KAVAR Canvas

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In-VIX-ible

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The following exchange is excerpted from a 1997 episode of the popular sit-com, Seinfeld. The episode is entitled, "The Slicer":

Elaine (Played by Julia Louis-Dreyfus) regarding her interest in borrowing a deli-meat slicer owned by her friend Kramer (played by Michael Richards): *Ooh...how about that; it worked! Wow, can I borrow that thing for a while?*

Kramer: *Oh no, I don't think so.*

Elaine: *Why not?*

Kramer: *Well, you're not checked out on it. There's a lot you need to know. It is a very complicated apparatus.*

Elaine: *What do I have to know?*

Kramer: *Well, where the meat goes?*

Elaine: *Right there. (Elaine points to the proper place)*

Kramer: *Where do you turn it on?*

Elaine: *Right there (Elaine again points to the proper place).*

Kramer (incredulous): *But……where does the meat go?*[1]

There are those that relate any and all aspects of life to a particular Seinfeld episode, (I happen to be one such person), but what, you have got to be thinking, relevance does the above exchange have to do with the typical topical subject matter of an investment newsletter? I'd suggest a great deal. Think for a second of the meat slicer as the "market", of Kramer as "conventional wisdom" and Elaine as the "persistent investor"- unfailingly focused on facts to guide her toward her ultimate objectives.

Consider that prevailing conventional wisdom suggests that the current complexity of capital markets should augur for extreme levels of investor anxiety, measured empirically by the interest in purchasing portfolio protection. Such protection should be popping in price as problems are pondered and people part company with the prospects for prosperity (more on that last point in a minute).

However, as reflected in the visceral VIX Index, volatility and the price of portfolio protection is actually pretty low. (See chart below—*source: Bloomberg*)

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The VIX Index shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market risk and is often referred to as the "investor fear gauge".[2]

So why would volatility be low? At the start of 2012, our team at Kavar Capital identified as a central theme an impending move higher in volatility, yet, to this point, it has been absent. With the well-worn worry walls of the Eurozone, the forthcoming fiscal cliff and an economic growth rate reduction in China, (the world's largest resource-sucking sovereign), how could volatility be anything besides elevated?

This leaves me to wonder: Does the conventional wisdom often increase opaqueness that serves only to obscure investor's focus on achieving objectives? And has the market, in its infinite discounting deftness already digested the prospective sources of solicitude?

Much as Elaine is not deterred in her desire to partake of Kramer's prized possession, so too, perhaps, have insolent investors incorporated issues imperative to their initiative of owning investments aligned with their ambitions - distractions be damned!

Let's consider some of the key concerns crystallized by the conventional wisdom, shall we? Please understand that this is in no way an attempt to minimize the issues or marginalize their consequences, but more to test the theory as to the foregone fears embedded in investor attitudes.

1. The range of prospective outcomes in the triumvirate of trouble, (the aforementioned worry-wall climbers), has narrowed, not broadened and has been adequately baked into the cake of current prices.

Regarding the European Union (EU): Greece, as we are all well aware, may secede from the EU. Were this to happen, the European banks that lent money to the Greek government, by purchasing their bonds, would face severe balance sheet pressure – enough so as to jeopardize their solvency and longevity. Because the European Central Bank (ECB) does not have the authority to lend money directly to sovereign credits (government borrowers) they do so only through European banking conduits. Given how globally intertwined the banking system has become, all counterparties to these European banks have exposure to potential collateral damage. The aggregation of these terms: solvency, collateral damage and counterparty risk, conjure up heaps of bad memories of the US credit market collapse of 4 years ago, leading conventional wisdom to assume the pattern may repeat. This outcome would be unequivocally undesirable. However, the preparation for this possibility is now in its third year, providing some contingencies to contain any contagion.

Regarding the fiscal cliff: Please raise your hand if you are one of the 17%[3] of Americans that approve of the job being done by our sitting Congress. OK, good. Now raise your other hand if you think we'll have all of the tax policy and debt ceiling debates discharged before the Presidential election in November. Anyone still able to tap his or her fingers on the table, anyone……or everyone? The truth is, we have become a country of status quo accepters. But not only in the defeatist and victimized sense – not at all – more in the adaptability and realigning sense. A recent study cited the ineffectuality of office holders on the perseverance and prosperity of capital markets[4]. Yes, in spite of the prevailing toxic legislative environment, economic advancement will endure. Undoubtedly, our government can serve as a tailwind or headwind in profit-seeking pursuits, but it is incapable of permanently impairing them. The market knows and accepts this, discounting much of its destabilizing drama.

Regarding a slowdown in China: Mandarin Mania may be moderating and rightfully so. No economy can outrun its natural cycle and China is no exception. Over the last decade and a half, China has admirably balanced the expectations of a developed economy with the aspirations of an emerging one. In the process, the US has benefitted from China's demands for our natural resources, its low cost manufacturing base and thankfully its obscene appetite for our government bonds. While China's central bank has begun relaxing monetary policy to attempt to stem any further tide in spending, natural suspicions arise

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across borders as to the effectiveness of any synthetic stoking. China's economy is slowing I'm afraid (oh how we'd like to swap stats with them in this regard – their 8.1% GDP rate[5] is weakening while the US GDP rate of 1.5% is stabilizing! [5]) and the market knows that as well. Perhaps the solace its sensing is manifested in the optimism on alternate sources of demand from the ever more emerging and "frontier" (hot new Wall Street term for small, yet economically emergent nations) countries.

