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Investment Strategy

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Don`t Worry About the Dollar!

Back in the mid-1970s, when I was just a "pup" in this business, I went to one of my mentors and said, "Lucien, it looks to me as if the dollar is going to go down. Should I be worried about stocks if that happens?" Lucien Hooper, sitting behind his desk, lowered *The Wall Street Journal* just enough so that I could see his eyes and said, "Don't worry about the declining dollar because stocks will go up enough to offset it!" Sure enough, the 28% decline in the U.S. dollar was offset by a 30% rise in the S&P 500. And that appears to be what is happening again as the U.S. Dollar Index broke to new reaction "lows" the first part of last week (basis the December Future) and stocks rallied. Worth mentioning is that despite the media's "beating of the dollar like a rented mule," the Dollar Index still resides above the "lows" made back in the spring and summer of 2008.

Nevertheless, the dollar's weakness has clearly been very positive for our "stuff stocks" (precious/base-metals, agriculture, energy, cement, timber, etc.), as well as stocks in general, and we have been bullish. Most recently, we have suggested, "that with credit spreads below their pre-Lehman bankruptcy levels there should be no reason why the equity markets can't 'fill up' the downside vacuum created in the charts by said bankruptcy, as can be seen in the following charts. That gives the S&P 500 an upside target of 1200 – 1250" (we include those charts again this morning). One admittedly very bright Canada-based strategist, however, took exception to my statement in last week's *Barron's* magazine. The only problem was, he got my quote wrong. As reprised:

"Picking up on a pronouncement by a chief investment officer of an investment firm that 'we're still at levels that are lower than we were before Lehman Brothers [went belly-up]. We're vastly better off than we were then." After stating a bunch of economic statistics that are worse now than back then he concluded, "If this is 'vastly better off,' (I) shudder to think what 'worst off' would look like."

Now, I don't mind ANYONE disagreeing with me. That's what makes a market. But, at least get the quote right! I said nothing about the economy and certainly didn't suggest that the environment is "vastly better now than it was then." The word "vastly" is particularly disturbing to me because it was never used, which caused one savvy seer to remark, "Why should you be upset by a strategist that completely missed the March lows and has hence been bearish all the way up?!" Of course, while people that live in "glass houses" (like me) should never "throw stones," if that strategist wants to debate the economy I offer the following.

To begin, clearly all is not well with the economy. Yet, statistics on industrial production, jobless claims, leading indicators, Philly Fed reports, etc. all show that the signs of recovery remain in place. In many cases, however, select pundits focus on the idea that some of the numbers are not as strong as expected. While that may be true, we are far more interested in the underlying trends. For example, industrial production bottomed about a year ago and has been positive for the past seven months. Meanwhile, jobless claims topped out last spring and have been trending lower ever since. Moreover, the recent Philly Fed number showed the strongest reading since the recession began; and, it showed that inventories continued to shrink. With inventories plumbing record lows there is little doubt corporate America will begin to replenish them.

Indeed, John Chambers, the CEO of Cisco, recently remarked, "The numbers are indicating that we are in the early, initial phase of a recovery – with the U.S. leading the way. The number for U.S. enterprise orders was dramatic. I think we are entering a period very similar to 1997 to 2004 where you will see a decade run of productivity increases." In past missives we have stated that this recession was an anomaly since it was the first time productivity soared. Clearly, that productivity "hop" was because corporate America cut costs dramatically. Since corporate revenues were hampered by unemployment, a reticent consumer, limited bank lending, etc. companies turned to the only thing under their control, cost cutting. The result caused productivity to catapult. Therefore, any pick-up in final demand falls straight to the profit line of corporate America. As our friends at the sagacious GaveKal organization note:

> "Steve explains why labor productivity is the most important cyclical variant to profitability-more so than the recent drop in the cost of capital. Indeed, the surge in labor productivity (+330% since its March low), reduces capital needs at corporations. This in turn helps explain both why cashflow as a percentage of GDP is so high, and why the economy has managed to return to positive growth even as credit continues to contract. Moreover, this reality should offer some comfort to those worried that increased government borrowing will crowd out the private sector, and adds credence to the rally in the equities this year. We think profits and

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cashflows should continue to exceed expectations, which is very bullish for the US market, especially relative to economies that are not keeping pace with productivity gains (e.g., Europe and Japan)."

Plainly, productivity gains have driven this year's explosion in corporate profits. In 3Q09 corporate profits surged 10.6% quarter-over-quarter (Q/Q), or at nearly a 50% Q/Q annual rate. More importantly, corporate profits have increased at a 28.6% annual rate over the last three quarters. As repeatedly stated, corporate profits drive an inventory re-building cycle, which leads to capital expenditures that causes corporations to hire people. Once employment gains kick in, consumption rises. That's the way it has always played and that's the way we think it plays this time.

