



Bullish on America

I began my career in investing in June 1978, just over 33 years ago. In those 33 years I do not believe there have been 33 days in which I have not read the *Wall Street Journal* or followed the business and market news. As those who know me will attest, I sometimes stay at resorts but I am never really on vacation. In those 33 years I have seen a lot and lived through a lot.

Never in my life have I been more bullish than I am now.

Can I really mean that, especially comparing these days to the opportunities we saw and successfully exploited in the housing bubble? What about the glory days of sludge in early 2009 when we were buying bushels of performing bonds under 30 cents?

From the outset it was clear both those trades had the potential to be “10 baggers.” Those calls, however, were not bull trades as such. What sold us on those trades was not so much the certainty that they were winners as the asymmetry between the huge potential gains and the minimal risks. On the mortgage trade our potential losses were limited to the known insurance premiums we were paying on CDS issued by, well, not AIG. As for the sludge trade, whatever the chances of a big win, we knew we would break even if just 10% of our sludge someday returned to par rather than going into reorganization.

The current case is a little different. It’s not so much that we have a shot at a 10 bagger and little downside risk as that we are looking at the surest double we’ve ever seen.

We have been saying for more than a year that we are enthusiastic about quality large caps. For some months we have been giving vent to our enthusiasm via a modestly sized trade in which we have been long large-cap, low-beta stocks and short large-cap, high-beta stocks. Broadly speaking we’ve been using low beta as a proxy for strong companies in control of their own destinies. These are typically companies in good businesses with traditionally high and stable

margins and with no more than modest exposure to commodity prices, economic conditions, or other cyclic factors. High beta was our proxy for firms lacking these attractive qualities but which in 2009–2010 had a big run, if only because they had been down so far the only way to go was up. Our thesis was that after two years of market tone dominating over fundamentals it was time for companies that earned their multiples the old-fashioned way.

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We still think this is true. Underpriced high quality names still abound in the market. It's the short side

of the trade we have fallen out of love with. Being short the high-beta names today would put us in a bet we want no part of.

As I argued in our investor conference call a week ago, we believe securities prices are being driven by two fears quite distinct in reality but that tend to overlap in investors' minds. One is fear of the double-dip, the second leg down, the recession that may already be upon us. On this prospect we are agnostic. We could be seeing a double-dip, or we might be in a soft patch. We have no special insight on this question and no opinions worth wagering on.

We do not want to make a bet on the prospects of the economy.

The second fear is of a collapse of the financial system. We do have an opinion on this one: it's not going to happen. That's a bet we are eager to make, properly hedged of course.

The current crisis is not remotely a replay of 2008. In 2008 the fate of financial markets rested on massive loans from insolvent borrowers to insolvent lenders and mediated through the hopelessly tangled thickets of "structured finance." It became impossible to determine readily who owed what to whom collateralized by what. Furthermore, it was unclear until much too late whether governments would address this crisis by saving the credit complex, or blowing it up. In the event, governments chose to do both on different days with predictable effects. Worse, once the collapse began, the tools at governments' command, or those they chose to use, could have only indirect and unpredictable effects on the core problem: the collapse of commercial credit markets. Stuffing money into big banks was at best a roundabout solution to the terror running through bond markets, a terror that threatened to turn financial crisis into business collapse. In the end TARP and its variants had remarkably little effect on commercial credit markets, which slowly healed themselves as the world refused to end.

Today's crisis has nothing to do with the shadow banking system or any other sort of shadow. Today's crisis is all out in the bright sunshine and remarkably straightforward. The supposed danger is that some major economic power (i.e., not Greece) will become unable to access credit markets. Spanish or Italian or French bonds will decline so steeply as to imperil the banks that own them or appear to do so, causing a run on global financial institutions as severe as 2008's.

This will not happen. As the European Central Bank made clear the week before last, the world's central banks, despite their virgin blushes, have not forgotten their true purpose in life. Just as the ECB reversed course to purchase the Spanish and Italian bonds it had declared it would

never touch, central bankers will always monetize as much government debt as necessary to ensure that the world's great economic powers will be able to borrow. All sorts of bad things may and probably will happen as a result of the bankers buying back dubious debt with even more dubious dollars, but a sudden collapse of the financial system is not one of them.

If the government debt crisis were a tenth as complex as the structured finance crisis we might be skeptical of central banks' ability to resolve it. It isn't. The thing is simplicity itself. The governments need legal tender with which to dispatch and ultimately devalue their debts; central banks can create legal tender. From the first, the only issue has been their willingness. That issue, were it ever in doubt, has been resolved.

So we don't want to bet on the economy, but we do want to bet on the financial system. The opportunity at hand comes from clearly distinguishing the two.

The short on high-beta stocks has become a bet on the economy. Too many of the high-beta names are extremely sensitive to both economic conditions and currencies. In the current environment these two factors are likely to pull in different directions, with the prevailing factor powerfully dominating markets.

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If the economy does go another leg down, high-beta names could get slaughtered. The marginal firms could get

slaughtered because that's what it means to live on the margin. The cyclic and commodity-driven firms could get slaughtered because continued pessimism on the fundamental, supply and demand story about commodities will push prices down even further than it has already.

