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www.NoyesCapital.com

(973) 267-8120

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Where have all the Bubbles Gone?

By Scott P. Noyes, CFA® CFP®

We just completed another good quarter for the U.S. stock market. During the first quarter of 2011, the S&P 500 index added another 5.4% to the 18.9% gain since August of 2010. As a result of the turmoil in Japan, the foreign equity market did not perform as well. Stocks in developed markets rose 3.0% and emerging markets' stocks rose 2.0%. Every day I come in and worry about what could go wrong. When I stop worrying, it will probably be the top!

My current investment strategy remains on maximum offense in stocks and maximum defense in bonds. I am hopeful that the upcoming corporate earnings season will continue to be more favorable than predicted. Since interest rates are likely to remain low, the major risk factors continue to be system-wide shocks and one-time events.

For the past year, investment flows have been moving from bonds into equities. In addition, capital markets (stocks, bonds & commodities) continue to receive new investment money that was previously directed toward residential real estate. It appears that stocks and commodities will continue to be the best game in town for 2011. While I expect this stream of new inflows to moderate over the summer, I am hopeful that the stock market will meaningfully add to its gains for the year.

Fixed Income Outlook

While I am negative on bonds for the year, I am not overly concerned that there will be a bond market collapse in the near future. We can save that problem for next year. For the next quarter or two, I am investing in areas of the bond market where the coupon rate can compensate for moderate declines in principal. I currently favor shorter maturity corporate bonds and high yield bonds, foreign fixed income, emerging market bonds and very long maturity bonds. I am avoiding high quality 3-10 year bond maturities as I believe this is where interest rates are likely to increase the most when the Federal Reserve stops providing liquidity through QE2.

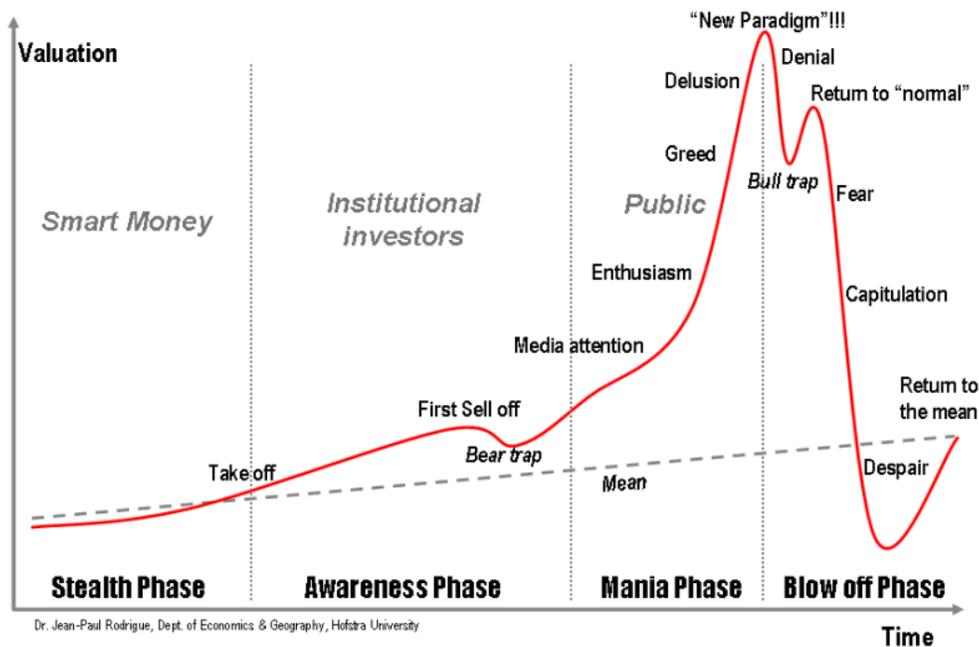
Commodities

The party in commodities is well under way. Due to the dramatic growth of worldwide production and global GDP, demand for commodities is rising. It cannot be controlled by any one government and cannot be stopped by modest increases in interest rates. While low interest rates help support higher commodity prices, the primary driver is real global demand. With two billion people in emerging markets trying to raise their standard of living, increased consumption of oil, metals and foodstuffs is a natural outcome. Prices of these commodities increased in both 2009 and 2010 and are likely to continue rising in 2011 as well. Countries such as India and China are combatting commodity inflation by raising interest rates but to no avail. It is likely to take meaningfully higher prices to reduce demand.

