

>: Where You Should Invest Your Money Now Â»

Thursday, March 23, 2006 / Dylan Jovine

Two days ago I wrote an article titled, "Don't be Seduced by a Sexy Stock market."

In the article I wondered aloud if the stock market's recent highs were here to stay ... or just an illusion, with bad news lurking underneath the surface. To illustrate my point I gave the bull side of the argument.

Today I'll touch on the bearish argument.

As members of my Fallen Angel Stocks service know, I believe that trying to make money by predicting the direction of the economy, interest rates or the stock market is a sucker's game.

Sure, it makes for interesting conversation at dinner, but the mental exercise yields very little in return. Who can really predict the direction of a mad crowd?

That being said, it's no secret that I think equity asset prices are way overvalued right now. The reasons I believe this are all the usual suspects:

Rising Interest Rates/Inflation: During the past 4 years of economic expansion, productivity growth has averaged a stunning growth rate of 3.3% annually.

(That compares to an average gain in productivity of 2.5% during the past 5 economic expansions. To further put that in perspective, even the expansion of the roaring 1990's - the previous record holder this past century - had productivity growth of only 2.7%).

What's made productivity growth so unique this time around has been the conspicuous lack of hiring during the same period.

It took 30 months for employment levels to catch up to the previous peak in this recovery. In contrast, during the famous "jobless recovery" of the 1990s, it took "only" 18 months for employment to recapture its previous peak. But there is pent-up demand for jobs, which companies are beginning to satisfy now.

If revenues stay the same, however, and companies continue to add employees, productivity will naturally go down.

The implications of this productivity slowdown for profits, the Fed and financial markets will likely be profound.

It's coming at the same time that slack in labor and product markets has dwindled. With the jobless rate below 5% and inflation expectations higher, firming labor markets are beginning to boost pay gains; average hourly earnings are up 3.5% from a year ago.

In a reversal of developments over the past four years, the one-two punch of slowing productivity and faster pay gains will help flatten profit margins, all else being equal.

Housing Bubble: Famed investor and billionaire Julian Robertson said it best recently when he said to the Wall Street Journal, "We have a real housing bubble, and the aftermath of this thing will really be something."

ARM'S: 40% of people who took new mortgages during the past several years got adjustable rate mortgages. The appeal of them is simple - it lessens the amount of money that the buyer has to commit to the mortgage.

But many buyers are facing mortgages that are being reset. Let's say you were paying an interest-only mortgage where the payment was \$1,000 per month. Originally you got the mortgage at an interest rate of 4.0 percent. However, when its time to re-adjust and interest rates are at 6.0%, your monthly mortgage payment will go up a painful 50 percent.

Twin Deficits: Let's not forget the two-headed monster of historically high budget deficits and trade deficits.

The Real Reason You Should be Bearish

Irrespective of the above, what should not matter for most equity investors is trying to predict the direction of the economy, interest rates, or the decline of the dollar.

What *should* matter most - or ought to - is finding individual companies selling for less than they are worth. And in that department, there are fewer and fewer options for the enterprising investor.

In other words, the market as a whole may look like "Goldilocks," but many companies are overvalued at these prices. That doesn't mean that you can't make money investing - far from it.

What we do here at *Fallen Angel Stocks* is hunt for stocks selling at a huge discount to what the underlying business is worth. This strategy is great for any market, but seems tailor-made for markets like this.

That's why we pick our spots here very carefully (we only have approximately 10 open stock positions at any given time).

To quote the great Jim Rogers: "I BUY downside panic and SELL upside hysteria!"

We couldn't agree more. We love nothing more than a fire sale - especially one that can make you rich!

You are what you read,



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