STRATEGIC IMPLICATIONS OF THE MARKET MELTDOWN

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Introduction

Although it might seem premature to speculate on the longer-term implications of the credit crisis, market meltdown, and governmental intervention while events are still playing out, long-term investors should always have one eye on current weather conditions and the other on the strategic implications of climate change. Thus, we offer the following *preliminary* observations—with a stiff reminder of the perils of prognostication.

Economic and Political Consequences

1. No depression. Although the credit boom and subsequent deleveraging of recent years does resemble that leading to the Great Depression in some respects, other attributes of today's developed economies are significantly different. Perhaps most importantly, government spending now constitutes about 20% of U.S. GDP and even more in Europe, compared with around 3% in the 1920s, and Keynes' notion that increased government spending can serve as a shock absorber when private consumption declines was a novel (and in some quarters unwelcome) idea implemented only when the depression was already well underway. As BCA Research recently noted, "government spending is a crucial source of growth when times are tough." Additionally, although historians disagree about the extent to which misguided fiscal and monetary policy exacerbated economic contraction, all agree it was more or less damaging. Notwithstanding the apparent myopia of the European Central Bank (ECB) to the looming crisis in Europe, contemporary central banks are not likely to tighten monetary policy as their economies contract. Finally, the economies of the 1930s had already retreated behind national borders—the high-water mark of globalization was 1913. Today (as we have seen in the meltdown), national economies are interdependent and major companies multinational; as a result, the good health of some will prevent those more seriously infected from becoming deadly ill.

2. Nevertheless, investors should largely ignore comment and analysis that extrapolates data from past recessions to predict where and when economic growth, corporate earnings, and the equity markets will bottom out. The context for this recession is different from that of any recession since the 1930s because its proximate cause is the unwinding of a massive credit binge, and the deleveraging this entails creates headwinds to economic growth likely to endure long after the technical recession is over. As Mark Lapolla of Sixth Man Research said of U.S. consumption in a recent interview, "as labor's wages lost pricing power … how could [people] continue to have an expanding lifestyle, one that grew far beyond their wage growth? It was all about taking that monthly payment and making it go further by borrowing more money." But now "on a family basis, household basis, community basis, city basis, state basis, adjustments need to occur throughout the financial system" as we learn to live within our means. Absent

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the leverage provided by cheap, abundant credit, the economy's sustainable level of growth will be significantly lower than it has been.

In the United States, this effect is most visible in the collapse in auto sales, which are also a leading indicator of a sharp decline in retail sales more generally, and household consumption more broadly. Thus, we would expect the earnings of companies highly dependent, directly or indirectly, on consumer demand not only to decline steeply, as they always do during a recession, but also to remain subdued for years rather than snap back as they did in 2003–06. As Merrill Lynch's David Rosenberg wrote in an October 6, 2008, commentary, "nearly one-third of the growth in [U.S.] domestic corporate profits … from 2002–06 came from financial leverage."

3. The equation is simple, but stark: more than 70% of U.S. GDP (and 18% of global GDP) is based on American consumption and that consumption has increasingly been based on credit. So when credit becomes less available and more expensive, knock-on effects occur almost immediately. Hence the strenuous efforts of the federal authorities to restart the stalled credit engine. The recent narrowing of blown-out credit spreads shows they are succeeding; however, a return to anything close to the credit largesse of 2002–06 is inconceivable. First, the amount of credit a bank (or other financial institution) can extend is a function of the size of its balance sheet and how much that balance sheet is leveraged. Well … balance sheets have shrunk dramatically, and it seems highly unlikely the authorities injecting taxpayer funds into these institutions will allow them to incur the imprudent levels of leverage that precipitated the crash. Second, as BCA Research noted in a recent special report:

   > The net stock of domestic debt rose by a staggering $21 trillion between end-2000 and end-2007. There is still a large amount of losses to be recognized, and banks will need to raise significantly more capital. … [Meanwhile], the ratio of outstanding bank loans to GDP currently is around 25% above its long-run trend, equivalent to an overshoot in bank loans of more than $1.3 trillion. And this just measures the loans remaining on banks' balance sheets—it does not capture the loans that were sold and securitized.

   In short, the 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.

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.[1] 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

[1] It is perhaps worth noting that the U.S. deficit, although at record levels in nominal terms, remains considerably lower, as a percentage of GDP, than in the Reagan years. However, the combination of spending to address the crisis and reduced tax revenues could quickly inflate this percentage. In an October 18, 2008, article in *The Washington Post* Lori Montgomery and Dan Eggen wrote that all the stimulus and bailout spending now committed or discussed could increase the deficit to $1 trillion, or 7% of U.S. GDP. In the same article, Rudolph Penner, former director of the Congressional Budget Office, opines that "we're going to make Ronald Reagan look like a piker in terms of deficit creation."

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 (although only the French will take to the streets!).

