MARKET PERSPECTIVE
BY RICHARD SKEPPSTROM

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New Era, Eurozone Woes, Gold

Moving between investment eras?

I believe we are in the middle of a transition period that marks the boundary – generally recognized in hindsight – between one investment era and the next.

Let me explain by rewinding back to the mid-1990s. At that time, investors somehow had convinced themselves that large-cap growth companies could expand at high rates forever and so they gladly paid outrageous multiples for those companies. That era culminated in the rise and subsequent collapse of the tech bubble. The ensuing recession wasn't that severe but it did wash away much of the excess. As the markets began to recover smartly in 2003, I can remember being bombarded with questions about when the old leadership would reassert. What about Coke and Cisco and AIG and Pfizer and Microsoft? Their day was definitely over. A new era was upon us. Frankly, I was happy just to take advantage of cheap valuations. It was an investment meritocracy again (no manias, no bubbles, few distortions) and I thought it would last. I was wrong.

The next era was already bubbling up below me. China's insatiable demand for raw materials, equipment and energy would soon begin to stress a global supply chain unprepared for the new demand surge. In addition, U.S. Federal Reserve largess and an abundance of capital were channeling into a long-established global housing boom that would soon become a bubble. The industrials, materials, energy and financials sectors boomed in the markets. The deepest cyclicals were the new growth kings. Banks leveraged their equity to home-price appreciation. Many investors were euphoric; a few were apocalyptic. I was concerned and confused. Painfully, and very nearly fatally, everything came to a sudden stop. The recession and market panic were severe. Once again, valuation opportunities were abundant and buying was easy. Helped by extraordinary Fed accommodation, countries haltingly regained their footing. Corporations did even better.

We are now back to the old highs in the markets. Stock valuations are now average by historical standards and corporate margins, while high, are defendable. We have come full circle again. It feels like an investment meritocracy, with a few odd twists, but my experience tells me the Fed's printing is being perverted. We are in the transition period between the last era and a new one. I expect to write a very different narrative for this new era; however, I just don't know how it will unfold.

Something's gotta give

The European mess isn't going away. George Soros recently made a very public and compelling case that Germany should either agree to Eurobonds or leave the euro. That isn't a new idea but it's a good one. It means the southern states' debt would still be denominated in the euro in the event of a break-up. It's a disaster to have your debt denominated in somebody else's currency when you devalue. Leaders insist the euro will hold together. But really, what else can they say? The political situation appears to be deteriorating as fast as the economic situation and sages like Soros have concluded that the current path is unsustainable.

I don't know if the current path is sustainable but I do know that markets have a nasty habit of forcing difficult decisions. The Germans won't agree to Eurobonds (sharing the responsibility for paying off all the debt) without actually facing an even nastier option. Given the worsening economic and political environment in Europe (combined with the Cyprus banking fiasco), I believe it's just a matter of time before the markets force Germany to make a choice. Buckle up.

I might have ignored Europe for a while longer but U.S. economic data has weakened lately and this is showing up in first-quarter earnings reports. With the S&P 500 Index pushing to 15 times earnings, I'm raising a little cash because I don't see much upside in risk assets from here while this percolates. I'm not panicking. Europe actually needs a new plan but I don't believe the United States is in danger of a recession.

Gold

I'm licking my wounds here. I'd like to have a significant inflation hedge but gold is more volatile than I assumed. As is often the case, I wasn't totally sure what gold's rise meant. Was it signaling an imminent rise in inflation or was it just another bubble courtesy of the Federal Reserve? It's clear that gold was caught up in an investment frenzy and that fever is now broken. Price support is undeterminable. I still believe gold can be a good inflation hedge but the markets don't like waiting. It's unclear what level gold will hold while central banks try, but fail, to create inflation. I've reduced my gold position for now.

Total Return Portfolio	
Equities	61%
Gold	3%
Cash	36%
Total	**100%**

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