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Market Correction, Summer 2011

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The market volatility of recent weeks has investors worried about a repeat of the crisis of 2008-2009. This is not 2008.

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Chris provides financial planning, investment planning and full implementation services to about 100 families.

We are pleased to welcome new clients.

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Perspective

The sharp market selloff in August is, at this point anyway, a normal correction. Since 1950 there have been 38 corrections of 10% or greater, or about one every 20 months. Only ten of these declines have been declines of 20% or more[1], known as bear markets.

The current situation is reminiscent of the correction of 1998 (now forgotten by many) which saw the US market drop about 20% in 46 days over the simultaneous Russian bond default, Asian currency crisis, and US hedge fund meltdown[2]. Canadian bank stocks fell about 30%, reflecting the financial sector focus of that crisis, yet the markets recovered smartly as it became apparent that the crisis was contained.

Corrections Not Predictors

Corrections do not predict economic recessions. In 27 of the past 37 corrections - 75% - there was no recession.[3]

Comparisons with the financial crisis of 2008 do not hold because there is very little leverage in the system now, says Eric Bushell of Signature Advisors. Investment banks and hedge funds have virtually no leverage and are sitting on tons of cash. In addition, the looming Greek default will likely be a managed default, not the surprise detonation of Lehman Bros in September 2008.

We have known for some time that the recovery from 2009 would be slow. The markets are coming to grips with that fact.

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[1] S&P 500, including August 2011
[2] Long Term Capital Management
[3] Tacita Capital Research, August 9, 2011

Portfolio Designed to Take It

Your portfolios are designed to withstand this sort of turbulence. Clients that are withdrawing regularly have bonds and other conservative income investments that are designed to generate cash flow. The equity component of your portfolio is similarly conservative: we have almost zero direct exposure to Europe, for instance.

One level down, your investment managers have been positioned conservatively since April and May: Eric Bushell (Signature Advisors) has been 15% cash, less than 50% equities and has had about 4% gold bullion. You will find that most, if not all, of the individual components of your portfolio have declined significantly less than the markets they are invested in. This is the way professional money management is supposed to work.

Professionals Buy not Sell

These corrections are naturally unnerving for many investors, especially with 2009 so close in the rear-view mirror. However, professional and other experienced investors have trained themselves to stand against the anxiety of price declines and see corrections as opportunities. The media trumpets fear, the pros are buying.

Even the crisis of 2008-9 surprised with a V-shaped rebound in market prices. People who sold into the market panic 'waiting for the storm to pass', locked in permanent and significant capital losses.

A temporary decline is a temporary paper loss. Trading out after riding down a decline, and then missing the recovery is a permanent loss.

Selling into a down market just in time for a price reversal upwards is known in the business as a '*whipsaw*'; it is considered an amateur pilot error, and is one of the main reasons individual investors lose (buckets of) money.

Experienced investors know that times of fear are times to buy - not sell.

US Companies Solid

Many companies such as Boeing, Caterpillar, and DuPont have reasonable growth prospects, are very well-run, have very strong balance sheets, and are selling at below-average valuations.

US industrial companies in total held a record $1.1 trillion in cash at March 2011, and are set to handily beat previous record earnings set in 2007. Let me say this again: the 500 best companies in the world are sitting on more cash, and are set to produce more profits for shareholders than at any time in recorded history.

The US market is selling at a P/E (price/earnings) ratio of about 12x, vs. its long term average of 16. A P/E of 12 represents an earnings yield of over 8% - compared to a 10-year bond yield of less than 2%. This difference between bond yields and stock yields is the highest since 1951[4].

Notes on US Manufacturing

While the immediate attention is on Europe, fully half of the entire world is growing strongly as more and more people are enjoying the benefits of a market economy.

Country	Population (millions)	2011 GDP[5]
Chile	16	+6
Argentina	40	+8
Turkey	73	+6
Brazil	186	+4
Indonesia	223	+6
India	1,100	+8
China	1,315	+9

The US has the industrial knowledge and expertise to produce high-value goods that these markets need more of, such as jet aircraft (see below). The US remains the world's largest manufacturer, at 21% of the world total, the same percentage it held 30 years ago. China is #2 at 15% and Japan third at 12%[6].

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4 Nick Murray, a long-time industry analyst and commentator, August 2011
5 2011 forecast GDP growth, yr/yr, Economist, August 2011
6 Nick Murray, a long-time industry analyst and commentator, August 2011

The number of US manufacturing jobs has fallen from 18 million to 12 million in the last 10 years yet they produce $1.6 trillion of goods annually. If US manufacturing was on its own it would be the ninth largest economy in the world.

