UPDATE ON STRATEGIC IMPLICATIONS OF THE MARKET MELTDOWN

March 27, 2009

Introduction

This paper reviews and revises our October 21, 2008, publication, "Strategic Implications of the Market Meltdown." At the time, we noted that although it might seem premature to comment on the longer-term implications of a crisis then in full spate, "long-term investors should always have one eye on current weather conditions and the other on the strategic implications of climate change." Five months later, during a significant bounce from the U.S. equity market's low of March 9, in the midst of the AIG bonus furor, and on the heels of the Federal Reserve's adoption of quantitative easing, it seems appropriate to revisit strategic questions even though the crisis has evolved rather than ended.

In particular, we would stress how important it is for investors to separate "noise" from "signal." By "noise" we mean the daily outpouring of data, headlines, information, drama—the intensely distracting media drumbeat of sound and fury that for long-term investors signifies little or nothing. By "signal" we mean that small subset of the torrent of noise that actually matters, that contains information that should inform investors' actions. The brouhaha over AIG bonuses is a good example: in the scheme of things, the bonuses are trivial, right? But the popular outrage they have incited has triggered massive political rhetoric and posturing—which would normally be irrelevant to investors. Not today. Bonus outrage leads to backlash against financial bailouts, constraining if not precluding future governmental actions that might be needed to maintain precarious stability in the financial system. At the same time, the instinctive American distrust of government is exacerbated and the financial sector left wondering whether contracts are still enforceable. In this environment, therefore, *political* ineptitude has economic consequences that may in turn affect investors.

Moreover, beyond AIG, the focus on fat-cat paychecks should give pause to any private investment firm thinking of partnering with the government in its efforts to offload distressed assets from banks' balance sheets. How about: "Hedge Fund Managers Earn Millions Using Taxpayers' Money!"? How tempting is that? The fact that such returns would have come from putting private capital at risk of loss? Irrelevant. And actually saved taxpayers' money, relative to the available alternatives? Irrelevant.

In short, going forward we would advise investors to think carefully about the *political dimensions* of investment decisions, which is something we are not accustomed to doing.

Synopses of our October 2008 comments and recommendations are in italics, followed by current thoughts.

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Economic and Political Consequences

1. *No depression.*

   This view has become conventional wisdom. Indeed, the term "Great Recession" has been coined both to capture the severity of this downturn and to differentiate it from the devastation wrought in the 1930s.

   However, we are uncomfortable with the increased focus among commentators on what lies on the other side of this contraction, and when, therefore, we can expect equity markets to start anticipating recovery. It may be that the end of the recession and the bear market will only be reached when everyone has given up thinking and writing about what lies on the other side—the chasm having proved so much deeper, wider, and exhausting than expected that the focus shifts from recovery to survival. This is not so much a prediction as a concern: like everyone else, we have no idea just how long and deep the contraction will be or how quickly and in what ways excess indebtedness will be purged. Alternatively, historical precedent suggests that the recovery, whenever it comes, could prove short lived; like a patient getting over a severe illness, this brutal recession will remain acutely vulnerable to relapse, particularly if and when the authorities start taking the patient off the morphine of extraordinary monetary stimulus, which they must do eventually to avoid igniting inflation.

2. *Investors should largely ignore comment and analysis that extrapolates data from past recessions to predict outcomes for economic growth, corporate earnings, and the equity markets.*

   Right. As we have repeatedly stressed, the larger context of this recession is a massive contraction in leverage, exacerbated by falling asset prices, largely immune to monetary stimulus, and profoundly deflationary.[1] The need to delever will persist as long as debt service requirements exceed the income or assets available to pay them. The impact on GDP growth, and corporate earnings, will likely prove far deeper than a conventional recession and last well after the National Bureau of Economic Research has blown the whistle to signal the recession's end. Consequently, investors should focus more on the progress of debt resolution in the developed economies than on their recessions *per se*.

