

# Jack Adamo's Insiders Plus

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March 16, 2013

Dear Friend & Client,

Thanks for joining me.

The market had another good week, towed mostly by the Dow Industrials and an outsized gain in the Transports. The S&P had a nice 10-point gain, though it failed to break into record territory. The laggard was the NASDAQ, which rose only a tenth of a percent. From what I've heard from tech guru Fred Hickey, that's not surprising. The number of companies giving negative guidance on recent conference calls was three times positive guidance, an extremely high ratio. On the broader market, he commented that net hedge fund exposure is the highest it has been since 2007. In other words, the speculators are out in force. That's fine, unless they get spooked, then they not only run, they short.

On the economic front, I've gotten used to conflicting data over the last few years. Recent numbers have been more consistently hopeful in the last month, at least domestically; overseas economic data have been mixed, although you'd never guess it from their stock markets. Most of the world indices seem to be in strong recovery mode, Brazil and Chile being noticeable exceptions. Japan, drunk on its new loose money policy is up 47% since October. The Japanese seem to have a yen for excess when it comes to markets. Their real-estate bubble was the biggest in history, even eclipsing Tulipmania in the seventeenth century. And despite the huge recent run-up, the Nikkei Dow is 70% below its 1989 high.

The motive force behind the world indices is the same as it is here and in Japan: liquidity. Every central bank is emulating the Fed and the stock markets are following suit.

## **Some Comforting Words**

As scary as this is to me in the long term, I was encouraged by two sages this week. These are guys who were investing when flint arrowheads were the next big thing. They are not known for being careless. I guess that's why they've outlived the mastodons.

Jeremy Grantham of GMO capital (which manages more than \$100 billion) is a serious numbers guy and an expert on bubbles. He was on Charlie Rose for the full hour a couple of days ago. He said he is underweight U.S. stocks, except for the large multi-nationals, and slightly underweight emerging markets. He thinks we're headed for big trouble, but not very soon. The Fed's loose-money policy should continue to hold up the equity markets for now. It's when it comes to winding it down that Mr. G expects all Hades to break loose. He was also fairly sanguine about the U.S. debt situation. He said it is manageable, if done right. He concedes that's a big "if", but said we are not yet locked into a catastrophic scenario. (My paraphrasing.)

Sage number two, Howard Marks, was a little less clear, but still generally encouraging. He averred that we are in a bond bubble, but it is only the fifth inning and that it probably won't take down the economy when it bursts. He also said stocks were safer than bonds because

"I can tell you from talking to institutions that after 13 years of having their hearts broken by the stock market, they still are still leery of stocks even with the recent rally. You can see that in their low stock allocations ..."

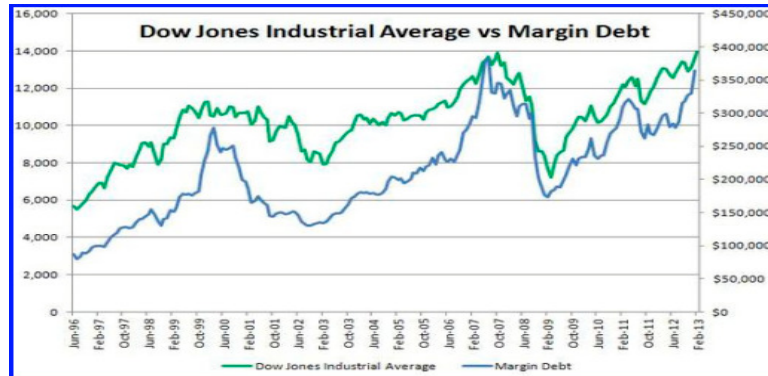
Low stock allocations are bullish for the market because as investors, even institutional ones, are more likely to get back into the market as the uptrend continues. Where the confusion lies is that bonds rising (for another four "innings") implies a weak economy and uncertainty, which is the opposite of what stocks like. I think the reconciling idea is that he felt the bubble was most evident

in riskier bonds that people were buying in a desperate search for yield. That would jibe better with favoring stocks, which are becoming much more sensitive to investors desire for dividends.

