

Lowly Analyst Newsletter

Volume 7, Issue 5, May 2007. Free Newsletter
CurtFey.com

In this issue:

The Economy and the Markets Market Bubbles

The Economy and the Markets

Below are the changes in expenditures by age. This is not the inflation of the items. This is the amount of money that is spent. It is influenced by fall of income with age. 2005: '55-'64 \$64,156; '65-'74 \$45,202; 75+ 28,552. It shows that expenditures increase faster than inflation. I plan with expenditure rates.

Annual Change in Expenditures by age 1999-2005

	55-64	65-74	75+
Food	2.4%	2.0%	2.5%
Housing	2.6%	2.9%	1.7%
Apparel & Services	0.8%	1.3%	-1.8%
Transportation	2.2%	2.1%	1.8%
Healthcare	3.7%	3.8%	3.6%
Insurance	4.1%	4.3%	4.5%
Medical Services	1.8%	1.2%	5.0%
Drugs	7.6%	5.3%	3.5%
Medical Supplies	-1.0%	1.3%	2.0%
Recreation	1.3%	3.1%	1.9%
Total Expenditures	3.9%	3.9%	4.4%
Consumer Price Index	2.6%	2.6%	2.6%

Source: Bureau of Labor Statistics.

Asset Classes: For the 6 months up mid value 13 %, mid growth 11%. small value 10%, large value 10%, large growth 9%, micro 9%.

Sectors: For the 6 months, Real Estate up 21%, Basic Matrl.16%, Consumer Srv. 14%, Telecom 14%, Transportation 13%, Networking 13%, Industrials 11%, Tech. 11%, Utilities 10%, Software 10%, Gold 10%,.Financial 8%, Biotech.5%, Healthcare 3%, Energy 3%, Commodities 0%.

Foreign Investing: For the past 6 months Malaysia up35%, China 26%, Singapore 23%, Mexico 21%, Brazil 20%, Poland 18% Russia 17%, Latin America 17%, Denmark 17%, So. Africa 15%,China %, Indonesia 15%, Emerging Mrkts. 14%, Sweden 14%, Austria 14%, Germany 13%, Spain 12%, Taiwan 12%, Hungary14%, Australia 12%, Hong Kong 11%, Pacific Rim 11%, India 11%, Israel 10%, Czech Rep.10 %, Developed Mkts. 8%,Europe 8%, Canada 8%. Japan 6%, Britain 5%.

Market Bubbles

1. Introduction

The four most expensive words in the English Language are "This times it's different". Human nature is not changing. Humans are not completely rational. (To be discussed in the next newsletter). Markets are not always efficient.

Since the beginning of human history we had speculation with booms and busts. These cycles follow the same pattern: Development of new Technology, availability of inexpensive funds, expansion of credit, diminishing of government control, rampant speculation, media report only prices not valuation measures, crash. We will look at the history of market bubbles and see what we can learn from it.

2. History

The Latin word *speculare* applies to a sentry who must look out for trouble. Rome in the second century B.C. had flourishing markets. The law allowed the transfer of property and the lending of money at interest. Rome had stock markets. Stock ownership was widespread. Prices fluctuated. There was speculation in property and commodities. Currency crises were frequent.

The 17th century Tulip mania and collapse is well known. Speculation is facilitated by free markets it remains an activity of clever professionals and of fools.

2. Economists View.

Speculators have finally achieved respectability. Economic text books hold that speculators fulfill an essential function, they make markets efficient. Allan Greenspan, former Federal Reserve Chairman said "The willingness to take risk is essential to the growth of a free market...If all savers and their financial intermediaries invested only in risk-free assets, the potential for business would never be realized."

Unfortunately it is usually the small investor who is holding the bag.

3. Technology Stocks

When new technology appears it is impossible to predict which firm will be successful. Historically

Investors only made average returns. A good book is Alasdair Nairn, Engines that move markets. Technology Investing from Railroads to the internet and beyond.

4. The Panic of 1907

From 1900 the automobile and the oil industries developed. At one time there were 600 automobile manufacturers. Trusts, huge combination of labor and capital were established preventing effective competition by individuals. Control of wealth went to a few hands. It ended with the downfall of an attempt to combine a chain of banks, cooper interests and other enterprises and the collapse of New York's Knickerbocker Trust Company.

5. Internet bubble

By the end of 1994 price/earnings and discount rates reached a low. Republicans took control of congress 1st time in 40 yrs., enacted tax cuts. Centrist Clinton lifted Government restrictions. In 1994 the Internet came to the public's attention with the public advent of the Mosaic Web browser and the nascent World Wide Web. The dot-com model was inherently flawed: a vast number of companies all had the same business plan of monopolizing their respective sectors through network effects, and it was clear that even if the plan was sound, there could only be at most one network-effects winner in each sector, and therefore that most companies with this business plan would fail. Founders made a fortunes, workers lost jobs. People left their job to day trade. Economy prospered. The press was uncritical. By early 2000 the Fed had increased interest rates 6 times. Markets topped in March 2000, the decline may have been triggered by courts declaring Microsoft a monopoly. Market bottomed in 2002.

6. Today's Situation

We are still in a bull market. Speculation is rampant and has achieved respectability. Trend following, renamed momentum investing, dominates. Currency trading endangers the stability of world financial systems. Derivative speculation increases. Economists claim that derivatives stabilize financial markets but they could create global havoc if something goes wrong. Option trading is surging. The collapse of Long Term Capital in 1987 shows that liquidity is not available when it is most needed. As a

result a severe market decline could trigger bank failures. The media display price histories only. Measures of valuation cannot be found. Capital is plentiful, taxes and government restriction are low, borrowing is rampant, credit defaults increase, labor power is weak, money gets concentrated in fewer hands. There are now over 9,000 hedge funds, more than the number of mutual funds.

Volatility of markets is still low but increasing. It is very important to controls risk. As long as the volatility stays low investing in stocks should be rewarded. But this bull market will end sometime.

7. Lessons from the past.

- a. Business cycles have not disappeared. markets boom and bust. Valuations always return to traditional values.
- b. Returns from investments increase with risk. High returns have high risk.
- c. Insiders usually make the highest returns.
- d. Technology companies become profitable primarily if they become monopolies.
- e. Investing in the early stages of technology is a loser's game.
- f. From 1802-2002 stock market real returns (after inflation) were 6.7%, standard deviation (risk) 17.5%. From 1802-2002 long term government bond real returns (after inflation) were 3.5%, Standard deviation (risk) 8.8%. (Siegel)
- g. There have been six major stock market peaks in the last 100 years 1906, 1919, 1929, 1937, 2000.
- h. Most bull markets start from extreme undervaluation.
- i. The drop from the peaks is usually about 40%.
- j. Average returns after the market drop were higher than average, they were never negative.
- k. US Stocks outperformed US Government Long term Government bonds 60% for 1yr. 65% for 2 yr., 74% for 5yr. 82% for 10 yrs. 96% for 20yrs., 100 % for 30yrs.
- l. US Long term price-earning ratio of stocks is 19. (Siegel).
- m. US Long term Government Bond coupon rate is 4.7%(Siegel).
- n. Valuation measures and yields must be considered for investing.
- o. No one can identify peaks and bottoms.