pass along my trading interest as several of you have money with me and I want you to have a brief update on the general ideas we are utilizing. I think it also might be interesting for those of you who believe in the efficient markets theory to see how those who don't try to play the game (and I do believe it is all very much a game).

### **Macro Thoughts**

There continues to be growing optimism that “the bottom is in.” This is being derived largely from a deceleration in the collapse of the various economies. The simple response is that economic activity was not going to zero. It is absurd to extrapolate anything other than that we are experiencing a temporary leveling. Whether this is sustainable for more than a few months is unknowable. I think there remain many reasons to believe that the intermediate future will hold much more heartache.

### **Topics of interest**

#### **The Stress Tests**

The stress tests are meaningless. They are a public relations gimmick that may backfire in a huge way.

#### **Flaws:**

- The arbitrary “worst case scenario”, in particular the employment numbers. Since the test was conceived the unemployment trend has been worse than the “worst case scenario”.
- Further to utilize a national unemployment number is not meaningful. It is my understanding the purpose was to determine what the credit losses would be at a certain unemployment number and that the methodology relied on some historical averages. Problems with this are: (i) there is not an average unemployed person – there is a huge difference in credit risk between a clerical worker with a couple thousand in credit card debt and an investment banker with a couple of million in debt; (ii) regional differences are huge – the national unemployment number (the national average) could include 2% unemployment in Texas and 18% in California

## **Extrapolation**

I just read an article about how the dollar was a winner no matter what happens. The writer cited the recent buying appetite by foreigners for US assets as a “safe haven”. The argument reminds me very much of the “real estate will always go up” because it has in the recent past. Things work until they don’t. The fact that until now foreigners have continued to buy US debt does not mean they will indefinitely. I find it difficult to believe that we will see a continued “flight to safety” in a country running huge deficits and printing money at a frenzied pace.

## **Who is the felon?**

Did Ken Lewis commit perjury when he testified that Paulsen and Bernanke had pressured him into not revealing the extent of Merrill problems to his BAC shareholders before the merger? Since he was in fact testified he committed securities fraud I doubt it. If he was telling the truth then why aren’t Bernanke and Paulsen going to be charged with securities violations for suppressing clearly relevant information in a merger?

Keep in mind that the multitudes continue to “trust” the government will fix our problems. Looks like there are many suckers born every minute IMO.

## **Reasons this rally will not be the beginning of the new bull**

The largest buyers of stock in the 2003-7 rally were companies themselves. The “lever up/buy back equity to boost EPS” was in vogue. Alas it is no more. Companies are hoarding cash. When they stop hoarding cash it will be to reinvest in inventory and business, not the company stock. Instead look for many companies to be selling stock as prices rise so as to delever. Then think about supply and demand – When the companies were buyers it increased demand and reduced supply. Now just the opposite will be occurring. This is particularly true of the poorly capitalized banks that are all the rage. Should BAC go up higher, you can rest assured BAC will be making secondary offerings in a large amount.

The markets have run up 20+% and many garbage stocks are up hundreds of percent. The idea that this makes now a great buying opportunity is lost on me. (and yes I am familiar that buying great companies as they reach 52 week highs is a sound way to invest – this does not apply to markets as a whole nor does it apply to fundamentally weak stocks that have huge overhead but have become the short squeeze flavor of the week.

## **Fiscal Policy – government spending will support the markets loss of the private sector**

This is what kept Japan out of a massive depression. While I am not certain of politics in that country, I am in this. The Republicans who disgracefully overspent the last 8 years are certain to trot out the old “Dems are Tax and spend” mantra if only to energize their base. Since I believe it unlikely that any government policies will keep us from a long recession, it is likely that the 2010 elections will come at a time where massive government spending had failed to improve the economy. Thus however meritorious the arguments that massive stimulative fiscal policy is needed, I think that the voting public will revolt and the Republicans will take back at

least some of their 2008 and 2006 losses and that this will make simulative fiscal policy much more difficult. (This idea is “work in progress” at my end, but I intend to share thoughts herein as they develop and the fiscal policy of this country will be one of the most critical investment issues of the next many years).

## Wild Cards

### The Swine flu public health emergency

I don't know nearly enough about such things, but know that the Asian flu problems in 2003 had a severe economic impact on Hong Kong. At a minimum, I would think this impacts airlines and hotels with significant exposure to Mexico. Should this blossom into something significant (a remote chance based on prior experience – think “bird flu nonpandemic”) it would come at a very poor time for the “green shoots” of recovery.

## Markets

### Equity

We continue to march higher now up for 7 weeks (the slight drop in the Dow and SP500 was entirely due to the Monday sell off and the overall tenor remains to buy buy buy). We are continuing to see the dregs run up huge daily percentages. This strikes me very much as shorts getting squeezed. There is no reason to believe that banks such as COF have risen in fundamental value by 150% in the last several weeks. To the contrary the “earnings” are manufactured and their outlook remains dismal. Thus fundamentals are irrelevant as long as the mob pushes the shorts. There is also a growing wave of bulls. So . . . I suspect that within the next two weeks we will be seeing an elevator drop down. This week is end of month mark up and the first day of the month tends to be an up day. Thus lots of reasons why this week ends up. However, I will be looking for large gap up opens to fade and will be looking for blow off tops in certain banks (this is when the last of the mob pushes stocks furiously higher until the last idiot is in and the stock then finds itself a Willie Coyote when the cloud clears and he sees nothing but a few thousand feet of air between himself and the canyon floor (note I do not think we are due for a collapse. Instead I think we are due for a sharp sell-off that will be bought – this is lightening in and out trading).

Down the line retailers are looking like really fat shorts. They have been a big benefactor of the latest “second half recovery” idea.

### Credit

The TBT moved up as the markets seem to be moving away from fears the Fed can hold down rates. I still think there is a limit to upside in the short term. It also pays to be cautious ahead of the Fed meeting as they are sure to come out with more aggressive quantitative saying statements.

## Gold and Silver

Gold has been trading without correlation to much of anything and thus IMO is now trading very much on a technical basis. If that is correct, gold is nicely set up for a run higher and there are specific catalysts this week in the Fed meeting (last time they came out with a “we are buying Treasuries and further expanding our balance sheet gold jumped about 5% immediately) and the China agenda re “reserve currencies”.

## Trading

### Past week

We went into the week without much short interest. During the week we attempted to short the banks at various points and repeatedly had to take small losses. The banks in general are ridiculously valued. They became even more so! We also had modest positions in gold and silver and sold covered calls against all of it. This also was a bad move as both appear to have found legs.

### Upcoming week

We enter the week without much short interest but with substantial margin buying power. Based on the GLD chart and the upcoming Fed meeting, I will begin taking long gold futures positions on Sunday night and long call options spreads on the GLD on Monday. If I am right we should make a move up to say \$950 on the spot price, which will set up a future run through \$1,000.

We will continue to look for signs of a top in the COF, BAC, MAC, WFC nonsense. At this point, what I would like to see is a strong gap up one day on the open after a big up day the day before. May well be that we stay away from the banks, but there is such a huge reward if this can be hit right that high risk can be warranted.

We will continue to look at post earnings run ups. I think there is money to be made shorting AXP after its huge run, but that is timing. I think there are intra-day opportunities in AMZN on the short side.

I will look to see if there is a sharp sell off on the TBT when the Fed announces its info on Wednesday. If it happens I will be a buyer.

It may also be time to look at favorites ALGT and JRCC.