3. *Lenders' capacity and appetite for lending is already sated at a time when demand has declined. Consequently, the credit engine the authorities kick-start may be more like that of a moped than a Maserati, and will remain in first gear for a long time.*

   In his 1933 inaugural address, U.S. President Franklin Delano Roosevelt thundered at the "unscrupulous money changers" of Wall Street and the feeble crisis management of the Hoover administration: "Faced by failure of credit they have proposed only the lending of more money." Today, we might characterize

[1] "The root problem is that debts that were incurred to finance assets at high price levels remain in place at their original amounts even though the assets they financed are now worth far less. ... Until the debts are brought in line with the assets and the income, there is no moving forward no matter how much liquidity is provided ... the self-reinforcing nature of the debt squeeze will only reduce incomes and asset values further." Bridgewater Daily Observations, January 21, 2009.

this as the Greenspan doctrine—and it's not clear whether his successor has embraced or abandoned the idea. However, we are now seeing increased awareness that repairing the broken financial sector is a prerequisite of broader economic recovery and that the financial sector cannot be repaired, and lending of any consequence resume, as long as it remains overindebted and swamped by toxic assets. Meanwhile, bailout fatigue, exacerbated by bailout disgust (those AIG bonuses again), threaten the Obama administration's ability to take the bold, decisive steps required—bold, decisive steps that should perhaps have already been taken to segregate good assets from bad across the financial sector so the latter could be aggressively disposed of, or allowing General Motors to file for Chapter 11 (so that government lending would subsequently take precedence over other creditors' claims during the restructuring), and so on. As Martin Wolf of the *Financial Times* has stressed, better to do *more* than might prove necessary, on the basis of worst-case assumptions, than to do *less* on the basis of hopes that might prove misplaced. At this point, it is completely unclear whether the new administration's scope to act is already shrinking or whether it retains enough firepower to mount a successful attack on the toxic assets problem.

4. *As governments spend money on bailouts, bank recapitalizations, mortgage refinancing programs, and so on, they will have less money to spend on other things. In the United States, this will not play well with those expecting a new (probably Democratic) administration to fund programs and initiatives eviscerated or ignored by the previous regime—although public works projects may be funded for stimulus purposes. In Europe, it may—ironically—strengthen the hands of French President Nicolas Sarkozy and German Chancellor Angela Merkel in their attempts to wean their citizens off government largesse. Or the voters may rebel and kick them out at the first opportunity. Either way, expect political volatility to rise.*

   Except for the last two sentences, this prediction has proved wrong. In the United States, the Obama administration has represented the crisis as a reason to invest much more in clean technology, health care, and education, rather than less (although it remains to be seen how much Congress will buy this). In Europe, governments have toppled in Iceland and Latvia, while riots and demonstrations have flared in several countries, including two massive street rallies in France already this year. Expect more, and perhaps worse, political volatility, which always unsettles capital markets.

5. *The euro will come under intense strain.*

   Correct. Overleveraged economies like Greece, Ireland, Italy, Portugal, and Spain, lacking the ability to devalue or engage in massive monetary easing (since their currency is the euro and their monetary policy is controlled by the European Central Bank [ECB]) are suffering contractions that may qualify as depressions before they have run their course. Such economic pain almost always triggers significant sociopolitical repercussions, but there are as yet few signs to indicate what these might be. Greece is perhaps the flashpoint. Ireland, Portugal, and Spain are all under severe deflationary stress, but their citizens seem perhaps more acutely aware of the benefits euro membership has conferred on them. Ironically, in the short term the weakest states may benefit from the deepening economic crisis in Germany and France, since this will prod the ECB toward the more accommodative policies the weaker states need. Nevertheless, the next few years will test the resilience of the common currency as never

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before. From its inception, the euro was more a *political* than an economic construct, and the strains are most severe where governments are most politically vulnerable.

6. *The most vulnerable economies are those of the Baltic States and Eastern Europe that have large current account deficits and consumers whose debts are denominated predominantly in Swiss francs or euros, because those offered cheaper interest rates than did credit denominated in their local currencies. Expect one or more of these economies to crash.*

   Perhaps not. The major Eurozone countries seem increasingly aware of the domino potential of financial crises in Central and Eastern Europe, transmitted through the failure of Austrian banks heavily exposed to them. Consequently, lifelines have been extended. More will be needed, but will probably be forthcoming. In addition, governments in these hard hit nations are biting the bullet and cutting spending while labor flexibility enables them to adapt relatively quickly to shrinking global demand. Economic contractions in these vulnerable countries will be severe and prolonged, but the *Financial Times*' Stefan Wagstyl argues that their debt burdens are less crippling than has been reported.