These reassuring comments add to last week's observations by Michael Darda and Laszlo Birinyi and boost my overall optimism about the intermediate term outlook for the market.

**But ...**

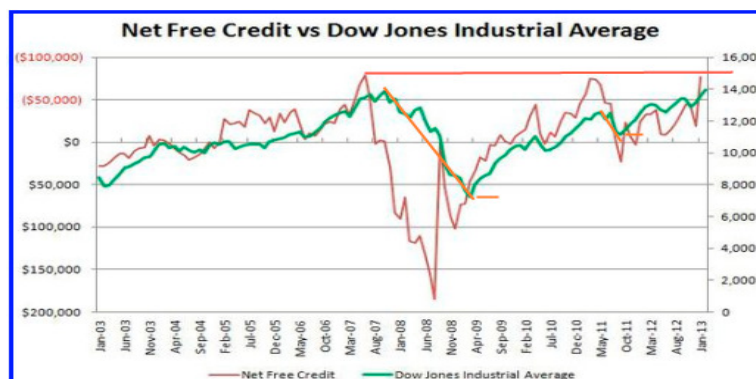
Despite these sources of encouragement, I'm still going to tread lightly for a while. The two charts below will begin to explain why.



Sources: NYSEData.com Facts & Figures, St. Louis Federal Reserve.

I found this chart and the next in a well thought-out piece by Dan Dzombak. It shows the level of margin debt to the DJI over the last 17 years. The green line is the Dow; the blue line is margin debt. As you can see, high margin debt is a clear warning sign for market tops, followed by long or steep (or both) bear markets. Note, however, that at least on the basis of the last two peaks, the absolute number needed to reach that tipping point is rising. This is almost certainly due to the increase in money supply. Whether that is due to increased real wealth or just more money in the system may not matter. The debt level may also be influenced by the lower cost of servicing the debt; however, a margin call is a margin call, regardless of your interest rate. So, it seems to me when a downtrend starts, selling is likely to accelerate with the same vigor, regardless of interest rates.

The above mitigating factors suggest that a big drop is not necessarily imminent, but this second chart gives further room for doubt.



Sources: NYSEData.com Facts & Figures, St. Louis Federal Reserve.

The above chart is also denominated in dollars (the plum-colored line), and the Dow is in green. However, here the dollars in the left-hand scale are net debt to equity in the margin accounts (labeled "net free debt" in the chart.) One could argue that the rising money supply should allow greater net debt, but the greater supply should also raise equity (the value of the stocks). The fact

that the accounts are still so far underwater raises a question whether the mitigating factors in this case are as strong.

This second set of data only goes back to 2003; that's when the NYSE started tracking them, so that presents its own limitations, but you can see the two prior peaks in the ratio were followed by substantial drops in stock prices. (See sloping red lines). The 2008 crash needs no reminders, the correction in 2011 was 17% -- not the end of the world, but we would certainly rather buy after the correction than just before it.

I said a few weeks ago that the market's "RSI" was quite high, meaning the market was short-term overbought by that metric, but that I thought the market could still run its traditional seasonal rally through the end of April.

However, I looked at these numbers again this week after I saw the margin figures above. I realized that, yes, the market didn't start its slide until late April last year, but it also didn't make any progress after mid-March. It only tread water for those six weeks, led by the big caps. The broad Wilshire 5000 peaked March 26 and the small cap index, the Russell 2000, peaked March 19, which is this Tuesday.

My conclusion from this large amalgam of inputs is that we're probably not going to resume the secular bear market, but the risk-to-reward over the next few months is not positive. I have a number of stocks I want to buy, some new, some additions, but I'm going to play it close to the vest. I have no doubts about the soundness of the companies, but if there's a good chance I can get them 15% cheaper by waiting a few months, that's what I'm inclined to do.

