ELF Capital Management, LLC
(Endowment Like Fund Management)

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Did the Market's Sentiment Experience a Perfect Storm?

Nothing gets one's attention more than political debates and plunging stock markets. And, lately, these activities seem to be more than coincidental events. In fact, one might even begin to think that they have become strange bedfellows.

In recent weeks we've seen equity prices decline by more than 10% and the logic is that fear and uncertainty has the momentum of a freight train. As I began to pen this letter, I watched the Dow Jones Industrial Average plunge more than 500 points in response to Standard & Poor's downgrade of the U.S.'s credit rating from AAA to AA+ and putting it on negative credit watch. This has led to a downgrade of many credit ratings of other entities linked to the full faith and credit of the U.S.

Investors dislike uncertainty and often react prior to sorting out what it all means. This type of reaction can make us feel like we are approaching immediate disaster or the opposite, that we are approaching nirvana. The current scenario is more a sentiment of leaning towards disaster; whereas. "market-bubbles" are often associated with sentiment leaning towards nirvana. Market pundits call this re-pricing risk in the markets – even though risk is often a moving target. If sentiment weren't such a fickle variable, it would be a more reliable indicator of what's to come.

With investing, it is important to remember that market prices rise or fall based solely upon supply and demand – all other reasons only serve to represent why supply or demand should act in a certain way. Any other reason only represents clues to potential opportunities. Prices go up because there are more buyers than sellers (stronger demand) and prices go down when there are more sellers than buyers (greater supply). Clues (rational reasons) and sentiment (not always rational) are the components that drive supply and demand.

Currently, sentiment is in a poor state resulting from a number of factors:

- Uncertainty over fears that European Sovereign Debt Crisis that has spread to Italy and Spain. Investors feel that political efforts are falling short in bringing about a sustainable resolution to the governmental debt challenges over there.
- Recent economic indicators in the U.S. have indicated a slower growth trajectory. Revised GDP numbers reflect that the Great Recession was greater than estimated and that the subsequent recovery has been slower than anticipated.
- Political debate, fear inducing rhetoric and a sub-optimal compromise over extending the U.S. Debt Limit has added to unhappiness.
- The most recent unprecedented downgrade of the U.S.'s pristine credit rating has been the latest blow to confidence.
- And a fear of reliving the 2008 Great Recession exists.

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When sentiment becomes extreme, history has shown that, more often than not contrarians have garnered greater rewards than the crowd. The question remains whether the "perfect storm" of unsettling factors above is warranted by the reactions of the crowd or whether the risks have been over-priced to the downside. This month's article will offer some thoughts on this "perfect storm" and how you might go about assessing the potential damage.

The Landscape Before the Storm

When we ended the first quarter of this year, we witnessed investors returning to the U.S. markets and exiting from emerging market stocks – the U.S. markets looked like the more attractive home in a "shabby neighborhood". The U.S. Central Bank's was weaning off their latest effort to stimulate growth in the economy – the now famous QE2 experiment. QE2 accelerated inflation in emerging Asian and Latin American countries – the by product of a declining U.S. Dollar. As a result, central bankers in the rest of the world responded by tightening their monetary policy in an effort to stem the inflation the U.S. was exporting.

In the last 12 to 18 months, equity market confidence was high but took intermittent drubbings due to mounting debt problems in the Euro-zone. The affectionate PIIGS acronym was coined to highlight the challenges of Portugal, Ireland, Italy, Greece and Spain. In the summer of 2010, U.S. stock markets fell when bond investors – the so called "bond vigilantes" – began to boycott Greek debt. After the April 2010 stock market highs, the U.S. markets fell more than 15% as a result of the fear that a Greek debt default would be the first "domino" to fall and cause another global financial crisis. Despite their unification challenges, Euro-zone central bankers and government officials crafted some short-term solutions as they continued to negotiate the evolution of their union and stock markets moved to new highs by the end of the year.

On an economic front, U.S. large company profits grew more than 18% by the end of June on a year over year basis. On the whole, other economies around the world were showing growth as well. If not for global supply disruptions from the earthquake disaster in Japan last March, it is believed that growth in the U.S. and around the world would have been more robust.

The Perfect Storm

In June of 2000, Warner Brothers release the film, "The Perfect Storm" which dramatized how an unusually intense storm pattern caught a group of New England fishermen unaware and put them in mortal danger. From the film's storyline: "In October 1991, a confluence of weather conditions combined to form a killer storm in the North Atlantic. Caught in the storm was the sword-fishing boat Andrea Gail."

In this article's sense, a perfect storm is the confluence of the above events that drastically aggravated the situation. This market's "perfect storm" came together as follows:

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Signs of the storm began to form in May of this year when exceedingly painful inflationary forces led to lower demand and a sharp reversal in commodity prices which spooked the equity markets. Then markets delivered a 4 day sell-off until government data came out that showed employers adding 244,000 jobs in April. For the next 5 weeks, markets drifted lower through a series of ups and downs before moving sharply lower at the beginning of June. The Greek debt drama resurfaced, the U.S. manufacturing index shrank roughly 10%, home prices slipped more than 5%, and gas prices at $4 pushed consumer confidence to a 6-month low. By the beginning of July, progress on a Greek debt solution and a smattering of encouraging economic news created the best one week stock market rally in the last 2 years and within a handful of days from month's end U.S. markets were just short of 2011's stock market highs. In the background, however, political debate had begun regarding the issue of placing conditions on raising the U.S. debt ceiling.

