ORCAM | ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

February 25, 2013

Equity Insights & Update

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

A Disturbance in the Force?

Thursday's unusual negative market occurrence evolved into a huge market route today as a confluence of events came together to stir up quite a bit of fear in the market. Three big events turned the markets upside down:

- Italy's election results throw the stability of the Euro into question as the new government is unlikely to support the harsh austerity measures that have been in place. This could be at odds with Germany and requirements to meet certain debt:GDP ratios.
- Chinese PMI came in much weaker than expected at 50.2. This was well below expectations of 54.2. But it is important to bear in mind that this could be partially due to the Chinese New Year and a volatile dataset from survey participants.
- Lastly, the Yen rallied sharply versus the Euro. This was at least partially due to the Euro concerns stemming from Italy, but also due to the fragile environment already in place in the foreign exchange markets where the Yen has been artificially talked lower via Japanese policymakers.

By the end of Monday's session the S&P 500 had closed lower by 1.8%, the Yen had rallied 4%+ versus the Euro (intraday) and the VIX had surged over 34%. Mr. Market, as they say, was throwing one of this

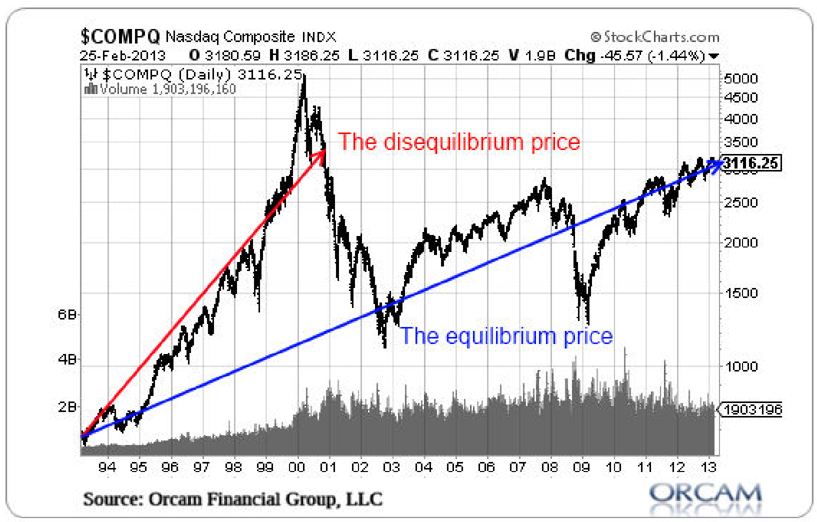
...continued

"If everyone is thinking alike, then someone isn't thinking."
-General George Patton

temper tantrums.

Understanding Price Disequilibrium

As you know, I've been discussing a potential risk of "disequilibrium" in the markets for a few weeks now. I want you to really understand how I think about this because I think it's a crucial component in proper risk management. As I mentioned last week, the tendency is to chase a rising market. But this is all too often the wrong approach as the market tends to become increasingly risky as prices rise. This isn't always the case, but it often is. This effect becomes even more exaggerated when prices rise in a very brief period. When prices rise in a very short period due to various factors we often see an environment where a price disequilibrium can develop. This creates a price compression. That is, the market begins to price in several quarters worth of positive market action inside of a very brief period. Often times this price action ends up being correct over a longer period of time, but ends up being wrong in the near-term as the disequilibrium proves overly optimistic in the near-term.



A prime example of this is the Nasdaq bubble. Were investors wrong that the internet was going to dramatically change the way the world operates? Were they wrong to price in this vast improvement in the way we operate our businesses and lives? No. But the issue was a dislocation between the actual timeline of these real-world impacts and the price of the shares that represented those impacts. As it turns out, the internet did have a massive impact on the world and it totally transformed the global economy. But it didn't occur within the timeframe that share prices represented. Current fundamentals and optimism were disconnected resulting in an extreme disequilibrium and a massive price compression.

Euphoria turned to manic irrationality which created an extreme disequilibrium and we all know how that ended. That same sort of thing happens in the markets in a much less irrational, but more frequent basis all the time.

My job as a risk manager has always been to identify when these potential disequilibriums are occurring. I don't think of it as timing the market. I think of it as viewing the summation of the system's variables and deciphering whether the odds create the potential for instability. Success is often about playing probabilities as opposed to guessing about future events.

Why does any of this matter you ask? It matters because negative volatility is a portfolio's worst friend. Not only does negative volatility create destructive permanent losses via the unfortunate math of share prices (for instance, it takes a 100% gain to overcome a 50% loss), but it creates uncertainty and instability within what is actually your savings portfolio. This throws a wrench in life's plans and creates turmoil. I try to smooth that out not by being able ride every single market move higher or by avoiding every single dip lower, but by smoothing out the path to generating real returns. A big part of this involves having a process for identifying extremely risky market environments. Being able to do that requires a highly structured understanding of the macro environment and a methodical, disciplined and mechanical approach to markets.

More Sequester Fear to Come?

On that note, I do wonder if there isn't a bit more fear to come in the coming weeks as the current disequilibrium corrects itself. The following is a nice summary of things to come via the sequestration cuts:

> The 2013 sequester includes:
>
> - $42.7 billion in defense cuts (a 7.9 percent cut).
> - $28.7 billion in domestic discretionary cuts (a 5.3 percent cut).
> - $9.9 billion in Medicare cuts (a 2 percent cut).
>
> $4 billion in other mandatory cuts (a 5.8 percent cut to nondefense programs, and a 7.8 percent cut to mandatory defense programs).

Continued…

> "The CBO estimates that the combined federal fiscal tightening taking place in 2013 is knocking 1.5 points off GDP growth for the year. Of that, about $^5/_8$ of a percent (or 0.565%) is due to the sequester. Macroeconomic Advisers similarly estimates that the sequester will shave off 0.6 points from the year's growth rate."

These aren't drastic economic altering changes to the budget, but they do negatively impact an economy that is already nearing stall speed. And when we throw in the renewed uncertainty regarding Europe it looks like Mr. Market's bi-polar disposition is likely to continue. As always, I'll keep you informed on where I think we stand as these developments unfold.

Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.