As for the stock market, clearly the *causa proxima* for "Friday's Fade" (-154 DJIA) was Dubai's default. Yet, that should have come as no surprise since the handwriting was on the wall back in 2006 when 24% of the world's construction cranes were operating in Dubai. If that's not the sign of a bubble I don't know what is. Moreover, last year, and most of this year, there were numerous stories telegraphing the pending economic collapse as Dubai's airport became repeatedly clogged with abandoned cars left behind by debt-ridden, laid-off foreign workers who were fleeing the country to escape Dubai's "debtors' prison." No, in my opinion the Dubai debacle is the result of the fallout from the previous bubble and not the start of another round of emerging markets' systemic crisis. Spurred by Friday's news, I went back and studied the three sovereign defaults that initially came to mind when I heard about Dubai. They were the Mexican default of 1982, the Russian default of 1998, and the Argentina default of 2001. Following those defaults the worst decline in the S&P 500 was 8.5%.

The call for this week: Friday's Dubai-induced selling was exaggerated by the limited audience so that sellers sold into a vacuum. Consequently, it will be interesting to see what happens the first part of this week when "The Street" returns from its extended holiday. Still, the shortened session turned out to be a 90% Downside Day. Such days are typically followed by a three- to seven-session "throwback rally" and then participants can determine if there is more to come on the downside. Yet as the keen Lowry's services writes, "Over Lowry's 76 year history, no major market top has formed without being preceded by at least several months of rising Selling Pressure. But, currently, Selling Pressure has been recording new lows in a downtrend dating from the Index's peak in March. Therefore, absent a sustained rise in Selling Pressure, the probabilities are against the formation of a major top and favor the continuation of the primary trend higher." That said, the divergences we have cited for the past month continue to mount. Most notable has been the lagging performance of the previously market-leading small/mid-cap stocks in favor of the large caps. This is what typically happens after a "run" like we have seen because portfolio managers don't want to "bet" their jobs, which they are not when playing the large cap universe. Over the past few months we have suggested that portfolios be tilted toward large caps for this reason. We also continue to favor special situations like 5.8%-yielding, Outperform-rated Spectra Energy (SEP/$27.69).

P.S. We are traveling again this week, so these will likely be the last strategy comments of the week.

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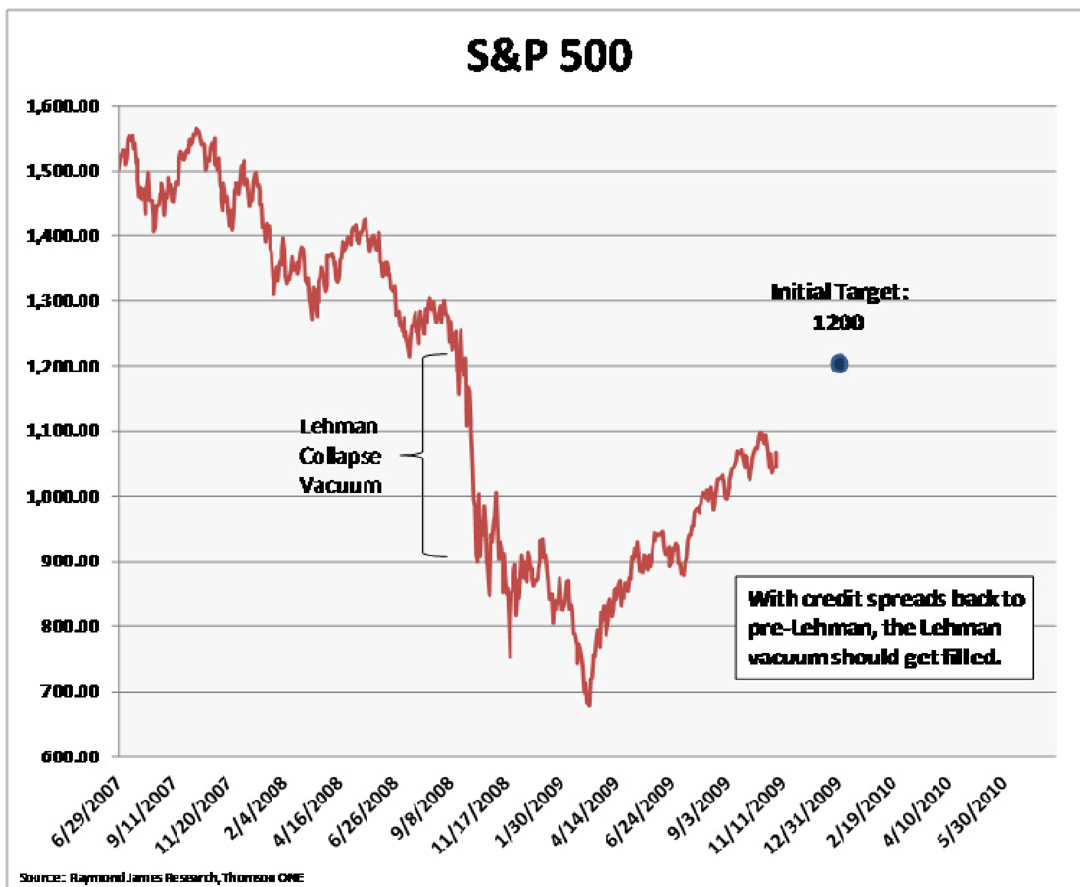

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