The Infliction Point Is Here

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Guest Comment by Larry Grossman, Certified Financial Planner, managing director of Sovereign International Asset Management Inc. and a member of the Sovereign Society Council of Experts.

Dear A-Letter Reader:

The US stock market is at an infliction point. "Infliction" is defined as the act or process of imposing something unpleasant.

I have seen this several times in my 20 plus years in the business. This week the Dow hit a 4-year high. On Nov. 29, 2005 it closed at 10,889 and yesterday it closed at 11,091. In between it's been a highly volatile up and down ride.

The Bulls want you to believe the world is rosy. "Gentle Ben" Bernanke, the new Fed Chairman, gives them great hope he can orchestrate a perfect soft landing. They seem convinced Ben will know exactly when to pull the plug on rising interest rates. The Bulls say high-energy prices are an anomaly and really don't mean anything. They claim inflationary pressures are caused by those high-energy prices. A tight labor market and high commodity prices will work themselves out of the system with no problem, we're told. And miraculously, the real estate market is going to have a soft correction; there really was no bubble -- and if there is, it won't pop, just hiss a little. Oh, and here's my favorite one; ignore the historic inverted yield curve that normally foreshadows a recession; "It's different this time."

Now, I don't know about you dear reader, but whenever I hear someone say "It's different this time," I start feeling a bit ill.

If we really want to figure out where the economy is going, (and I argue this is the most important thing to know when it comes to your investment portfolio), then we must figure out which economic indicators really can "foretell the future". The problem is, by the time government and the market recognize a recession has begun, the damage to your portfolio already will be done.

Look at the facts. Consumer spending has driven our economy in large part. And where are consumers going to get the money to continue this pattern? Credit cards have doubled their required minimum payments, and interest rates have risen on adjustable rate mortgages and home equity loans. The personal savings rate actually went negative in 2005 for the first time since 1933 in the Great Depression! How much longer do you think that can continue? And if you really dissect the numbers, fixed costs as a share of family income are actually higher today than they were in previous decades. When you combine higher energy costs with less cash to spend and a negative savings rate, you inevitably have consumers with less discretionary income to spend. It's that simple.

Yet here we are with a market at a 4-year high. How do you explain that?

Plain and simple; not everyone reads the tea leaves the same way and so the mantra is "It's different this time." Honestly, the last time I heard this was in 2000 -- right before the tech bubble burst. I had just written an article called "The Internet Bubble Goes Pop" which was scoffed at by some but followed by the lucky few.

Don't get me wrong. I am not predicting a crash, just the potential for a very difficult year. I won't be surprised to see the market end lower this year than where we are today. I could be wrong, (have been before), but if I am, it will only be in my timing and not in the outcome.

So if you buy my assessment, what do you do?

Look to the sectors that perform well in a Bear Market and an economic downturn. Look overseas where stock markets have performed much better than in the US and are likely to continue to outperform the US for the foreseeable future. And even though we have had a strong move in precious metals and commodities, you should buy these sectors whenever they experience pullbacks.

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