

# A few comments on the markets....

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Once policymakers finally realized the scope of last year's financial crisis, they came in with financial bazookas blazing, all part of a hastily-crafted "shock-and-awe" strategy. This has included 0% interest rates, quantitative easing (including over \$1 trillion in Fed purchases of mortgage-backed securities and Treasury bonds), \$1.5 trillion budget deficits, and a variety of bailout programs, such as the \$700 billion TARP fund. These are truly staggering amounts; to provide some context, the \$85 billion given to AIG alone was more than the combined annual budgets of Singapore and Taiwan.

Despite all the money spent on stabilizing the "too-big-to-fail" banks, concerns remain. The spin machines in Washington have been working overtime to make sure that financial markets believe in the stability of the big banks, chanting, "Nothing to see here, please move along. Don't worry, they all passed the stress tests. Nothing to see here." It's one big game of spin control, with regulators trying their best to induce positive psychology in investors and consumers.

The government programs clearly succeeded in defusing a situation that came within days of financial meltdown. They put out the fire and created a level of economic stability. But, aside from a stock market rally and a runup in commodity prices, little has gone toward helping the real economy (some new jobs would be a nice touch). And, the reality is that the fundamental problems which led to the crisis have yet to be addressed. Many are concerned that policy moves have increased, not decreased, systemic risk, partly due to policymakers' approach of increasing debt to resolve the problem of too much debt.

In the current environment, it's important that investors not become complacent about downside risks in the financial markets. We continue to be defensive in our portfolio models, with an emphasis on income and capital preservation. Our models remain underweighted to equities – stock exposure is clearly an important part of an investment portfolio, but aggressive positions at current levels aren't warranted since uncertainties in the economy still pose significant risks.

Within equities, we continue to be overweighted to non-US stocks and will be looking to further diversify into foreign stock funds. On the fixed income side, we remain weighted to the front end of the yield curve, with an emphasis on short-term investment-grade bonds and high quality municipal bonds. Strength in the US dollar will be viewed as an opportunity for portfolio shifts into non-US bonds, including foreign inflation-protected bonds and emerging market debt.

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### **More debt, anyone?**

Among the policy moves being questioned are the government's attempts to persuade consumers to spend more money and take on more debt. The "cash for clunkers" program resulted in 700,000 vehicles being sold, but at a taxpayer cost of \$3 billion. The \$8,000 tax credit for first-time home buyers triggered home sales, but is expected to cost taxpayers over \$15 billion. In many cases, these programs are just pulling sales forward, borrowing from sales that would have occurred in 2010. Bottom line: short-term artificial stimulus can only provide short-term artificial economic support.

Critics view these stimulus programs as huge misallocations of capital. A recent white-paper report from the Brookings Institute concluded that the home-buyer credit actually costs about \$43,000 for each additional home sale it produces. That's because most of the two million or so home buyers expected to claim the credit would have bought a house anyway. Only about 350,000 are considered to be additional buyers generated by the program.

### **Big banks rolling our dice**

For me, the Troubled Asset Relief Program (TARP) is a source of amazement. Originally designed by Treasury to buy toxic assets threatening the financial system, TARP funds have instead been used as handouts to big banks, helped to bail out floundering auto companies, and funded an ineffective program for home mortgage modifications.

Nobody really knows what the banks are doing with their TARP money. They aren't lending the money out and they still have the toxic assets (which, if anything, are getting more toxic as foreclosures mount). In fact, it looks like the big banks have used TARP money, along with huge amounts of liquidity injected into the banking system by the Fed, to trade and speculate in the financial markets.

Yes, big banks have used taxpayer dollars to make an absolute killing in the stock, bond, and commodity markets this year. For example, Goldman Sachs had revenues of \$12.4 billion in the third quarter, of which trading and investments accounted for \$10.1 billion. If the bets go bad, taxpayers pick up the tab. But, the bets paid off, which is one reason Goldman can give \$20 billion to its employees this year, or nearly \$700,000 per person.

