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Mid-year review

July is here and we thought it appropriate to take a retrospective look at what transpired thus far in 2010. We use the January 2010 forecast issue (Volume 2 Issue 1) to assess where we are in our predictions. The January forecast issue affirmed that 2009 was the year of the "head fake". The head fake metaphor comes from the sports world to describe a deceptive action on the part of a player. In basketball, a player with the ball darts or leans their head in one direction hoping to deceive the player defending. The player with the ball hopes that by leaning their head in one direction, it causes the defender to move in that same direction. The player with the ball then moves in the opposite direction having "faked out" the defender. The ball handler leaves the defender behind. Good defenders, however, are taught to focus on the other player's core. The head can do all it wants but ultimately it is the core of the body which determines the player's ultimate movement.

Investors have to be defenders too. During the credit bubble, investors lost their way. It seemed as if no matter where the player with the ball was going, investors where always going in the right direction. Stocks went up, investors followed. Real estate went up, investors followed. Then came 2008 and the start of the credit implosion. Down came stock prices, poof went real estate. Investors suffered for sure but then 2009 arrived and so did the "green shoots". Investors were "faked out" by their government and by a powerful bear market rally in stocks.

The government head fake emerged when they decided to guarantee most mortgages originating in the U.S. The federal government tried hard to levitate the residential real estate market while the market itself was heading in a different direction. Homeowners sopped up federal guarantees and tax credits.

The federal government itself is one large head fake. They give the great appearance of health when their own financial condition is abysmal. This has not deterred investors from chasing government debt.

The stock market bulls came charging back with a ferocity unseen in quite some time. After hitting an abyss of pessimism, the market made a significant low in March 2009 and roared strongly for the rest of that year and the first four months of 2010. Investors fell for the "head fake" by not recognizing the move for what it was, a strong bear market rally.

The most worrisome head fake occurred in the banking industry. Some banking institutions in the United States deemed "too big to fail" received lavish gifts from Uncle Sam. Then we had relaxed accounting rules, demanded by government, giving banks the appearance of health without properly recognizing the losses in their portfolios, hence the term zombie bank. The core of banking remains unhealthy. Investors certainly have not paid attention to this.

Investors have been paying attention to the defender moving the head and they ignored the core. The core of most investing today is rotten but the players are looking at a different part of the body.

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