

EPIC ADVISORS, LLC

Weekly Market Commentary

May 6, 2008

Sean Hannon, CFA, CFP

Life is complex. From the moment we awaken each morning, a never ending cycle of decisions appears. For most people, preparing for work, getting children off to school and enduring a morning commute offer increased stress levels. By the time their workday begins, stress has become elevated, fatigue encroaches and then we realize our day has just begun. To combat this repeating cycle, we simplify. Taking mental short cuts that allow our choices to become easier and our stress level lower, we can better cope with life's complexities.

The average person's morning rush serves as a microcosm of the financial markets. When considering how international trade and monetary policy will affect the economy and markets, most people look for simple answers to complex problems. While deciding to eat the same cereal each morning may simplify our daily lives, the financial markets do not provide the same ease. As investors, mental laziness leads to quick, sudden losses.

So how does one cope with the myriad complexities an investor faces? Over the years, I have seen that Wall Street tends to accept some information while rejecting other. This filter creates an environment where certain data does not matter. However, it will matter in the future. Within this shift is where a forward thinking investor can profit from pending market change.

As an example, consider the price of oil. Five years ago, oil traded near \$30/barrel. Today, oil trades above \$120/barrel. During this price increase, various forecasters described how the price was disconnected from market fundamentals and would eventually return to prior levels. It never did. The next approach was to stress how higher oil costs would lead to inflation and constrict the economy. While oil continued marching higher, these economic bears abandoned their viewpoint and adopted a stance that increasing oil prices would not matter. But will they?

When we consider the role that oil plays in our economy, escalating prices will eventually have a negative effect. Rising energy cost directly impact all people who drive to work and heat their homes. Further, energy is a key component in chemicals and plastics. As input and transportation costs rise on goods we purchase, financial stress quickly spreads. With a tank of gas costing almost \$80, we have less disposable income and flexibility. Since the consumer represents the majority of economic growth, it is clear the shrinking disposable income will translate to shrinking economic growth. As always, the true question is when this shift occurs. Eventually the high cost of oil will matter.

Picking these turning points is always difficult. After all, rising oil prices leading to constrained economic growth is a rational, straight-forward argument. However, anyone investing on this thesis has done poorly. As oil has increased 4-fold over the last five years, we have not seen the direct impact one

EPIC ADVISORS, LLC

Weekly Market Commentary

May 6, 2008

Sean Hannon, CFA, CFP

would expect. Does this mean the thesis is incorrect or that the market has not realized economic reality? Unfortunately, the definitive answer will be provided after the profit opportunity has passed.

The tendency of markets to act independent of visible facts leads some to believe that the market knows best. Since many profit seeking investors spend their time and money attempting to determine the proper price of an asset, many people believe this collective wisdom offers the best prediction of the future. In the current environment, bulls are seizing on the market's discounting ability to determine that the future will be better and prices are going higher. After all, the signs of economic malaise are clear. Housing remains weak, credit remains tight and inflation pressure remain high. The Federal Reserve (Fed) has indicated that they are finished reducing interest rate and that the next move in interest rates will be higher. Banks continue to report massive credit losses that will continue into 2009 and actively seek expensive, dilutive capital. The consumer is showing signs of fatigue as higher commodity costs reduce disposable income and the employment picture remains unsettled. Despite all these facts, the markets push higher.

Recognizing that the short-term trend of this market is higher, we must ask ourselves if the collective wisdom of the market has seen through a shallow recession, a brief bear market and is now ready to head higher. While the argument is possible, I do not find it plausible. As the past has taught us, markets can discount the future, but they can also disconnect from reality.

Over the past twenty years, the US economy has morphed into a system that relies upon debt to fuel consumption. During the past five years, easy credit was the jet fuel that allowed our economy to recover from the tech bear market. However, the credit crunch has altered the landscape. Prior credit cycles were characterized by an environment where counterparties were uncertain if they would be paid. If broker A sold you a stock, he expects to receive cash in return. If that cash is not delivered, broker A will be reluctant to offer his service to you in the future. This counterparty risk has always been addressed by the Fed pouring money into the banking system. The arranged buyout of Bear Stearns is an excellent example of how a compliant Fed will help prevent a counterpart default from rattling the system.

Unfortunately, the current credit crisis is much different. During the housing boom, banks made many loans that would have been deemed too risky in the past. By requiring lower down payments and providing teaser interest rates, housing becomes affordable to a group who had been locked out of the market. The result was higher demand leading to higher housing prices. Banks felt the virtuous cycle of home price appreciation could continue indefinitely and therefore relaxed underwriting standards. As

EPIC ADVISORS, LLC

Weekly Market Commentary

May 6, 2008

Sean Hannon, CFA, CFP

the culture of securitization took hold, banks made poor loans, sold them to an outside party and then created more bad loans. As these loans turned bad, banks are left with large losses, depleted capital base and less willingness to extend new loans. The lack of new lending will make it difficult for consumers to increase their spending. Lack of new spending will ultimately yield lower economic growth.

Given these mixed signals from a market believing the worst is behind us and economic environment that remains fragile, who do we believe? As mentioned earlier, the battle between the market and the economy will eventually resolve itself with a definitive action. Until then, we must invest in an uncertain environment and profit accordingly.

Over the short-term, the trend is higher. The markets have bounced sharply from the lows recorded in early March with the Dow Jones Industrial Average (DJIA) rallying 10% in two months. Normally, I would consider such a move as a sure signal that we have come too far too fast and need to pause. However, my timing model is 69% long (a relatively neutral reading) and other sentiment indicators do not show the markets to be overbought. While this does not guarantee we move higher, it shows that a fair amount of strength remains. Further, the markets have begun to ignore bad news and move higher on good news. The ability to selectively filter news flow is another sign that the next move may be higher.

Given the ability to head higher over the coming weeks, investors need to be disciplined. Shorting stocks into a market pushing higher can eventually turn profitable, but may increase volatility and test your emotions over shorter periods. Similarly, chasing a rally by buying stocks you are not willing to own for long periods increases the chance for loss if markets reverse. Therefore, the best approach is to maintain your investing style, gain more exposure to the market to benefit from strength, yet own a portfolio of solid companies who you would be willing to hold through an uncertain economic future. Simplification may work in our normal lives, but financial markets require we pay acute attention to all details.