If you're raring to go and are impatient with my caution, by all means, go ahead and add to positions in solid companies like **Westinghouse Air Brake Technologies Corporation** (NYSE: WAB), **General Mills, Inc.** (NYSE: GIS) and **Companhia de Bebidas das Americas** (NYSE: ABV).. You won't lose money in the long run, but I'd rather see you keep your powder dry for now.

## Gold Update

According to the Wall Street Journal, The Commodity Futures Trading Commission is discussing whether the daily setting of gold and silver prices in London is open to manipulation. No formal investigation has been opened. The CFTC is examining various aspects of the so-called price fixings, including whether they are sufficiently transparent.

The piece went on to explain that gold prices are set twice daily by five banks via teleconference. Three banks set silver prices. The fixings are then used to determine spot prices world-wide, and help determine the value of derivatives tied to the metals.

The five banks that set the gold price are: Barclays, Deutsche Bank AG, HSBC Holdings PLC, Bank of Nova Scotia and Société Générale. Barclays was involved in the LIBOR fixing scheme for which it was recently fined. No one went to jail.

These sorts of allegations have been going around for at least a decade, and have been discussed in detail in various gold news media. In fact, the CFTC said early in the Obama administration's first term that they were thinking of looking into it, but as we've seen, the administration has done very little about financial malfeasance. The admission a couple of months ago by the Department of Justice that they didn't want to prosecute bankers for fear of upsetting the financial system was just the icing on the cake. My guess is that the current talk will amount to nothing as well, although, like LIBOR, maybe the fact that the miscreants are foreigners who (presumably?) don't contribute to U.S. political parties, may give this a slightly higher chance of actually doing something.

Still, no one in any government wants to see the price of gold rise, so I'm still betting any meaningful action is a long shot.

I was thinking of adding another 2% position to Newmont this week, since the stock yields over 4%, however, the charts still look horrible for the whole industry, so I'll bide my time here as well.

## PORTFOLIO UPDATES

**Sasol Ltd. American Depositary** (NYSE: SSL) continues its recent struggle with a weak currency and political turmoil in its home country of South Africa. The currency issue is a double whammy in that much of its expenses are denominated in stronger currencies, then earnings translated back to the stronger U.S. Dollar also suffer.

Half-year results showed revenues up 3% and operating profit down 8% in local currency but down 16% in dollars. Net EPS were down 12.4% local, 21.3% in dollars at \$2.23 a share. The company will pay a \$0.67 dividend for the half. The payout ratio is a very conservative 29%. The balance sheet remains hard as steel with debt-to-equity under 7%.

Despite these less-than-stellar results, Sasol seems to be pulling out of its slump. The chart has been making higher lows since mid-year 2011, and is making generally higher lows *and* higher highs since November of 2012. Those two elements in conjunction usually signal a firm trend. The 50-day moving average has also crossed over the 200-day, which is generally recognized as a sustainable trend as well.

We don't own the stock for its chart; we own it for the company's dominant position in energy in fast-growing Africa. It is almost certainly the best-positioned firm on that giant, resource rich continent. It is also the most stable of those based there.

We're still 7.7% underwater in Sasol, but we're up 4.8% year-to-date, and I feel good about our prospects to have a profitable year with it. Buy Sasol Ltd. American Depositary up to \$55. Take a 4% position in the High Income Portfolio.

**M&T Bank Corp.** (NYSE: MTB) passed its stress test and emergency plans this week without any problems. I was disappointed to hear the company has no plans to raise its dividend, but it seems to be focusing on rational, steady growth at the moment, and that requires capital. Besides, the stock price is providing adequate total return for us. We're up 29.8% in slightly more than a year. Hold M&T Bank Corp. I'm hoping for a pullback in the second quarter, so we can buy more.

Of our companies on a calendar fiscal year, only three haven't reported yet, **Silver Wheaton**, which reports this coming week, and our two Chinese energy companies, **CNOOC Ltd.** and **PetroChina Company Limited**. Churchill once called Russia, "a riddle, wrapped in a mystery, inside an enigma." He could just as well have been talking about China. Despite weak earnings over the last several quarters, PetroChina seems to be getting some traction, while CNOOC looks awful. That's strange because PetroChina has exposure to refining which Beijing has hobbled by fixing gasoline and other fuel prices, causing big losses for refiners. CNOOC is strictly an upstream operation with no such problems, although its earnings and reserve replacements are nothing to write home about, except to complain.