7. *A potential outcome of the crisis is a devaluation of the "Anglo-Saxon" model of capitalism, whose leading proponents have in recent decades trumpeted the virtues of free markets and derided most forms of government intervention in and control over capital market affairs as so much sand clogging the smooth running of the market mechanism. Will the prevalence of "Anglo-Saxon" capitalism and American influence in international financial forums be diminished? Maybe not.*

   The *Financial Times* has started printing guest commentaries on "The Future of Capitalism"—with very pedestrian results so far. However, the impulse is right: as they look ahead, investors should try to parse the implications of a smaller, less leveraged, chastened, and more heavily regulated financial sector. And beyond the financial sector the implications of higher household savings rates: Gary Shilling has pointed out that a 1 percentage point increase in the savings rate over the next ten years amounts to $5.5 trillion in deferred consumption (and even this figure is less than the $13 trillion of wealth Merrill Lynch estimates had been destroyed by year-end 2008). And beyond diminished credit, reduced consumption, shrinking indebtedness, and higher savings, will this crisis spawn broader sociopolitical shifts in the United States as well as Europe?[2] Although we realize that investors' attention must be concentrated primarily on navigating today's treacherous environment, to the extent they can look to the future, they would do well to broaden their reading to include sociological and political analyses.

8. *Government spending by developed countries will increase significantly. Will this stoke inflationary fires? No.*

   We find many clients sure of two assumptions: first, that government stimulus will "inevitably" result in higher inflation; secondly, that one outcome of this will be a significantly weaker U.S. dollar.

[2] Those interested in pursuing this line of thought should see Benjamin M. Friedman's *The Moral Consequences of Economic Growth* (Knopf, 2005).

Maybe. Beware of certitude. Along with interest rates, there are no financial indicators less amenable to forecasting than inflation and currency exchange rates. It would be a mistake to bet the ranch on either of these assumptions. Similarly, it would be a mistake to dismiss either as implausible—both are eminently plausible, but far from a sure thing. If the hole we are in proves deeper and wider than anticipated, the Fed and other central banks can pour and pour and pour without filling the hole—and until the hole is filled, no inflation. For now, investors would do better concentrating their attention on the world as it stands, which is a world of minus signs, not plus signs: less credit, less leverage, lower sustainable earnings, less GDP growth, less demand, and shrinking oversupply. Clearly the corporate world is intently focused on surviving a world of less; hence, the depth and rapidity of layoffs and slashed capital expenditures. The only "mores" are more defaults, more bankruptcies, more restructurings, more deficits, and more financial regulation.

So we stick with our earlier view that inflation might well prove problematic somewhere down the road, especially in light of the quantitative easing central banks have now undertaken, but that investors should be focusing today on the cold winds of deflation that fiscal and monetary stimuli seek to avert. What happens, for example, if U.S. efforts prove inadequate—and the political will to do more is lacking? What if the Europeans prove too complacent about the efficacy of their automatic stabilizers and realize too late that they should have heeded American calls for more aggressive action? On the other hand, what if successive stimulus packages work—sort of? That is, what if the price they exact is a "lost decade" of stagnation (shades of Japan), when it might have been better to take more pain, for a shorter period, and get it over with?

And with the expectation of reflation and/or inflation comes the expectation of rising interest rates. We have already categorized U.S. Treasuries as "very overvalued" and a number of commentators characterize this asset class as leading candidate for the bubble to end all bubbles.

However, the last time everyone "knew" that interest rates were slated to rise, we warned loud and clear that such certainty was a snare and a delusion. And so it proved. Similarly today, we have no idea whether U.S. Treasury rates will rise or fall over the next year or two. Nor does anyone else. Our only advantage is that we *know* we don't know. Don't say that with all the issuance coming down the pike the yields on ten-year Treasury notes can't go below, say, 2%. They can. They might.

