

# Market Outlook

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### Is This the End Of ...?

The stock market declines of October and November have left investors stunned and breathless, as the speed and magnitude of the drop are unlike anything the current generation of investors has ever seen. As the grim reality of the collapse of the mortgage-based derivatives market set in, investors were left bewildered and battered as we witnessed one of the greatest financial market panics of all time. Given that the stock market was already down significantly from its October 2007 high, the magnitude of the decline, and its relentless nature, began to feel as if it were taking on biblical proportions.

While “biblical” is surely getting carried away, we are certainly living through a historical watershed moment. Many writers have described the economy of 2008 as the “greatest economic crisis since the Great Depression.” These profound moments in history, of course, don’t happen randomly. What often gets lost in the discussion of where we are headed is that the answer to that question may be found by considering “What is this the end of?” The discussion below considers that question, and though we can’t make definitive statements without the benefit of the hindsight we will have five years from now, we would like to provide food for thought.

#### *Is this the end of...the leveraged lifestyle for America?*

Underlying the hue and cry over financial and government solutions to the current crisis is the question of whether American’s ability to borrow to support our lifestyles has come to an end (chart). We have used our homes as ATM machines to withdraw equity to buy “stuff,” leaving us with plenty of possessions, tons of debt, and a nagging question whether it has made us any happier. Back in 2006, it seemed as though the financing

merry-go-round would never stop, and that rising home prices would cure all ills. Moreover, easy financing cultivated an unspoken attitude that the debt would never have to be paid back, just rolled over. Free money—what could be better?

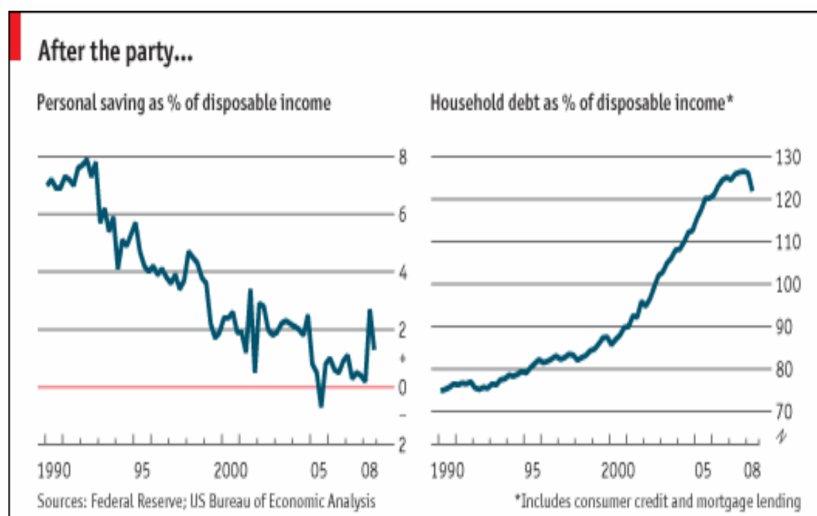
Now that the piper has to be paid, a generation is hitting middle age and repeating the mantra “Never again.” They realize that there is a limit to how much one’s future can be borrowed against, and have been so burned by their profligate ways that they are unlikely to ever return to their leveraged lifestyle. Future borrowing will be funded with income and cash flow, which makes it all the harder for banks to lend, regardless of the amount of money the Fed provides to them. It seems that every generation must learn a bitter lesson regarding speculation, borrowing, or spending. The current episode is the baby boomers financial Waterloo.

#### *Is this the end of...the negative savings rate in the US?*

This is the flip side of the leveraged lifestyle. The savings rate has been dropping for 18 years, dipping briefly below zero percent (chart). If the credit culture that developed over this time is reversing, we should see the savings rate rise also. A good thing, too. We will need it to

amount of Treasury debt being issued to bail out Citigroup and others.

*Is this the end of...highly unregulated markets?* The number of hedge funds and the market for credit derivatives has grown exponentially since 1998, almost all of it outside the control of bank and stock and bond market regulators. The hope that these markets would police themselves has come crashing down for a very simple reason. Markets for highly leveraged products, especially those designed to protect against loss, work well enough as prices rise or are stable. When prices fall,



and the underlying “insurance” needs to be cashed in, everyone finds themselves trying to jam through the exit at the same time. The predictable result is a market crash for the product, or the case of mortgage derivatives, the market essentially evaporates, because only sellers remain.

