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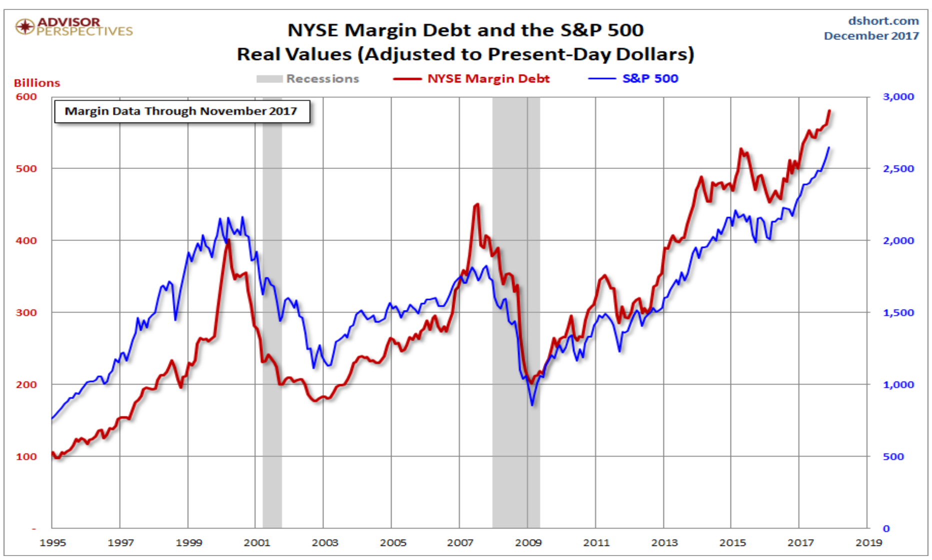
Damn the Torpedoes, Full Speed Ahead

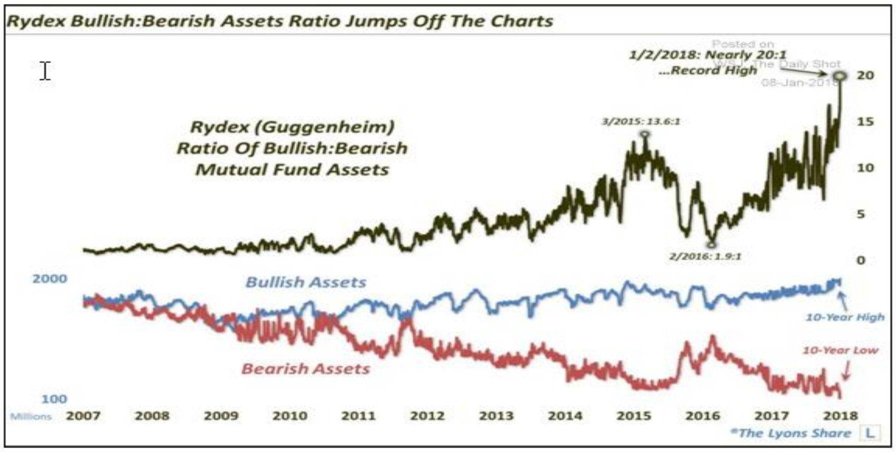
"The four most expensive words in the English language are, this time it's different" – William Bernstein

The title of this quarter's newsletter is widely attributed to Admiral James Glasgow Farragut, known more commonly as David Farragut. Admiral Farragut was a naval officer for the Union during the Civil War. On August 5, 1864, in a battle for the port of Mobile, Alabama, the captain of another ship hesitated at the mouth of the harbor. Farragut yelled out for an answer to the delay. The other captain shouted back that the port was heavily mined (torpedoes as they were known). Farragut's reply would become famous. In a bold move, he ordered his ships into the harbor. Most of the Union ships made it safely, and captured a key access point to the Gulf of Mexico.

Farragut's phrase seems to capture the sentiment of most investors presently. To start, the average amount allocated to stocks in an individual investor's portfolio has only been greater at one time in recorded history. According to the American Association of Individual Investors (AAII), stock allocations currently stand at 72% of the average investor's portfolio. The highest recording was in March of 2000 at 77% (very briefly). The average allocation is 61%. At the same time, investors are growing increasingly comfortable with the notion of borrowing against the equity position in their stocks to buy more stocks (margin debt). The graph below gives you some historical perspective on stock market margin debt (red line) against stock prices as measured by the S&P 500 (blue line). As you can see, margin debt is approaching $600 billion. The previous highs were in 2000 ($400 billion) and 2007 ($450 billion). Notice how highly correlated these two measures are. Notice also that margin debt peaked, in both 1999 and 2007, before the stock market began falling.



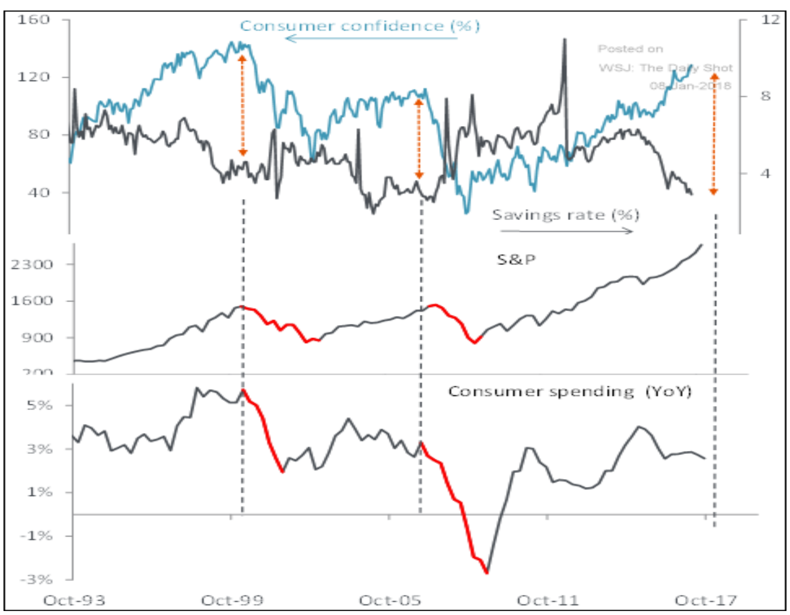
Investors are acting on their extreme optimism, by placing a $20 bet on the continued rise of the stock market for every $1 bet against it.



Source: @LanceRoberts, @JLyonsFundMgmt; Read full article

In the midst of all of this euphoria over stocks, the average American is struggling to keep up. According to the Federal Reserve Economic Data (FRED), Consumer debt is now at 26% of disposable income – the highest since the 1970's. The Bureau of Economic Analysis (BEA) indicates that the average American has spent more than he makes now two years in a row. Approximately 70% of Gross Domestic Product (GDP) is dependent on consumer spending. Want to know how the economy will fare, check in with the consumer.

Consumer confidence (blue line below) is peaking at the same time individual savings rates (black line) are crashing. Check out the performance of the S&P 500 (third line - black and red) after each of the previous wide gaps between these two measures.



It may truly be different this time. Consumers may continue to take on more debt to support their spending. Stock prices may continue to grow much faster than underlying earnings. The Federal Reserve may navigate its way smoothly in its effort to reduce its balance sheet while simultaneously raising interest rates, and avoiding an economic slowdown. Pigs might finally learn to soar. Damn the torpedoes…