The Psychology of Investment Bubbles

When trying to determine where we are in the price/value cycle, I like to look at the stages of past investment bubbles. There is a clear psychology to the formation of these bubbles as can be seen in Exhibit 1.

Exhibit 1 - Investment Bubbles Have Four Distinct Phases of Behavior.



The Stealth Phase

Typically value investors and those with very long-term time horizons buy during the stealth phase. These investors are infuriatingly patient and deliberately coy because they will wait for months or even years for the right P/E ratio or a bad earnings report to give them the opportunity to swoop in to buy as much as they can at dirt-cheap prices. These are the Warren Buffett's and Wilber Ross' of the investing world. Currently, bank and health care stocks would likely be in in this stealth phase.

The Awareness Phase

Investors in the awareness phase are big institutional investors who pour over stock charts and fundamental analysis screening programs for 18 hours a day. These firms have dedicated research teams who are constantly on the lookout for new opportunities. It is their job to do the research, read everything including the fine print in the 10K, and beat the bushes to find the next hot sector or commodity before anyone else does. Currently, technology and industrial stocks would be in the awareness stage.

The Mania Phase

During the mania phase, everyone jumps on the bandwagon. The hot investment idea will get mentioned in every publication from the Wall Street Journal to The Today Show. This is the stage when the bubble lures in the retail investor by focusing on past performance and presenting the illusion that future appreciation will continue at the same pace... At this point, the cycle begins to act like a bit of a euphoric or narcotic and all people think about are 20% gains in a month and two stock splits a year. In other words, it is purely unobtainable mania brought about by something proverbially spiking the punchbowl. I would consider gold and commodity plays to be in early to mid-mania stages.

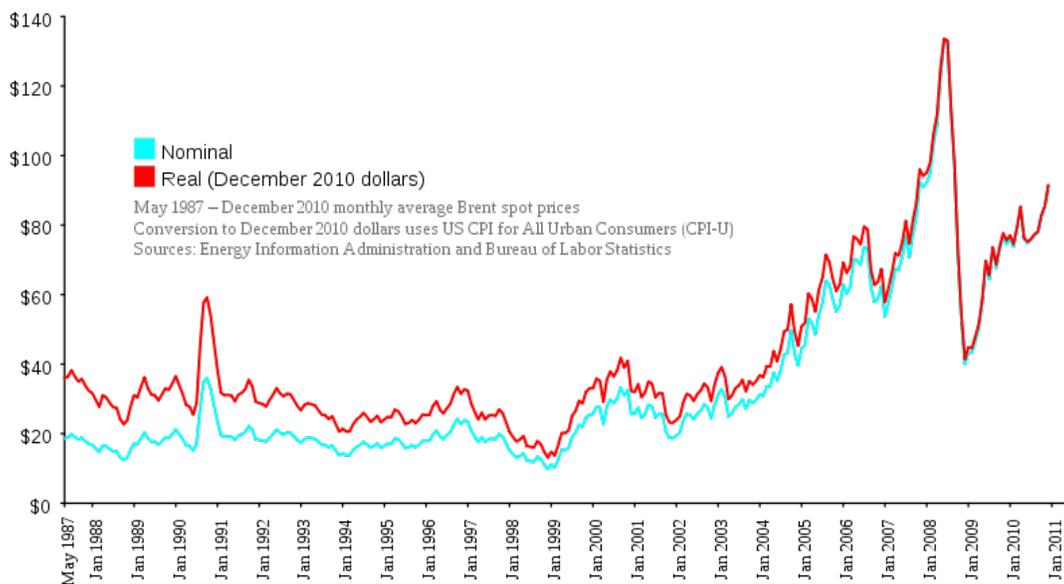
The Blow Off Phase

In the Blow Off phase, investors assume the “it will come back” mentality and fail to comprehend or are afraid to admit that they’ve just been had. The big institutional investors and fast money traders will have predetermined stop loss orders in place and when those are tripped in mass quantity, the bottom completely falls out and panic selling begins. The best traders will also begin to pile on short positions which accelerate the selloff. In the end, prices will be pushed below historical trendlines because investors overreact just as much on the downside as much as the upside.