### **Smaller banks: not too big to fail**

In contrast to the "too-big-to-fail" banks, small- and intermediate-sized banks are struggling to survive. Big banks are fully protected by implicit government guarantees, but smaller banks have no such protection. That's unfortunate since they do most of the lending to small businesses, which account for much of the hiring in our economy. To survive, most smaller banks have cut off the flow of credit to their clients, with lending to small businesses steadily declining for the past several months.

Many small banks are too scared to lend because they're sitting on a growing inventory of unrecognized losses in their asset portfolios, largely comprised of commercial loans. Commercial real estate prices are currently down 39% from their peak in 2007, according to the MIT Center for Real Estate. Commercial real estate sales activity is practically nonexistent. And with nearly half of all commercial loans coming due in the next five years, most loans may be upside down and unable to qualify for refinancing.

### **Faith in a V-shaped economic recovery**

Wall Street has embraced the future and it sees a strong “V-shaped” recovery. This is based on the premise that the recession is over and, when postwar recessions are over, they’re followed by robust recoveries. The deeper the recession, the stronger the economic rebound. Today’s V-recovery scenario assumes that cost-cutting and inventory restocking will lead to surging corporate profits, which will then trigger increased business spending and corporate hiring. Stronger labor markets will then inspire consumer confidence, which results in higher consumer spending. That’s how it’s supposed to work in a typical business cycle. The only problem is that we are dealing with anything but a typical business cycle. Instead, we’re dealing with the end of a secular credit expansion, something the economy hasn’t seen since the 1930s.

### **Rising unemployment....**

Last week, the governor of the Bank of England, Mervyn King bluntly stated, “It’s the level, stupid – it’s not the growth rates, it’s the [depressed] levels that matter here.” He’s referring to the fact that the absolute levels of income, debt, and unemployment, not just the rates of change, are what matter today. When an economic report shows a minor uptick, the financial press hypes it as a full-blown turnaround and reason for much celebration and high-fives among CNBC reporters. But, what you have to look at is how that minor uptick compares with the ongoing major downtrend.

This is especially true when it comes to the dismal unemployment situation, which has seen minor upticks fall by the wayside, as job losses continue to mount. The current headline number is the 9.8% unemployment rate. But, if you include underemployed workers (full-time workers that have been forced to take part-time jobs) and discouraged workers who have given up looking for jobs, the real unemployment rate is 17.0%. That’s about one in six workers. Part of the problem with the labor situation is that a number of business models are now broken (autos, home construction, commercial real estate development, finance, retail sales), which has resulted in job losses that are permanent.

### **And rising home foreclosures**

Mortgage defaults and foreclosure rates continue to rise. US properties subject to foreclosure totaled nearly 938,000 in the third quarter, up 5% from the second quarter and up 23% from year-ago levels. And, according to the Mortgage Bankers Association, that’s coming off a record high 13.2% (about one in eight) of US households with mortgages either in foreclosure or at least one payment past due at the end of the second quarter.

Negative equity is becoming a serious problem, not only for homeowners, but also for banks holding mortgage-related toxic assets. According to First American CoreLogic, as of June 30, about 32% (or 15 million) of all mortgaged residential properties were underwater and worth less than the amount owed. Another 2.5 million mortgaged properties were approaching negative equity. This means that negative equity and near-negative equity mortgages represented almost 38% of all residential properties with a mortgage in the US. All indications are that the negative-equity rate will continue to rise and spin off more foreclosures.

The foreclosure crisis appears to be moving beyond subprime mortgages and into the prime mortgage market, as a growing number of borrowers with good credit are heading into foreclosure after losing their jobs. Higher-quality prime loans accounted for 58% of foreclosure starts in the second quarter, up from 44% last year, according to the Mortgage Brokers Association. And, according to Zillow, about 30% of foreclosures in July involved homes in the top third of local housing values, up from 16% when the foreclosure crisis began three years ago.

### **The deleveraging consumer**

Whether consumers are truly changing their debt and spending habits is a critically important question for the economy. Outstanding consumer credit fell by \$12 billion in August, this followed a record \$21.6 billion decline in July and was the seventh consecutive monthly decline. On a year-on-year basis, consumer credit fell by 4.4%, the biggest drop in over 65 years. Debt contraction has clearly damaged the retail sector; the Fed estimates that 8,300 store closings have been announced by retailers so far this year.

