RBC Wealth Management

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From "Irrational Exuberance" to "Panicked Pessimism": How did we get here and what do we do now?

By any historic measurement we have had a bear market correction in financial markets around the world. Since the highs for major indexes in August or October of 2007, most are down by 35% or more…the broader the index the more severe the decline seems to be (the majority of stocks are down more than the DJIA & S&P 500).

That doesn't tell the whole story though: we have also experienced a significant time correction retracing to market values last seen in late 2003. In fact, the DJIA & S&P 500 are back to the levels they traded at in 1998 or 1999. The compound annual return for the S&P 500 since December 31, 1999 is -0.9%. The return for the MSCI World Index is -2.1%.

For the sake of comparison, since 1914, the S&P 500 has had 21 bear markets averaging declines of about 36% and lasting an average of 74 weeks. More recently, since 1942 the S&P has gone through 14 bear markets with a 31% average decrease and lasting approximately 64 weeks. Some of these bears were short and sharp: for example in 1987 the S&P went down 35% in 14 weeks. Other corrections have been more prolonged: from March 2000 the S&P went down 49.7% over 133 weeks ending in October of 2002.

Given this historic context, the current correction is deeper than most and it has lasted as long, or longer, than average. Some would argue that we have set a ten year base that may allow a significant bull market to emerge.

Many in the investing world call the current environment "unprecedented." The Auction Rate Securities market, which was long considered a "safe" alternative to lower yielding money market funds, seized up early this year. Certain money market funds fell below $1 par value recently resulting in the implementation of a Treasury guarantee program (which RBC is participating in) to reassure investors about the safety of principal in the most basic of investments.

Credit in general seems frozen: stories abound about consumers with a credit rating of 800 (the highest possible) being denied auto loans. Libor (the London interbank offered rate), the rate at which banks offer to lend unsecured funds to other banks…long considered the most stable and important interest rate of all, has experienced the largest rise on record with the overnight rate going from 2.95% to almost 7% over the last 10 days or so. This rate affects everything from home loans to credit card rates. Similarly, the commercial paper market – where corporations fund near term financial needs such as purchasing inventories or managing working capital – has come to an almost complete halt. This is why the Fed announced today that they will create a fund to begin buying U.S. commercial paper in order to "stem the bank-run-like panic."

Needless to say, the list goes on: consumer confidence is at crisis levels similar to or exceeding those of past market bottoms, volatility (a measurement of investor fear) is at or above the peaks of past corrections (the VIX has averaged 20 since 1986 and recently hit 70 – the highest ever!), the spread between high yield corporate bonds and investment grades stands at over 10% (the spread of corporates to the 10 year treasury is 12%) - another historic high, 3 month treasuries yield around 1/2% while the S&P 500 yields over 3% - reversing the historic trend and resulting in the highest absolute yield the S&P has had since 1991, unemployment levels have risen dramatically, housing starts have fallen sharply, the inventory of homes for sale has risen to record highs (as prices continue to decline), and almost 90 percent of stocks are trading below their 200 day moving average. In short, although GDP remains positive (estimates call for a 1.3% increase in q.4), by most measurements we are in recession - one which I believe began at least a year ago.

So, why should we believe things are going to improve?

In response to these conditions, regulators in the United States and elsewhere have taken dramatic action over a protracted period of time. The Federal Reserve has lowered interest rates from 5.25% in June of 2006 to the current level of 2%. This action is as aggressive as any period in the history of the Federal Reserve. They are likely lower the funds rate again this week, and it may ultimately go to the 1% level reached in June of 2003. European rates continue to be quite high by comparison with a discount rate of 4.25% and they will likely follow suit, perhaps this week in a coordinated action with the U.S.

Additionally, the FDIC guarantee on individual bank account deposits was raised from $100,000 (set in 1980) to $250,000 - Ireland and Germany have guaranteed all bank deposits. This should help re-instill confidence in the bank system.

As previously noted, the Fed has committed to purchasing commercial paper in an effort to normalize a market funding mechanism crucial to the corporate world and to "Main Street." Energy and commodity prices have come down sharply, thus reducing inflationary pressures. Oil has gone from $147 a barrel at the high to around $90, a correction of 38%. It is worth noting that the actual number of miles driven in the United States this year will be lower than 1981 despite an increase in population from 180 million to 320 million – demand patterns for traditional sources of energy are changing in an irretrievable fashion. Natural gas is down 50%: corn, wheat, soybeans, and orange juice prices are down by 40% or more. There have been significant declines in the price of steel, zinc, lumber and many other commodities as well. The positive impact of this decline in inflation has yet to be felt throughout the economy, but will have a very real influence in coming months.