While regulated markets are less than “efficient” in an academic view, they are efficient if they keep the market working when they are needed the most: during times of financial stress. You can expect more regulation to corral investors, especially in hedge funds and derivative products. Expect restrictions on short-selling to reappear, and banks to have to bring their “off balance sheet” adventures back on to the balance sheet along with increased capital reserves against them.

*Is this the end of...the Federal Reserve's belief that asset bubbles can't exist?* In the clean and perfect world of academia, bubbles can't exist, since the proverbial rational investors will simply not buy an asset that is overvalued.

In reality this is far from the case, as we are now cleaning up our third major bubble in 10 years (internet bubble, housing, and mortgage derivatives). To deny their existence at this point is naïve, to say the least.

Not only does the Fed need to accept their existence, they also need to recognize that they can help create them. Cheap money, lack of regulatory oversight, and a well-established pattern of bailing out speculators (i.e. moral hazard) can clearly foster these “once in 500 years” events with alarming regularity. While the Fed's stated mission is to constrain inflation and promote growth, Fed policy (among others) over the past 10 years has contributed toward destabilization, rather than the other way around. The sooner they accept the reality of their policies the better, especially since the current massive injection of money into the system risks creating yet another bubble down the road.

*Is this the end of...overpaid and ineffective CEOs?* A clear fallout from the last few financial crises has been

the decline of the “trophy CEO.” These overpaid hacks seem to have gone out of their way to destroy shareholder value, all under the guise of enhancing it. They have demonstrated that rather than being the high-powered, independent thinkers they hold themselves out to be, they are the leaders of the herd mentality in corporate America. And once the company hits the skids, they are more concerned with golden parachute severance packages than with the companies they brought down. Lehman Brothers, AIG, Citigroup and General Motors are all examples of colossal blunders of modern business management. Hopefully, we are witnessing the end of short sighted management

strategies and the quarter-to-quarter earnings manipulation that goes with it.

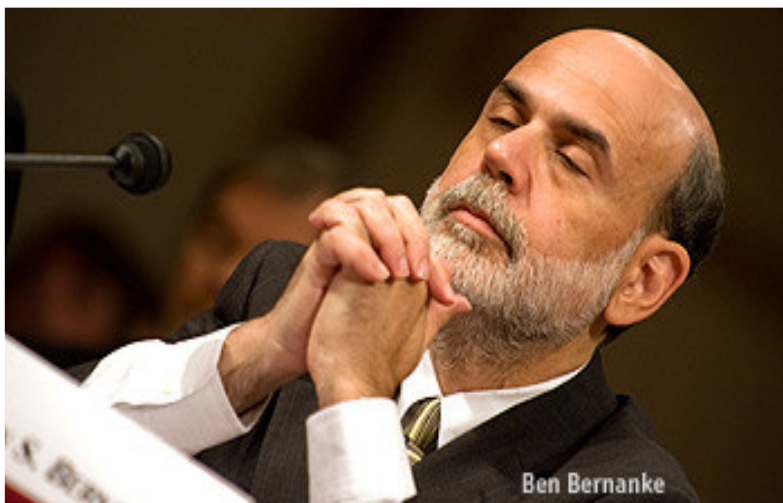
*Finally, is it the end of...the long period of overvaluation of stocks?* According to Value Line, the current price/earnings ratio (p/e) of their universe of 1500 stocks is now 10.2. At the last peak in July

2007 it was 19.7, and at the peak in 1999-2000

it was about 19. The last time the p/e was so low? October of 1987, after the market suffered its historic crash.

It is well-known, but long-forgotten (especially in the heat of the current crisis), that major, long-lasting bull markets start from a period of low valuation. Stocks must be cheap, in other words. This seemed to be fuddy-duddy thinking a few years ago, as the credit binge reached its zenith. Now, however, as we are undergoing a revulsion of debt, and a revulsion of risky assets, stocks are reaching bargain levels we haven't seen in 20 years.

Mere value doesn't mean stocks will automatically go up, and there is a good chance they will overshoot to the downside, getting even cheaper. But as stocks continue their march downward in response to the end of numerous cycles, they are laying the groundwork for the next bull market. And that will be a beginning worth waiting for.



Praying he doesn't create another bubble