On the other hand, if we don't see a double-dip, if the current slowdown turns out to be only a soft patch, the upward forces on the prices of commodity-driven stocks could be explosive. Why explosive? Could commodities really rebound so strongly in such a modest recovery? Possibly. For despite all the chatter about Chinese demand, fundamentals were not the decisive force in the rise of these stocks in 2009–2010. Commodity stocks rose, as they usually do, on the decline of the dollar: the spread between the international price of the dollar and its domestic buying power. To give just one example for now, consider steel, which we last wrote about at any length back in 2004 when our Long Short Equity fund, then called Intermarket, was just getting started and had taken significant positions in several small steel companies.

At the time, the conventional wisdom in the financial press was that the 250% rise in steel prices from late 2001 through mid-2004 had been driven largely by Chinese demand. The decisive question in the opinion of most analysts was for how long net Chinese demand would continue to grow before it was curtailed by either slowing Chinese growth or the growing Chinese steel industry. A decline in Chinese demand, it was feared, would push prices back down to the levels of three years before that had driven U.S. steel companies to the edge of the abyss.

As we wrote at the time, what most analysts seemed to miss was that both the collapse of steel prices starting in the late 1990s and their subsequent revival were driven not primarily by

Chinese demand but by the state of the dollar. By 2001 the international value of the dollar had risen so far from its nadir that gold was selling for just over \$250 an ounce, after ranging around the \$400s since the mid-1980s. International steel prices fell accordingly. Meanwhile the price of U.S. labor (and other steel company costs governed by the domestic value of the dollar) stayed steady, crushing steel company earnings. By 2004 that situation had reversed. Both gold and steel traded at much higher prices internationally whereas domestic costs at U.S. steel plants had not moved much at all. The U.S. steel producers had been losing money on the arbitrage of the U.S. dollar vs. the international dollar, the CPI vs. the gold price. Now they were making money on the same trade.

This is the great hazard of being short U.S. commodity-driven stocks right now. Domestic inflation still appears restrained and in any event is not powerfully linked to the price of gold in the near term. The value of the dollar on international commodity markets, however, is very closely linked to gold. In recent weeks gold and commodities have moved in opposite directions. Gold prices are being driven by fears about the dollar, but commodity prices are being driven by fears about the economy, especially the notion that a financial markets crisis might become economic catastrophe. Gold and commodities never move in opposite directions for very long, however. And since the breakdown of Bretton Woods under Nixon the monetary story has always dominated the fundamental story over the mid to long term.

To look at it the other way round, if we believed that the financial system were on the verge of collapse, our high-beta short would stay on. In a catastrophic credit contraction high-beta stocks would almost certainly suffer disproportionately.

So: we are getting out of the low-beta/high-beta trade because we don't like the short side. Yet enormous potential remains in high quality equities of a certain type. As of last week more than 160 of the S&P 500 companies traded at a lower enterprise value than they did in November of 2008. Put aside, if you will, the impaired financials, Bank of America, Citigroup, AIG, etc. What about Goldman, now trading at a discount to book approximately the same as when Buffett bought into the company? And yet Goldman has no apparent funding issues and indisputable

government-protected status. How about Wal-Mart or P&G with fortress-like balance sheets, plenty of cash, and dividend yields generous by their historic standards?

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Over the decades a variety of dividend-seeking strategies have provided solid absolute returns, the dogs of the Dow being one of the more well known. Today with most of the S&P 500 paying yields higher than Treasuries and often higher than high-grade corporate debt, throwing darts at that esteemed collection of companies qualifies as a dividend-seeking strategy.

We are not going to throw darts, however. Among the legion of great American companies that are paying attractive dividend yields there is an even more attractive subset. These firms are engaged in what are best described as unleveraged buyouts of their own shareholders. Dozens of strong American companies, yielding three-ish dividends, selling for low multiples of cash flow,



and holding enormous piles of cash have, at length, decided what to do with the money. They are buying back their own shares at a rate of 4, 5, or even 6% of the current float per year. At current rates of repurchase, early in the next decade there will be but a single share of Wal-Mart outstanding. Chary as we are of predictions, we guess the bid will be more than \$50.

If there is no double-dip we will probably collect on our bet earlier than expected.

so cheap is that Mr. Market is confusing in his mind the threat of a double-dip and a financial collapse. If Mr. Market were thinking clearly, he might focus on the relative advantages that such strongly positioned firms have in a recession. The firms we are looking at vary in their sensitivity to the economy but none are among the most sensitive large caps. Sensitive or not, their powerful balance sheets and dominant positions in their industries position them to emerge from a recession in far better shape than the average firm. The same market gloom and confusion we believe is suppressing their shares currently could intensify if the double-dip comes, making these stocks even cheaper. But their ultimate rebound is hardly in doubt. If there is no double-dip we will probably collect on our bet earlier than expected.

These are the companies we want to own now. Our notion, on which the trade does not depend, really, is that the reason they are

—*Andrew J. Redleaf*
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