The banking/financial system is being remade before our eyes with an unprecedented wave of consolidation and the transformation of Goldman Sachs and Morgan Stanley from investment banks to commercial bank holding companies. As a result, they will be subject to more restrictive regulation limiting leverage ratios and controlling capital more tightly. This will likely limit profit potential, reducing return on equity in good times, but stabilizing returns in more challenging conditions. The reduction in banking system capacity should lead to less cyclicality and will be a good thing in the long run.

Regulators are also re-examining rules related to short sales. We have a temporary ban on shorting financial stocks, naked shorting is being eliminated (short sellers must ensure they can borrow the

stock…not just have a reasonable expectation they will be able to) and reimplementation of the uptick rule (which can act as a “brake” on aggressive shorting) is being considered.
FASB rule 157, “mark to market”, or “fair value measurements”, is being re-examined as well. This rule has unfairly punished financial companies as liquidity in certain securities, particularly mortgage related products such as CMO’s, CDO’s and CDS’s, has been paralyzed. As companies have written down the value of these investments in order to clean up their balance sheets this rule has forced the industry to mark down assets/investments to fire sale prices which may not be reflective of their true value over time.

Surprisingly, after the fall of Bear Stearns and Lehman Brothers (both situations in which the financial community was only willing to purchase assets after the companies had collapsed), we now have a competitive bid situation for a bank: CitiGroup and Wells Fargo are fighting over the acquisition of Wachovia. This signals that there is finally a realization that even a troubled bank has valuable assets prior to its dissolution.

After much debate, Congress passed the Emergency Stabilization Act authorizing the formation of The Troubled Asset Relief Program known as “TARP”. The final bill is far from perfect, but it will serve a valuable purpose: allowing banks to sell illiquid assets to a fund run by the U.S. Treasury (at values which should prove to be low over time – in other words, I believe the fund will make money for tax payers) in order to free up their balance sheets to resume normal course lending. This program is similar to the Resolution Trust Corp formed in August of 1989 to aid with the saving and loan crisis, and is very much in the interest of every day Americans. “TARP” is designed to restore the normal flow of credit which is essential to reinvigorating the economy.

Should investors put cash to work now? What if you are already fully invested and don’t have new cash to put to work?

It is not possible to forecast precisely when this market will bottom. There are simply too many confusing variables to deal with. However, governments and regulators in the U.S. and around the world have been using every tool possible to stabilize the system and get it working efficiently again.

The correction has been severe compared to the past. Stocks and bonds are inexpensive when analyzed using traditional methodologies. The S&P 500 is trading at 11.5 times 2008 consensus earnings estimates of $89.53 and 10.5 times 2009 estimates of $96.88. The long term average is approximately 16 times earnings. Even if you assume earnings of $77 for next year…a 20% discount to consensus estimates, the S&P is trading at only 13 times forward earnings. As previously noted, dividend yields are high (although we don’t know yet if payouts are sustainable), bearish sentiment is high and the environment is ripe for positive surprise.
For cash not currently invested, I would suggest averaging into the market 1/3 now, another 1/3 in early 2009 and the balance in the second quarter of 2009. Obviously, this recommendation is tempered by the admonition that we must constantly reevaluate investment decisions depending on new events and the success, or lack thereof, of actions taken by authorities to stimulate the economy and the markets.

For those fully invested, I am constantly reviewing portfolios and the individual securities held in them. Many investments we hold have performed poorly with declines of 40%, 50%, 60% or more from their highs. I have held these due to my ongoing belief in their fundamental value and potential for price appreciation. Some of these now have tremendously high dividend yields of 12%, 14% or higher. As the market normalizes, these yields should come down due to price appreciation resulting in very good total returns. Other holdings have low yields, but trade at compelling valuations relative to future earnings, cash flow and an improvement in business operations.

However, even some holdings that I believe are good values may be sold over the coming months for tax reasons and/or to reposition into securities and sectors that may be more appropriate for the current environment. For example, the yields of selective real estate investment trusts look attractive on an absolute basis and relative to past spreads to 10 year treasury yields. Similarly, I am looking at Exchange Traded funds providing exposure to foreign markets which have become more interesting at current prices. I also believe there are compelling investment possibilities in alternative energy solutions such as wind, solar and tidal power and look to add to stocks in this sector over time.

In summary, this has been a brutal market cycle, but like others in the past we will move beyond it. Unfortunately, it is late in the bear market to play defense. Instead, we must look forward to the opportunities of the next several years. It is difficult to avoid emotional reaction to such challenging economic and market conditions, but I believe we are seeing investment bargains experienced only during major market dislocations.
Best regards,

Terry