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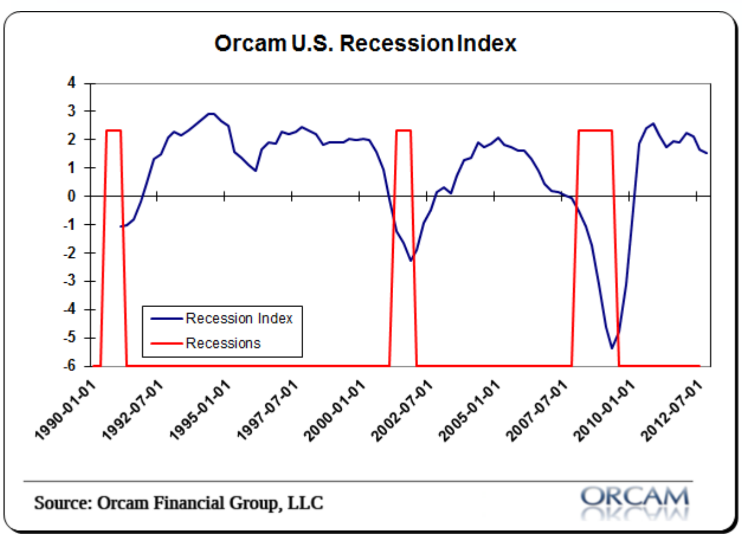
A Fiscal Cliff Resolution?

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

Markets are rallying today on rumors of a fiscal cliff agreement. I still think this is something that will get done before year-end. My timeframe remains sometime before mid-December. But the market is already beginning to price-in an agreement. This is good news as the market hates uncertainty. Less uncertainty is a positive catalyst moving into year-end. Let's review the big picture.

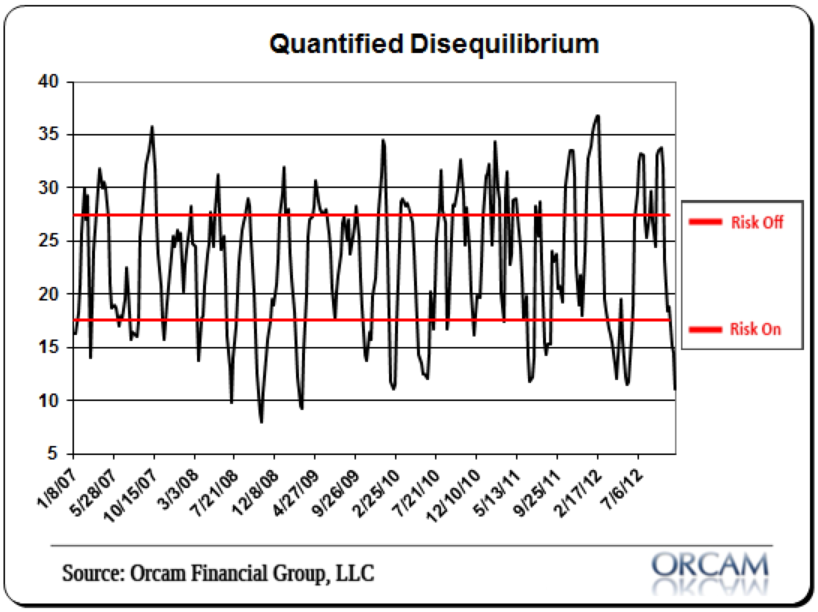
The Big Picture

Still no recession….Investors who have been excessively pessimistic in the last 12 months have dramatically underperformed. This was in large part due to a number of vocal (and credible) sources who called for recession in late 2011. Our U.S. recession model didn't see this then and doesn't see this at present.



Long story short—Less uncertainty is certainly good news.

Our equity model has become quite constructive. The current reading is consistent with a market where the risk/reward favors long positions. We are more inclined to buy dips and establish positions at this juncture rather than moving to a more negative posture. Although this index does not provide us with specific daily entry/exit points, it has proven, historically, to provide an extremely good barometer of the risk/reward regarding potential buying/selling points in the market. The model has not yet provided an official "buy signal" but current readings are at depressed levels where a turn in the index is a near certainty. That should be consistent with a more positive tone in the equity markets in the coming months.



Less Certainty is Certainly Good News

The key to investing in this market in recent weeks has been predicting the degree of uncertainty in the market. I am still of the opinion that the equity market is likely to favor the upside into year-end as the uncertainty around the fiscal cliff wanes and investors focus on the fact that the economy is not falling off the cliff that many have envisioned. I still think a deal on the fiscal cliff is likely before the middle of December. Unfortunately, it looks like recent talks may prove my low $100B estimate for cliff cuts to be too optimistic. We're more likely to see $150-$200B in cuts to the 2013 budget. This will hurt the economic recovery, but shouldn't torpedo it. It still looks like a muddle through economy to me.

Excessive Pessimism is a Portfolio's Worst Friend

It's fashionable these days to be extreme about everything. We hear about "fiscal cliffs", endless recession calls and other such items that sound very scary, but in all likelihood, turn out to be mere bumps in the road. I've been rather vocal about my thinking that the "fiscal cliff" would be more like a "fiscal bump". Those positioned for a disaster scenario here are likely to be disappointed.

Pessimism is not to be shunned in portfolio management, but there is a time and place for it. The persistently pessimistic asset manager is fighting very powerful long-term positive trends that make his/her life exceedingly difficult. It is, in my view, not a sustainable or optimal view from which to construct a portfolio strategy.

There's a tendency in the investment world to allow your feelings and biases drive investment decisions. If we see the market going up when we're not participating we feel like we've missed out. It's natural to say "I'll wait for it to come back down so I can get in where everyone else got in". One of the hardest things to harness in the investment world is this perception of being "left behind". But you can't manage your portfolio with such a destructive mentality. The investor who views the investment world through this prism is like the poker player who doubles down just because he/she lost the last hand. That's not prudent money management. You must play every hand as if it is its own.

You cannot let past mistakes excessively drive future decision making. Instead, we must learn from mistakes so that we can avoid making them in the future. Excessive pessimism is the worst kind of mistake an investor can make.

I view the human being as a species that is always pushing forward, always striving to improve, break new records, and exceed boundaries. This doesn't mean there will be no mistakes along the way or that the human being is incapable of hardship. Rather, we should embrace this long-term trend, but approach it with measured optimism, even a bit of skepticism. But fighting it through persistent negativity is almost guaranteed to be a losing battle. Portfolio construction should be based on the same basic mentality.

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