Despite these headwinds, we're not doing too badly in the stocks, with deficits of 10.5% and 5.6%. Despite short-term weakness in Cathay, I want exposure there because the long-term growth prospects far exceed those available here. However, I've gotten wind of an ETF that focuses more on consumer companies with the PRC. These are less likely to suffer government interference for social causes. When I finish my due diligence on it, we may switch out of one or both of our energy holdings. Meanwhile, at least PetroChina looks like it may move into the black for us before long.

**General Mills, Inc.** (NYSE: GIS) reaffirmed its earnings guidance for the fiscal year (ending in May) of \$2.65 to \$2.67 per share, before certain items. I'll have to wait for the 10-K to see how important the items are. The company also previewed its fiscal 2014 plans, which include stronger EPS growth in the high single digits, and increased cash returns to shareholders.

CEO Ken Powell said, "We are completing a two-year period of significant investment that strengthened our business in our core U.S. market and meaningfully expanded our base in international markets. Our focus now is on integrating the new operations and executing well across the entire company. We see stronger growth in our immediate future."

With a P/E of 17, a 3% yield and high single digit growth, General Mills is reasonably priced. We've already made 11.6% in owning it 3 months. I expect the company to keep it coming. General Mills, Inc. is a buy on pullbacks below \$44. Take a 3% position in the Main Portfolio.

**Aberdeen Australia Equity Fund** (ASE: IAF) has quietly crept up 11% in the 2 months we've owned it. It is slightly above our buy range for now. Buy Aberdeen Australia Equity Fund on pullbacks below \$11.50. Take a 2% position in the Main Portfolio.

When **Royal Dutch Shell, Class-B** (NYSE: RDS-B) reported last month I was satisfied with earnings, but said I'd have to check the full report when it came to the SEC on form 20-F, the annual filing for foreign companies listing in the U.S. The item in question was "other income" which was not broken out in the press release.

The disclosure in the Shell report was excellent. The amount of other income was insignificant at less than 1% of revenues. Most of it was gains on asset sales in line with the company's ongoing efforts to streamline operations. Things are still a little rocky at Shell, and the company hit a setback in its Arctic drilling by failing some disaster-readiness tests, but Shell is on the right track and making good money. Although earnings are not lock-step increasing every year, the trend is solidly in the right direction. We're 3.7% in the red with Shell so far, but it will make up that ground and more in the next few years. Buy Royal Dutch Shell Class-B up to \$77. Take a 3% position in the in the High Income Portfolio.

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Here's hoping the recent improvements in the economy continue. Last year, Initial Unemployment Claims jumped in March, but reverted to their bad old ways in following months, as seasonal adjustments proved too generous. Meanwhile, we're in a dicey period to be adding to our holdings too aggressively. Nonetheless, the holdings we have are doing very well, with the exception of our hedge and our gold stocks. The latter are coming into a seasonally stronger stretch. That should tell us something about the strength of the overall trend, which admittedly has not looked encouraging lately. I'm not in the least bit disturbed by the depth of the pullback, however, the duration does give me pause, so I'm looking forward to getting more perspective from now through May.

By the way, the Jeremy Grantham interview referred to earlier is extremely interesting on U.S. and world economics, as well as everything that affects them or is affected by them. Here's the link if you want to give it a look: <http://www.charlierose.com/view/interview/12812>. About 15 minutes into it there's a 10-minute digression on environmental matters. (Actually, it's not totally a digression, but the focus changes.) Some of you may or may not be interested in that part, but you can fast forward the interview if you're not.

That's it for today. I look forward to talking with you again soon.

Jack

Questions? Write to Jack at: [jack@jackadamo.com](mailto:jack@jackadamo.com)

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