US manufacturing workers are twice as productive as the next ten most productive economies in the world. They are so productive because they are educated and use sophisticated and expensive capital equipment – machinery and computers – to make highly engineered and technically difficult things like jet aircraft, diesel engines, and so on.

US demographics are also good – its young and growing population is far superior to Europe's older demographics. Europe may become just a sideshow as they struggle with demographic and pension headwinds.

Behind the Scene – The Greeks, the Americans, and the Dreaded Double Dip

Macro issues stemming from the banking crisis of 2008 continue to dominate the markets, so it is worthwhile thinking about them.

This correction seems to have been triggered by the Sarkozy-Merkel 'summit' in early August to deal with the deepening Greece/Euro crisis, and by the media-hyped spectacle over the US debt ceiling. The post-Euro summit announcements were lame and failed to address the heart of the matter – that Greece is insolvent and the German people are refusing to underwrite additional funding.

The markets were also spooked by the strength and intransigence of the Tea Party in the US Congress. We all may agree that a balanced budget is preferable to a deficit, but now is not the time for a 'no compromise' Tea Party balanced budget. The US economy is like an aircraft struggling to gain airspeed and in danger of stalling - the correct response is full throttle. A pullback in spending now would likely stall the plane.

In economic terms, the US banking crisis and nationwide home price declines are deflationary shocks. US consumers have gone from being net borrowers to net savers, effectively pulling money out of the economy. While this is good for the economy long term, in the short term everyone running to the same side of the boat is dangerous.

Rebalancing the fragile economy requires both monetary and fiscal policy to be coordinated and 'loose'. The correct policy here is for the US government to manage the slack with short term deficit funding[7].

The US debate was unnecessary because the US economy is nowhere near the limit of its actual ability to service its debts. The US is not Greece. The US has the luxury of time to work out the balance between tax increases vs. service cuts to balance public finances. To continue the analogy, the US has altitude and fuel; Europe does not.

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[7] Spending is economically preferable to tax reductions because a significant portion of tax savings will likely go to debt reduction. Infrastructure spending is far preferable to typical US pork-barrel spending.

Immediate Decisions Required

Elected policymakers in Europe are avoiding tough decisions by doing as little as possible as late as possible. The Greeks, having been rescued once by the French and Germans last year, are showing only lukewarm interest in bringing their economy to order. The German people have indicated that they have written their last bailout cheque to Athens.

Greece's national railway illustrates the depth of Greece's troubles: it took in revenues of E174 million, yet spent E246 million on wages, and incredibly, had total losses of E937 million, according to the Economist. This means the railway spent a fantastic E10 for every E1 of revenue. The situation is laughable except the Greeks are rioting in the streets about having to change their ways.

Eurobonds a Non-Starter

The latest idea out of Brussels is 'Eurobonds' - Euro countries' borrowings would be issued and guaranteed by the group as a whole. This is Eurospeak for France and Germany underwrite everyone else, and it is as ridiculous as it sounds. The only way it makes sense for the Germans to underwrite Greek debt is if they have control over Greek government spending, or some recourse if Athens fails to meet its obligations. [It shouldn't take much imagination to see that a German 'foreclosure' on the Greek government is a non-starter. It isn't even funny.]

As Margaret Thatcher caustically (and correctly) said, the Euro won't survive its first crisis, because 'Europe is not yet ready for another round of German discipline'[8].

The endgame in Europe is approaching fast and here's my guess: Greece defaults by 'restructuring' its debt to reduce it by half. Germany and France recapitalize their banks to the tune of about $300 billion and $90 billion respectively, and the IMF coordinates financing for Greece along the Mexico and Argentinean bailouts of the 1980's and 90's.

Greece may decide to leave the Euro along the way, and best of luck to them …

In any event, all the markets want is a decision: announce the Greek default, step up to protect the French and German banks, and be done with the delusion of saving Euro members at any cost. The Euro is holding up well against other currencies, indicating that the markets are not very concerned about its survival and that it's likely Greece that goes.

The markets - and the world - know what needs to be done and they will welcome the decision.

Thank you again for your understanding and patience. As always please do not hesitate to call; I would be happy to discuss your strategy in whatever level of detail you would like.

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[8] Margaret Thatcher, 'Statecraft, 1999; Thatcher was vilified for her view that the Euro would not survive its first crisis. She also worried that a reunited Germany would dominate the less-industrious Europeans and lead to difficult stresses. Just because you are politically incorrect does not mean you are wrong.