MONONGAHELA CAPITAL MANAGEMENT

PERCEPTIONS

Cycles not Trends

As we fight our way through a never ending litany of frightening economic news, souring markets, and political fumbling, we are given to wonder if we will ever see an end to the misery. The grinding 17 month bear market has taken a severe toll on the American psyche. The markets are so depressed that the question most investors are now asking is not when the bleeding will stop, but rather if the bleeding will stop. Our answer remains that the markets are cyclical in nature and that trends do not stay in place indefinitely. The bleeding will stop and prosperity will return.

Note that as the Mississippi River winds through the heart of America, flooding occurs cyclically, not annually. When the Mississippi does flood, the river diverts its course, flowing across the numerous low lying sand bars, cutting new channels that eventually become the main channel. Mark Twain observed this phenomenon and commented on it in his novel “Life on the Mississippi.” Twain noted that the river had been shortening its route by just over a mile a year for a number of years. Twain, tongue in cheek, extended that trend, noting that “Any person can see that seven hundred and forty-two years from now the lower Mississippi will be only a mile and three quarters long.”

The basic fallacy of extending trends in a straight line into the future is supported by the observation that the world as we know it hardly ever comes to an end. Despite dire predictions of running out of oil, communism taking over the world, bird flu pandemics, or polar ice caps melting, systems seem to find some self balancing mechanism. In the 1940’s it was an accepted scientific fact that by the year 2000, there would not be enough land to feed the growing US population. Logic argued that a fixed amount of land was necessary to grow food and support livestock to feed a fixed amount of people. The population was growing at a fast pace while land was being taken out of agriculture to provide housing. Extending the trend of population growth and decline in available farm land, the inevitable conclusion was that the US would become a third world country. Obviously, farmers learned new soil management and new breeding techniques, along with more efficient means of production. The trend that looked inevitable in the 1940's was reversed and the US quickly became an exporter of surplus grains.

The favorite forecasting tool for analysts is the endless extension of current trends. When the Dow crossed 14,000 in October of 2007, analysts were moving their targets to Dow 20,000, or Dow 30,000 even as high as Dow 36,000. Now with the Dow at 6,800, analysts are extending the trends lower, often in an effort to score the most dismal forecast. We are bullish over the next five years, fully recognizing that the Dow could trade within a range of 5,500 to 14,000. A great deal of the risk has already been removed from the markets. In a 60/40 portfolio allocation, the potential downside risk from this point is probably 10-15% and the upside is 100%.

We fully expect the cyclical movements to continue in the markets. We will adjust portfolios according to the ever changing investment landscape. We will try to minimize losses as the markets probe the lower end of the range. Within each client's comfort level, we will keep as much of the portfolio intact as possible in order to participate in the eventual recovery.

Regardless of the state of affairs, people will still drive, use Kleenex and Scott tissue, buy groceries, and fill prescriptions. Chevron, Kimberly Clark, Procter & Gamble, and Johnson & Johnson will continue to grow. In the meantime we will collect significant dividends and stay with quality until trends reverse, or until the Lower Mississippi is a mile and three quarters long.

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