9. *Even if government intervention extends beyond the financial sector (General Motors?), history does not, in fact, support the instinctive response that this will necessarily prove detrimental to investors. The nature and composition of the opportunity set will shift, but we should not therefore assume that in aggregate it will be any less.*

To be honest, the GM call was a lay-up.

More than ever, investors need stereoscopic vision. On the one hand, their *strategic* perspective should be significantly influenced by the unfolding political and economic drama; on the other hand, market movements are uncorrelated with such events in the short run—it is worth recalling that during the

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terrible hardships and tremendous uncertainty of 1932–33, before and after the election of President Roosevelt (who was mum about what he planned to do) the stock market rose 137% from July 1, 1932, to June 20, 1933. So we continue to rely on the market itself to inform our view of prospective risk and return. What can we glean from history? What do current valuations tell us? What is the rate and direction of earnings revisions? What do market participants seem to care about/react to the most? What are sentiment and insider buy/sell indicators suggesting? Where are the most and least compelling opportunities outside of public markets?

10. *In the aftermath of the global recession, we should expect U.S. and European growth rates to lag those of Asia by a wider margin than previously anticipated. From an investment perspective, therefore, we would reiterate our recommendation of a strategic overweight to Asia, underweight to the United States. More tactically, although they are highly geared to the global economic cycle, we would expect Asian markets to emerge from the bear market sooner and more forcefully than western markets, especially if they succeed in stimulating domestic consumption.*

    No change. China remains the canary in the coal mine of Asian recovery. Upticks in Chinese bank lending, steel and electricity consumption, and retail sales have encouraged cautious optimism in China-watchers. But "cautious" is the operative word here—outright optimism is premature.

11. *However, the crisis has certainly damaged the financial prestige of the United States and in doing so might accelerate the conversion of the global currency regime to a multi-currency framework, within which the U.S. dollar serves as the primary, but no longer the sole, reference currency. ... Central banks will not permit a run on the U.S. dollar, but over time expect further weakening of the dollar against the Asian and Middle Eastern currencies and those of other resource-rich emerging markets.*

    Although it still seems both plausible and probable—especially in light of recent suggestions from the head of China's central bank that the International Monetary Fund's special drawing rights might be expanded to serve as a reserve currency in place of the U.S. dollar—this view is now uncomfortably mainstream. There are certainly good reasons to think the U.S. dollar might stay stronger longer than conventional wisdom expects, and so we feel less assured predicting its necessary depreciation.

12. *This crisis will ramp up the probability of backlash against globalization, not only in the United States, but also in Europe.*

    Happily, not so far. With a few exceptions, which have quickly attracted sharp backlash, politicians of all parties on both sides of the Atlantic have, on the whole, resisted the siren song of populist protectionism. In short, we have been encouraged by the genuine and robust commitment to globalization and by the efforts (albeit faltering) to envisage global regulatory standards for the global financial system. The successful cooperation of major countries in prying open tax havens is a small, but perhaps significant, indicator of the possibility of coordinated action on a broader front.

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Investment Implications

1. *Continue to avoid leveraged investments. Around the world, those individuals, companies, governments, and countries that have little debt and lots of cash will enjoy a tremendous advantage over those struggling to pay down debts in an environment of shrinking asset values, constrained credit, and deflating economies.*

   No change. Indeed, we would stress the value of low leverage and enhanced liquidity in institutional balance sheets in general, not just in the investment portfolio.

2. *We would assiduously avoid any manager whose valuation of financial sector stocks failed to recognize not only that these earnings were aberrational, but also that growth rates in this sector are likely to remain below their earlier trend for many years. Similarly, we would be skeptical of any analysis of consumer-driven companies that failed to incorporate a significant allowance for diminished consumer spending.*

   No change. Indeed, more broadly, we would look for investment managers with a cogent thesis as to how the investment landscape has or will be changed, and what kinds of companies and investments will emerge as winners and losers as a result. Conversely, we would avoid investment managers that seem to think the world will be as it was, the investment landscape the same.