These events just set the stage for what was to come…

In the last days of July, storm forces began coming together. In Washington, political wrangling and rhetoric spawned fear and anxiety. The public considered what pain our politicians would inflict on us as a consequence of promoting their ideological desires. This prompted the ratings agencies to put the U.S. credit rating on negative credit-watch for an unprecedented downgrade. Then, on the last Friday of the month, the U.S. Commerce Department released revised GDP numbers that were significantly lower than what was previously released. By the last trading day of July, stock markets slid more than 4% posting the worst week in a year.

Just as Washington's fear factor ended with a resolution to raise the debt ceiling and effectively "kick the can down the road" to the next election period, the next shoe dropped. Bond vigilantes fled from government debt issued by Italy and Spain sparking greater fears of a debt contagion emanating from Europe. And, by the end of the first week of August, Standard & Poor's lowered the credit rating of the U.S. one notch to AA+.

In the last 16 days, this confluence of events pushed U.S. stock market indices into negative territory, erasing any gains for 2011. The Dow Jones Industrial Average dropped 15%; the S&P 500 dropped almost 17% and the Russell 2000 dropped more than 22% before bouncing off their end of day lows.

Assessing the Damage

The U.S. downgrade: First let me explain S&P's letter ratings. Their investment grade ratings range from AAA to BBB-. Of the multiple notches, the U.S. still garners among the highest level of the investment grade ratings. Not perfect, but near perfect. The downgrade was a warning to Washington to get its fiscal situation in order and on a more sustainable trend. Anyone who's run a business or a household knows that living beyond one's means is not a sustainable path. The U.S. is in the early stages of investor impatience and has time to straighten things out. Again, it was a warning. The most interesting observation in the aftermath of the downgrade was that there was more

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significant demand for U.S. Treasury securities after the downgrade than before. This was a vote of confidence that the U.S. will get it's fiscal house in order whether we accomplish this with the current set of elected officials or with a more effective set of them come the 2012 elections.

The U.S. revised GDP numbers: The fear of a new economic recession may prove to be nothing more than a temporary slowing of growth. Inflation itself was a sufficient enough threat and the perfect storm knocked back commodity prices so much that inflation should begin to fall as a result. At the same time, QE2 was driving inflation globally and that program ended as of June 30th. More importantly, despite the downward revisions of historical GDP measures, corporate profits for S&P 500 companies in the first half of 2011 – more accurately measured, I might add – were up 18% in the second quarter from the year earlier period. Retail sales were up strongly in July. Lower commodity prices and improving supply chain activity coming from Japan could serve to improve margins further for U.S. companies. Add to this that the U.S. Federal Reserve Bank remains highly accommodating and an upwardly sloping yield curve are strong tailwinds rather than headwinds. Job creation remains a sore point and the last reported numbers were better than expected.

If I had to pick, I'd prefer slow growth over fast as I believe slower growth creates greater stability and jobs over the long term. For many businesses, it is easier to plan expansions in a more stable environment than it is when the landscape changes rapidly.

Problems in Europe: If you've ever studied "game theory", you know that when players are faced with two or more suboptimal choices, they will opt for the path that results in the least pain. To date, Europe's leaders have kept their fear mongering to a far less level than what we've gotten from Washington and, at the end of the day, they will take whatever steps are necessary to stabilize the situation while they continue to push for fiscal reforms. Also, the Euro-zone has been impacted by inflation similarly to the U.S. and lower commodity prices will provide relief to their economies as well.

Washington spawning fear: The heated debt ceiling debate has ended with a resolution that should take us into the next election. Hopefully that reduces opportunities for the inflammatory rhetoric to continue. If not, the 2012 election season is right around the corner and we'll see which of the two ideologies appeals to the broad majority.

Sentiment: Despite the well known adage that "the markets can stay irrational longer than one may be able to remain solvent", sentiment only goes so far. Sooner or later, the economics of "Main Street" provide the markets with the rational realities that need to be considered and investors follow. The U.S. financial system is far stronger than it was before the Great Recession; households are on the mend and spending more prudently.

If we learned anything from the Great Recession, it should be that the effects of fear caused greater damage than the circumstances we were fearful about. Fear caused a great many to completely hoard cash and stop spending which harmed almost every sector of our economy. As a result, more jobs were lost than should have been and the fears became self-fulfilling. I hope we learned that lesson.

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As for the markets, I may exert a great deal of effort keeping abreast of current events looking for economic "clues" but don't know everything. Nevertheless, I am more optimistic than the market sentiment is reflecting right now.

ELF's Outlook and Performance

Given this month's commentary, I've more than covered my thoughts about the economy and the markets. So, let me move into strategy…

We went into this latest correction holding more than 55% cash which stemmed from a concern over the end of QE2 and how the markets were reacting to the Greek debt challenges. This decision was made before Washington took center stage arguing about the debt ceiling. That intuition served us well. When the markets began to sell off wildly, we revved up our GARP and asset allocation models and assembled a buying list.

In the last three weeks, we took a contrarian role and nibbled into the downturn. At this time our average cash levels across client portfolios is 15%. We are overweight US markets in large and small capitalization stocks with exposures in Asian and Latin American emerging markets. Technology is our favored sector and have added positions in energy and industrial sectors as well.

Our portfolio clients ended the month of July down 1.65%. Here are some comparative numbers for you to review:

	Jul 2011	3 Month	Y-T-D	1 Year
ELF's ETF Strategy (net)	-1.65%	-5.11%	2.80%	2.46%
S&P 500	-2.15%	-5.23%	2.75%	17.31%
Russell 2000	-3.67%	-7.89%	1.71%	22.45%
MSCI EAFE Index	-1.65%	-6.55%	1.30%	13.89%
MSCI All County World	-1.73%	-5.89%	1.59%	15.93%

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