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Dow Breaks Out to Record High

Tuesday, October 3, 2006, after many attempts, the Dow Jones Industrial average broke out to its all time high. While the thirty stocks of the Dow made a statement, the S&P and NASDAQ lag. To understand this dichotomy of a record high Dow, and a lagging S&P and NASDAQ, we need to go back a few years.

When the market crashed in 2000-2002, it was no ordinary crash. Not only was it steep, the NASDAQ lost 78%, the S&P lost 49%, and the Dow 38%, it was also the longest decline since the great depression. Of the three indices, the Dow had gone up the least, fell the least, and therefore had less ground to recover. Actually the increase in the Dow was primarily limited to about eight stocks in the Dow index. From the market trough on October 9, 2002, the S&P has climbed 72%, but is still 13% below its previous peak. The NASDAQ is still down a stunning 55%. It has taken four years for the Dow to recover the losses resulting from the end of the "Goldilocks" economy. In fact the S&P trades at the same level that it did in 1999. One wonders if the NASDAQ will ever recover its high water mark. In the meantime the economy has grown substantially. These facts demonstrate the long standing effects of the crash of 2000.

While the Dow is at new highs, the bond market is showing skepticism, and predicting a slowing economy. The yield curve has been flat to inverted since the beginning of the year. Every inversion in the past 35 years has been followed by a recession within one year. Obviously, both the Dow and the bond market cannot be right. One can understand my caution. Can the Dow hold onto its gains, or does the bond market have it wrong?

(Factoid: The word "weak" was used 50 times in the September Federal Reserve "beige book" a roundup of regional economic reports, up from 40 in July, according to Merrill Lynch. "Weak" was used 53 times in January 2001, two months before the last recession began. WSJ 9/30/06)

The recent quarter was one of unusual turbulence. The quarter results actually began on May 9 when the market broke after Chairman Bernanke's comments to Maria Bartiromo over lunch. (See last quarter's letter) In May, Fed speakers were on the rubber chicken circuit talking up inflation and talking about raising interest rates.

A war in the Middle East punctuated the volatility. As the war subsided, tensions eased, and commodity prices, particularly oil and gas took a sharp fall and a slowing economy became more obvious. In previous letters I mentioned the world's central bankers were in a high stakes game with OPEC to slow the world's economy and therefore the demand for oil. Not surprisingly the central bankers won.

Oil prices plunged 13% in the quarter. Quarterly GDP numbers showed a decline to a growth rate of 2.6%, with the bond market predicting further slowing. Recent Institute for Supply Management numbers show weakness, while sales at Wal-Mart also show weakness.

During the quarter we repositioned our portfolios to respond to the new realities and outlook. There is always a delay in repositioning at such inflection points in the market and we suffered accordingly. We sold stocks, many of which had been good gainers for us. Most of the stocks we sold are lower today than when we sold them. For a time we were heavily invested in cash waiting for the outlook to clarify and to cushion the portfolios from further falls. While we were conservatively in cash, the market began its ascent, and we were left behind for a while. We also bought consumer staples to cushion us from a downturn, and they failed to participate in the run-up. We bought stocks such as Walgreens, and CVS, only to see them drop sharply as Wal-Mart announced new pricing plans. Healthcare also was surprisingly weak during the quarter. As the market turned up, our conservative portfolio held us back. But we thought it was prudent in light of the market outlook to remain cautious.

October is traditionally one of the weakest months for the market. Who can forget that the depression started in October 1929, or that the Dow had its biggest one day drop since the Great Depression, down 22.6%, on October 19, 1987.

We have now repositioned the portfolio for a downturn, but not a hard landing. We are emphasizing consumer staples, financial and health care stocks. We think these sectors will provide us the best cushion over the next six months. We of course maintain a diversified portfolio of other positions.

While we remain cautious, our outlook is not as pessimistic as a few months ago. Interest rates will probably remain stable over the next few months; we do see the next rate move as a downward move. The price of oil is well off its peak. Tensions in the Middle East are not as high as they were. Still we are cautious right now, and we may underperform the benchmarks as a result.

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