3. *During any recession, demand for commodities/natural resources diminishes. However, we would regard the sharp sell-off in commodities/natural resources as a cyclical decline within a secular bull market (i.e., the inverse of the equity market's 2003–07 cyclical rise within a secular bear market). We would cautiously initiate or add to commodity/natural resource investments.*

   No change.

4. *Expect an avalanche of high-yield bond defaults, starting about now. This will be a huge opportunity set—multiples the size of that in 2002–03. And full of dangerous value traps because of the issuance of so many low or no covenant bonds in recent years. But expert managers should clean up. Spreads are already wide, but may well widen further as default rates soar.*

   This is now underway.

5. *Private equity fund managers will come under increasing pressure from limited partners (LPs) to shrink the size of funds launched during the credit boom. Given the diminished access to cheap credit used to finance or recapitalize portfolio firms and the problems rolling over existing debt, buyout funds will call down capital from LP commitments to inject more equity. Unable to generate returns from leverage (and/or other forms of financial engineering), these funds will find it increasingly difficult to outperform public markets (which are getting progressively cheaper), net of their onerous fees.*

   No change.

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6. *At some point (not quite yet), the prospective returns from equity market beta will look sufficiently rich that investors should question whether the prospective equity market–hedging plus alpha-generating capabilities of their long/short equity hedge funds justify 1/20 or 2/20 in fees. For example, if equity markets were priced to generate returns of, say, 12% annually over ten years, the lower volatility and moderate portfolio diversification benefits of such hedge funds would hold less appeal.*

   No change, but worth adding perhaps that hedge fund managers with proven abilities to navigate volatile markets are increasingly valuable. Although daily volatility, as measured, for example, by Chicago Board Options Exchange Volatility Index, has declined since last October/November, we expect that equity markets will remain unusually volatile on, say, a monthly basis.

7. *Finally, it is important to note that equities are now considerably cheaper and in many cases attracting buying interest from disciplined value managers (like Warren Buffett). We do not know how the markets will develop tomorrow, but despite continued caution believe that long-term investors should be buying on further weakness, rather than allowing their strategic allocation to equities to decline.*

   For example, buying, or at least rebalancing into, equities in early March would have proved extremely profitable already (late March). We think, however, that investors will get another chance—that the decline-advance-decline pattern of November 2008 – early March 2009 is not prelude to an extended equity market run, as was the decline-advance-decline of October 2002 – March 2003. The current rally is likely to give way to further weakness much more quickly. It has been generated by marked improvement in capital market liquidity—and in the short run, markets care more about liquidity than anything—but liquidity concerns having been allayed, solvency concerns will increasingly come to the fore.

Conclusion

Paradoxically, the key recommendation of this paper on the *strategic* implications of the financial crisis is to avoid focusing too much on the opaque future *at the expense of* the present. Their asset values having shrunk, many investors should be taking a hard look at the liability/financial obligations side of their balance sheet (if they have not already done so), rather than simply planning a future predicated on a robust recovery.[3] Despite the carnage, not all equity markets have yet plumbed the valuation depths typical of major bear market troughs. Nor have the overindebted sectors of the developed world by any means emerged yet from the wringer of deleveraging—there is much more of that to come.

Finally, whether championing or excoriating massive governmental intervention in the developed economies, investors must at least consider what could go wrong, rather than simply assume that all will be well. For example, what if interventions like the U.S. Treasury's just-announced Public-Private Investment

[3] See recommendations in our February 2009 Asset Allocation in the Current Environment paper *Hard Choices for Hard Times*.

Program do *not* succeed, as the earlier Resolution Trust Corporation did, in cleansing bank balance sheets and restoring their health? Or what happens if—having successfully induced reflation through massive monetary stimulus—the Fed and other central banks start tightening to pre-empt inflation? Or if they *don't* do so because—under pressure from their governments—they are afraid to plunge their economies back into recession, deciding that inflation is the lesser evil? Or if U.S. Treasury bond yields rise as buyers' balk and/or foreign owners take advantage of the Fed's purchases to reduce their exposure?

While hoping for the best, we should still insure against worse.

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