5. Nevertheless, government spending by developed countries *will* increase significantly. Will this stoke inflationary fires? No. Inflation results from the emission of too much money into the economy (and judging how much is too much is, of course, the job of central bankers). The primary route by which money is transmitted to the economy is through banks and other financial intermediaries, and their ability to do so is controlled (or not!) by reserve requirements and other regulatory impediments to excessive leverage. Among the major causes of the credit bubble that seeded the real estate bubble and led to the inevitable collapse of both is the relaxation of impediments to leverage by various U.S. governmental authorities, particularly the Federal Reserve under Alan Greenspan and the Securities and Exchange Commission under Christopher Cox. Having just suffered a meltdown as a result of inflation in the credit and real estate markets, we are unlikely to go down that path again for some time. Meanwhile, the deleveraging process (including the continued decline in house prices in the United States, United Kingdom, and several European countries) will continue to exert a strong disinflationary pull. Government spending will be financed by selling bills and bonds to savers—and the massive wealth destruction in real estate and stock portfolios means that for the first time in several decades savings rates in developed countries will rise; indeed, BCA recently commented that “the world will soon be awash with excess savings that could drive rates down.”

6. Commenting on the contagious wildfire effects of the Asian financial crisis of 1997–98, former U.S. Treasury Secretary Larry Summers said: “Global capital markets pose the same kinds of problems that jet planes do. They are faster, more comfortable, and they get you where you are going better. But the crashes are much more spectacular.”

   Responding to the damage caused and anger inflamed by a spectacular crash, governmental authorities inevitably adopt a “never again” mindset (which often diverts their attention from whatever developments might lead to the next, different, crisis). The most obvious outcome of the bank bailouts will be reining in the risk appetite of financial firms through more rigorous prudential regulation. This will impair their profitability, but more importantly it will also curb their ability to flood the market with credit (as noted above). Consequently the more credit-sensitive economies (e.g., United States and United Kingdom) will suffer tougher adjustments than those less accustomed to living on tick.

   However, 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.

7. 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

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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.

The most vulnerable economies are those of the Baltic States and Eastern Europe that have large current account deficits[2] 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.

8. A potential outcome of the crisis is a devaluation of the "Anglo-Saxon" (as the French love to call it) 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. Responding to the idea of a summit of world leaders to coordinate responses to the financial crisis, French President Sarkozy is quoted in *The New York Times* of October 18 as saying, "this sort of capitalism is a betrayal of the sort of capitalism we believe in." And those "who have led us to where we are today should not be allowed to do so once again."

   Will the prevalence of "Anglo-Saxon" capitalism and American influence in international financial forums be diminished? Notwithstanding Mr. Sarkozy's evident glee, we would not be so sure. In fact, we would expect the euro to undergo its toughest test since inception as those European countries most vulnerable to the credit bust (Greece, Ireland, Italy, Portugal, and Spain, which benefited the most from credit-fueled expansion) fall into deep recessions and suffer significant wealth destruction. Fettered to the ECB's monetary policy, which is typically oriented to the larger economies of France and Germany, the smaller economies (including the five listed above) lack the stimulative levers of aggressive interest rate reductions and/or currency depreciation. In short, they are faced with a grim choice of riding it out or increasing government spending, which would in some cases swell already severe fiscal deficits.[3] Recognizing this, the markets have sharply increased the risk premium embedded in their sovereign debt, which adds insult to injury by raising their borrowing costs.

   Under far less malign circumstances, some Italian politicians started agitating against the euro several years ago, and the belief of many citizens of these countries that adoption of the euro resulted in higher prices has eroded popular support for the currency union. We would hesitate to handicap the odds of defections, but are reasonably sure the integrity of the euro will come under intense strain.

[2] As points of reference, the U.S. current account deficit is 4.7% of U.S. GDP and that of the Eurozone 0.4%. Those of Estonia, Latvia, and Lithuania are 11.8%, 13.8%, and 14.0%, respectively. Hungary's is 5.9%, Poland's 4.9%, Slovakia's 5.6%, and Slovenia's 6.6%.
[3] Current account deficits as percentages of GDP are Greece, 14.0%; Spain, 9.8%; Portugal, 9.0%; Ireland, 3.5%; and Italy, 2.5%.

9. 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 US$ serves as the primary, but no longer the sole, reference currency. Tangible evidence of this shift will come in the form of abandoned pegs, among which we would guess those in the Middle East to be most vulnerable. Timing? Highly uncertain, but perhaps within a few years if not sooner. Consequences? Further headwinds for the United States in the global economic competition since the significant benefits of seignorage will steadily evaporate. Central banks will not permit a run on the US$, but over time expect further weakening of the dollar against the Asian and Middle Eastern currencies and those of other resource-rich emerging markets.

10. This crisis will ramp up the probability of backlash against globalization, not only in the United States, where isolationism has deep roots and politicians are, as usual, scoring points by contrasting the solid, yeoman virtues of Main Street with the corrupt and greedy crooks of Wall Street, but also in Europe, where voters are likely to attribute lost jobs to the *American* financial crash.

    George Soros has long commented on the dangerous disconnect between a global financial system regulated only at the national level and on the consequent need for a truly global regulatory framework. We would like to believe this might emerge from the summit meetings just announced, but think it unlikely any nation will cede sovereign authority over what it (anachronistically) regards as its domestic financial champions to some global agency. A more likely, and damaging, outcome is that each nation will seek to restrict the activities of "foreign" financial entities.

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.

2. During the credit boom, financial sector profits were massively juiced by leverage—hence the crash. 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.

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.

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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.

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.

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.

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.

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