Past Bubbles - Oil in 2007 and again in 2011?

Who can forget the oil bubble which began in 2007? Wasn't it was fun to pay \$100 to fill up your SUV every five days? In a period of less than 18 months, oil prices nearly tripled from less than \$50 per barrel to \$147 (Exhibit 2). While it took nearly five years to create this bubble, note the horrendous sell-off which pushed prices back down to \$35 per barrel and occurred over only six months. Currently oil is pushing \$109 a barrel and is very likely on its way to \$130 or higher. Double tops are a fairly common occurrence. I believe the fun part (higher prices) of this bubble is still ahead of us.

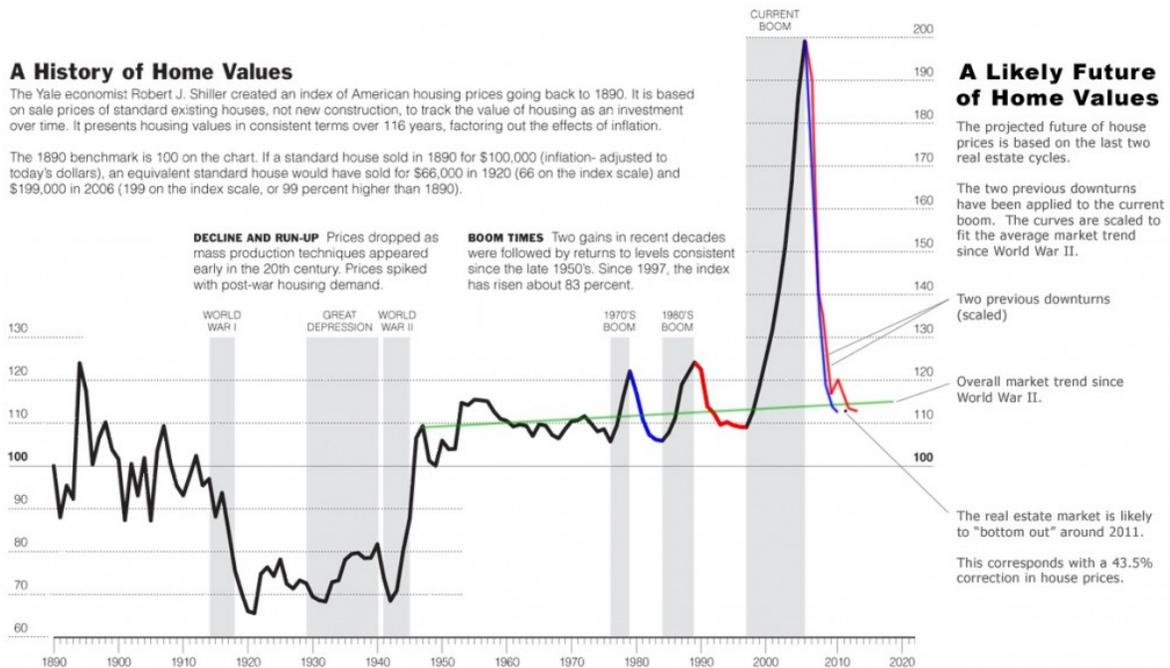
Exhibit 2- The Most Recent Oil Bubble Collapsed in Less Than Six Month in 2008



The Real Estate Boom- 1998-2007

I can't believe I fell for it! Take a look at the massive deviation from the green historical trendline in the price of real estate (Exhibit 3.) The lack of controls on credit and very easy to obtain mortgages fueled this bubble. I doubt these conditions will return for a very long time. In my opinion, real estate has returned to being a consumption item rather than an investment vehicle. Real estate prices have returned to the breakout level and should find a bottom in this range.