Yet, consumer debt levels have just begun to come down. According to the Federal Reserve, total household indebtedness peaked at the end of 2007 at 132% of disposable income. By the end of March, it had fallen to 124%, still very high when compared to 61% in 1984. If the 25-year secular credit expansion has indeed ended, we could see a deleveraging process that continues for an extended period, as debt levels get back into alignment with consumers' debt-servicing capacity.

### **Deflation now, stagflation later**

In recent weeks, we've heard more talk about the possibility of deflation. Actually, we're already seeing signs of mild deflation. The Consumer Price Index is negative, the Producer Price Index is negative, wages are falling, money velocity has been negative for a year, and capacity utilization is at historic lows -- all classic signs of a deflationary environment.

Deflation proponents believe the current cycle is a classic debt deflation, the aftermath of years of credit overextension, followed by a credit bust which occurs when repayment becomes impossible.

Deflationists believe that the stimulus now being pumped into the economy isn't nearly enough to offset the collapse of credit and resulting loss of demand in the private sector. The question of whether we see deflation or inflation has huge implications for investors. At this juncture, the possibility of getting trapped in a Japan-style deflationary period cannot be taken lightly.

### **The Hope Rally precedent**

From its all-time high reached in October 2007, the S&P 500 dropped by 57% before reaching the March lows. It then bounced off its lows with a stunning 62% recovery. The magnitude of the rally off the March lows has convinced many investors that, given its magnitude, this bull market must be the real thing. However, there have been precedents for such large head fakes.

In 1929, the stock market dropped by 47.9% in about nine weeks. That was followed by the "Hope Rally," a 48.0% five-month recovery which topped out in April 1930. About that time, people were singing a popular hit song, "Happy Days Are Here Again," which was featured in the film *Chasing Rainbows*. That was right before the stock market started down again, reaching an ultimate low in July 1932 for a total market decline of 89.2% during the 1929-32 period. This is not to predict a 1930s-type experience, but serves as a warning for investors who may have grown complacent about downside risks.

## **Economic scenarios**

The US economy may be starting to climb out of a deep recession, but it is still far from doing anything more than “stabilizing.” Of key importance is the extent of follow-through seen after fourth quarter 2009, which is getting temporary boosts in growth from inventory rebuilding and stimulus programs. By early 2010, these one-time benefits may start to wear off, allowing more lasting, negative factors, such as reduced consumer spending and weak jobs creation, to take hold.

When determining appropriate asset class weightings for our portfolio models, we assess the probabilities of different economic scenarios and then weight our model allocations accordingly. Currently, our four most likely scenarios for 2010 are as follows:

**Stagflation (45% probability):** slow, anemic economic growth and continued deleveraging in the consumer sector. The US economy is held down by higher interest rates and a weak dollar. This is similar to PIMCO’s “new normal” scenario.

**Deflation (30% probability):** debt contraction continues to weigh on the US economy as we go into a Japan-style deflationary environment. Government policy produces few results and the threat of rising protectionism looms large.

**Moderate growth (20% probability):** the initial economic rebound, coupled with strong growth in China and other emerging markets, significantly improves business and consumer confidence. Home prices stabilize, foreclosure rates decline, and job losses taper off.

**Strong growth (5% probability):** corporate revenues are strong, leading to higher consumer spending and falling unemployment. Higher interest rates and inflation concerns are key market factors, as the Fed and other central banks pull liquidity back out of the financial system.

We’re in the midst of a multi-year transition of the global economy and have left behind an era that was driven by debt-financed consumption in the US. Eventually, we’ll reach an environment of stable economic growth, but there are still some major speed bumps in the road ahead.

Renowned economist Peter Bernstein believed that most market participants fail to see shifts to new environments because mass thinking is always dominated by the immediate past. Today, it’s critically important that investors realize we’re dealing with a new analytical framework and not rely on outdated ways of thinking.

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