2. The US Stock market has been running in place now for darn near 13 years – the price level is stagnant, but valuations have dramatically improved. And all the while, the expected returns on competing investments have diminished considerably.

I received an e-mail from a trader pal of mine last month, the subject of which read: "What a long strange trip it has been……." The content reflected my statement above: that the collective movement in the S&P 500 Index has aggregated to zero (not including dividends) over this statistically significant period of time. See chart below:

	11-Oct-1999 (Monday)	29-Sep-2006 (Friday)	11-Jun-2008 (Wednesday)	5-May-2011 (Thursday)	22-Jun-2012 (Friday)	*% Change October 1999 to present*
S&P 500:	1335.21	1335.85	1335.49	1335.10	1335.02	Unchanged
Trailing 12 mos EPS	48.60	86.02	77.39	93.60	101.84	110%
Trailing 12 mos P/E	27.5	15.5	17.3	14.3	13.1	-52%
Forward 12 mos EPS	56.65	73.56	60.31	101.84	107*	89%
Forward 12 mos P/E	23.6	18.2	22.1	13.1	12.5	-47%
2-year T-Note Yield	5.79%	4.69%	2.62%	0.47%	0.30%	-95%
10-year T-Bond Yield	6.02%	4.63%	3.97%	3.06%	1.62%	-73%
30-year T-Bond Yield	6.16%	4.76%	4.53%	4.23%	2.69%	-56%
S&P 500 Earning Yield, TTM EPS	3.64%	6.44%	5.79%	7.01%	7.63%	110%
S&P 500 Earning Yield, FTM EPS	4.24%	5.51%	4.52%	7.63%	8.01%	89%
Crude Oil	$21.27 bbl	$62.91 bbl	$136.38 bbl	$99.80 bbl	$79.96 bbl	276%
Gold Bullion	$318.8 oz	$598.60 oz	$879.70 oz	$1481.40 oz	$1569 oz	392%

Source: Oppenheimer Asset Mgmt, Bloomberg & Thompson Reuters

**Forward 12-month earnings estimate is the First Call consensus*

In conjunction, as I mentioned on the first page, many investors have been content to part company with the prospects of prosperity. This is an alliterative attempt to illuminate the results of a recent American Association of Individual Investors (AAII) poll[6] that indicates a serious drop in investor optimism: from 30.2% of investors reporting bullish attitudes about the stock market, to 22.19% for the week ending 7/19. Going back to 1987, the average rate of bullishness is approximately 38.9%. Perhaps most interesting about this latest report is the chop in optimism came during a week when the market actually went up almost 2%! To me this says only one thing: macro concerns trump micro conditions in the current market environment. Investors are burying the principles of valuation and the general rules of diversification in favor of protection. Protection from the presumption of impending volatility. While it boils my blood to hear talking heads hasten the hordes into stocks, "because there is nowhere else to go," it may capture the case to consider the current context in capital allocation.

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3. King "Put-In-Common": Led by US Federal Reserve Bank Chairman, Ben Bernanke, activist monetary policy around the world has effectually established a floor for stock prices. Pavlovian in its doggedness, global markets have come to expect liquidity backstops, balance sheet expansions and any other innovative fiscal fabric woven tight enough to fashion a sufficiently salubrious safety-net to goad asset price growth in the midst of an ecumenical deleveraging.

Just last week, Chairman Bernanke gave 2 testimonies on Capitol Hill –splitting time amongst our elected officials in the Senate and the House. His mood fluctuated somewhere between damp and dour. He made no mention of intensifying any infusions of easy money – his stimulating source of simoleons that have been slathered across Wall Street and Main Street under the menacing monikers of QE1, QE2 and the ever-popular (particularly in the summer) Operation Twist. Yet the market presumed that Helicopter Ben (a nickname bestowed upon the Chairman in 2002 after he referenced Nobel Prize winning economist, Milton Friedman's deflation-fighting measures of using a helicopter drop of money to stabilize prices) was coyly toying with the Congressional brain trust – essentially rekindling the art of economic reverse psychology in real time. Stock markets rose, volatility declined over the 2 days of testimony.

In summation, the recent suppression of volatility seems to have dulled the blade of the market to those still invested in stocks. In an age defined by shortened synapses between thought and action, perhaps we should've expected recognition and reaction reflexively in financial markets. But conventional wisdom exists in only two dimensions: description and dissemination. What it cannot determine is: duration or depth. While many issues within the global economy are well-ascribed and their predicted impact is embedded, we must continue to assess any need to bias the balance of clients' accounts into or away from identifiable sources of risk. The key is maintaining dimensional vigilance as we assess all aspects of exhilaration. So, let's give Elaine the credit she deserves in this Seinfeldian imagery – focusing on the basics, simplifying instead of complicating and filtering out known noise are powerful coping mechanisms – for both meat slicing and markets.

[1] http://www.seinfeldscripts.com/TheSlicer.html

[2] source: Investopedia and Bloomberg Market Data

[3] http://www.politico.com/blogs/on-congress/2012/06/surprise-congresss-approval-rating-ticks-up-125855.html

[4] http://sweetness-light.com/archive/ap-most-doubt-president-affects-economy

[5] http://www.tradingeconomics.com/china/gdp-growth

IMPORTANT DISCLOSURES:

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