Exhibit 3 - Real Estate Prices have Returned to Previous Trendline Levels.



The Dot Com (Tech) Bubble – 1998-2000

Who can forget the technology bubble of the 1990s? That much-loved period when America could do no wrong and any crappy company could create a website and double in value within two months. The truly sad thing was that according to almost everyone, these companies had great fundamentals and the huge run up in prices was sufficiently validated. On top of this, you were vilified if you said anything to the contrary. This type of ebullient language is typical at the top of a bubble. Now after ten years of a sideways market, technology stocks are just starting a meaningful come back in performance (Exhibit 4).

PS. I imagine the housing chart for 2008 to 2018 to look similar to this tech bubble chart.

Exhibit 4 - The Dot Com Bubble Burst in 2000.



The Bond Market Bubble – 2009-???

Remember the good old days when 10% corporate bonds were easy to buy? The markets were petrified about a return of inflation and thought these high yielding bonds were a bad risk. Not anymore! Investors are lucky to find good bonds yielding 4%. My guess is that as the banking system recovers and levers up its balance sheet, interest rates will start to turn higher. This may occur slowly at first and then accelerate into 2013 and beyond. For now, we believe a defensive posture towards bonds is warranted.

Exhibit 5 - Bond Yields Are Significantly Below Trendline



Is There a Bubble in Gold?

Now that gold has breached \$1,400 and appears destined to move meaningfully higher, it has all of the makings of another market bubble. If you are a believer, there is still time to buy gold before it reaches \$3,000 an ounce. If not, then you should consider selling your unneeded gold and silver jewelry at today's great prices. I have set aside target prices to sell bullion-value coins and jewelry. Taking a profit is rarely a bad thing. My guess is that investors are not fully committed and the price of gold has higher to go. All bubbles eventually pop, but there could be more gains yet to be had. If the gold bubble mimics those of the housing market and technology stocks, it is just entering the parabolic stage.

Exhibit 6 – Up, Up and Away for Gold Prices!



My Current Market Strategy

I believe that during 2011 some markets will behave as if they are in the mania phase of a bubble, while others will not. Stocks, bonds, commodities and foreign exchange all have to be evaluated separately. There will be a point in time when reducing portfolio risk and moving to the sidelines is the prudent investment decision. Currently the stock market is behaving well because the current of incoming investment flows are positive. I do not believe it is in a bubble, but it may react to those bubbles around it. My current investment strategy remains on maximum offense in stocks and maximum defense in bonds. I am hopeful that the upcoming corporate earnings season will continue to be more favorable than predicted.

My key recommendation is to stick with your investment plan regardless of the “crisis of the day.” During the 2008 crash, the investors who really lost out were those who sold stocks, moved to CD’s, and were not invested when the market’s rebounded. When markets turn, they do not ring a bell to let you know it is time to get in again. I recommend that you remain invested, diversified and patient.

If you don’t have an investment plan or believe it is off track, you should get one. At Noyes Capital, we help evaluate your risk tolerance, time horizon and financial needs. These are analyzed to establish an Investment Policy Statement and construct a well-diversified portfolio of stocks and bonds designed to help you achieve your goals. Let us worry about the details for you.

We remain focused on building portfolios that succeed in a global context. In this light we have three biases in our portfolios:

- 1) **Add more income investments to portfolios.** We seek income opportunities in the form of high dividend stocks, investment grade bonds, municipal bonds and equity income trusts. We believe this strategy adds to portfolio stability and helps meet your income needs going forward.
- 2) **Overweight Asia and Emerging Market Equities** – We follow the global growth story. China, Brazil, India and Korea are projected to continue on a strong growth path during 2011 and 2012. We like positions in stocks and bonds that profit from their growth.
- 3) **Stay with long-term equity holdings.** We believe that equities will outperform bonds over the next two years. While holding stocks may feel terrible at times, we believe that you will be rewarded for patience. Stay the course.

Please call me if you have any questions at 973-267-8120

Scott P. Noyes, CFA[®], CFP[®] is the President of Noyes Capital Management, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey. www.noyescapital.com

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