Farm Creek Securities, LLC
Farmcreeksecurities.com
fc@farmcreeksecurities.com
89 Roton Avenue, Rowayton, CT 06853
(203) 838-1025

The Sound Investor Series #79

Climbing the Wall of Worry

Ed Hynes, CFA
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The stock market's recent performance has been excellent and with any luck this should put everyone in good holiday spirits. Let's hope it keeps climbing in the New Year!

Many investors appear to be surprised by the market's strength. But as long-time observes know, the market often goes up in the face of skeptics. Wall Street has a catchy cliché to describe almost anything and this particular phenomenon is called "the market climbing the wall of worry."

Now the concern is that more and more investors are getting comfortable with a strong market while it looks like we may be getting close to the top of the wall.

A useful way to gauge investor sentiment is to look at the VIX index, also branded the "Fear Index." The VIX is the symbol for the Chicago Board Options Exchange (CBOE) Volatility Index and measures the price of short-term options on the S&P 500. Right now the VIX is hovering just above 10, which is near the bottom of its long-term range of from 10 to 40. This indicates that there is very little fear in the market. In contrast, when the market was falling last summer, investors started to panic and the VIX shot-up into the low 20s.

The Fear Index gets its name because nervous investors aggressively buy options to protect their investments, driving option prices and the VIX index up. When investors are bullish and less inclined to seek protection, option prices and the VIX tend to fall. Right now investors are showing no fear although the upcoming holiday trading lull may account for some of the VIX's low level.

Another interesting indicator of fear or complacency is to compare the interest rates on bonds issued by the U.S. government with those issued by so-called "Emerging Market" governments. The difference in interest rates (or spread), increases when investors are nervous and demand higher interest rates on "Emerging Markets" bonds to compensate for the risk of investing in those countries. Like stockholders, bond investors are currently exhibiting very little fear and demanding only an extra 1.74 percentage points of interest on emerging market debt relative to U.S. Treasuries.

I wouldn't be surprised if today's complacency ends with consumers and investors getting cold feet in January and heading for hibernation. The optimism from last fall's drop in gasoline prices has about run its course and if seasonal cold weather kicks in, consumers will be forced to worry about their heating bills again.

Reservations concerning the housing industry are also likely to weigh on the market's outlook. This week the government reported a bounce-back in housing starts in the month of November, but starts still have not recovered from their horrendous fall in October. Even after November's increase, housing starts are still down 25.5 percent over the last year. Permits for new construction, a forward looking indicator, continued to fall in November and are now down 31.3 percent from a year ago.

The futures market also forecasts that housing prices will continue to deteriorate as we move into the spring. Prices of single family homes in major metropolitan areas are expected to fall 1.5 percent in this year's 4th quarter; another two percent in the 1st quarter of 2007; and one percent more in the 2nd quarter before leveling out in the 3rd quarter. These expectations, as reflected in the futures market, may be right or wrong but they give us a feel for what we might expect.

You might be scratching your head asking why I am reviewing the short-term market outlook when you know I don't advocate jumping in and out of the market and trying to time your next move. The answer is that I believe if investors are prepared for the ups and downs of the market they are less likely to make rash decisions hopping in or out at the wrong time.

If the market takes a hit and you feel the need to do something, first try reviewing your long-term strategic plan and see if it needs adjusting. If it doesn't, do not do anything. Next, check to see if any small tactical changes need to be made such as rebalancing your portfolio. This is also the time of year tax planning should be a concern and if you can lower your tax bill without fundamentally altering your investment strategy, you should do it.

Do you currently have a net capital gain due to buying and selling investments this year? If yes, you should examine your portfolio to see if you have any investments that are currently trading at a loss and you wouldn't mind selling. (Remember you can only record the loss for tax purposes if you do not buy the same investment back within 30 days.)

Even if you don't have net capital gains, if you have investments with short-term losses, that you are about to give up on, it might make sense to harvest those losses before they become long-term losses. The rational is that short-term losses are potentially more valuable than long-term losses since they can be used to off-set future short-term gains. This saves you money because short-term gains are normally taxed at your ordinary tax rate rather than the preferential tax rates used for long-term capital gains. If you decide to make any adjustments due to tax considerations, it is smart to first check with your tax adviser.

I hope everyone has a Great Holiday and a Happy and Prosperous 2007!

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. Ed@farmcreeksecurities.com. Farm Creek is a registered broker-dealer NASD, registered investment adviser and member of the National Futures Association. This series of articles is available at farmcreeksecurities.com.

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