

Market Outlook

September 2009

Andre Ratkai, CFA President
Praxis Advisory Group, Inc.

Now for the Hard Part

Wall Street and Main Street have both marked the somber one-year anniversary of the fall of investment bank Lehman Brothers. Like many grim anniversaries, there was no celebration, but rather a quiet remembrance of those panic-stricken days of last fall when the financial world seemed to be spinning out of control. At the time, the sense of fear was palpable, as institutional and individual investors alike sought for safe refuge in vain. Banks became pariahs as their derivatives holdings came into question. Money market funds, viewed as bullet-proof, if boring, investments, came unglued as the Lehman default caused the Reserve Primary Fund to fall below its \$1.00 per share net asset value, a virtually unheard of catastrophe for a money market fund. Investors were so scared they caused the yields on Treasury Bills to be slightly negative by early December. In other words, safety of principal was so paramount investors were willing to pay the US Treasury to hold their money. The Lehman bankruptcy marked the end of the greatest credit bubble the world had ever seen.

With the benefit of hindsight, it's safe to say that the seat-of-the-pants response by the Fed and the Treasury saved the day.

Not having any modern precedent for the implosion of the credit markets, they had to devise solutions on the fly, so to speak, never being sure which program would have the most beneficial effect. Their actions stopped the snowballing collapse of the credit and stock markets, brought stability to the system, and coordinated action with central banks around the world to stave off an even worse outcome.

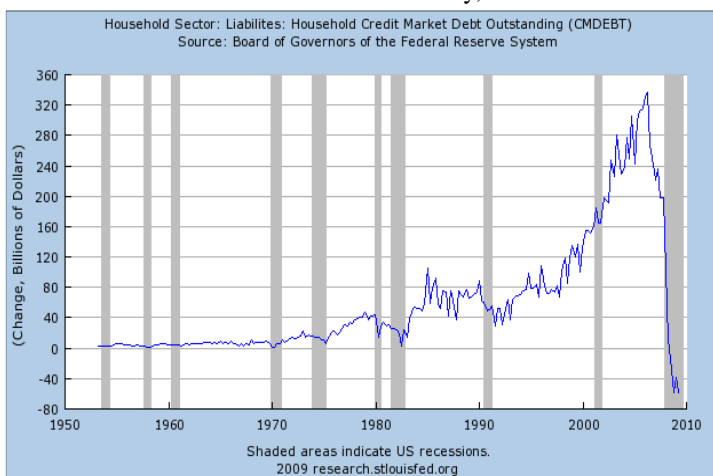
But now comes the hard part. The unprecedented provision of liquidity to the banking system was like a shot of adrenalin to a cardiac patient: it treated the immediate symptoms, but the underlying cause didn't go away. The Fed's liquidity programs have helped banks like Citigroup and Bank of America limp through this period, but they still have massive amounts of hard-to-value derivatives on their books. Moreover, the residential mortgage market, the basis for many of the failed derivatives, is still suffering from high foreclosures and unwillingness by banks to restructure late or defaulted mortgages.

The hard part will be fought on three fronts. First is the Fed's withdrawal of liquidity from the system. They appreciate the precarious nature of this task, so it is likely to be gradual. But it appears to be beginning now. Growth in the monetary aggregates (the "money supply") has been slowly moving into negative territory over the summer. The Fed's public statements mask what is happening under the surface. Surely this is in part due to their fear of fomenting inflation, but it's also a response to a more stable landscape where the problem banks are better known than they were a year ago.

The second front is interventionist policy on the part of the US government. The speedy bankruptcy and restructuring of GM and Chrysler, the Cash for Clunkers program, and the (multiple) extensions of unemployment benefits are just a few examples. While extraordinary times require extraordinary measures, the Obama administration is finding the public does have limits on the amount of Federal deficit spending they can tolerate. This spending, combined with dramatically lower federal and state tax receipts, is pushing the practicality of Federal spending to the red line.

Finally, can we count on the consumer to come back and spend

the way they have over the past ten years? After two stock market collapses in ten years, and more importantly, the wealth loss caused by falling home prices, they are unlikely to do so. The media has made much of the increase in the national savings rate, as households guard against possible job losses and rebuild their balance sheets. Anyone who counted on higher asset prices to support their borrowing is now finding the true burden of their debt.



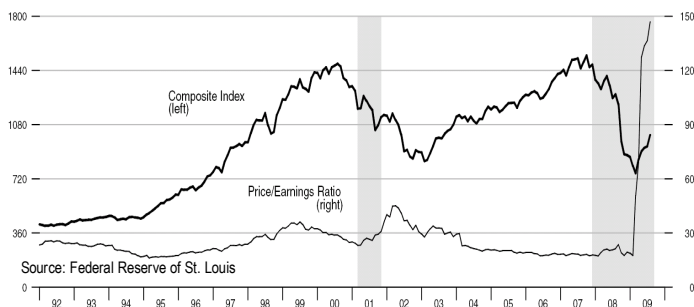
So is it plausible to think that the consumer will come back and spend with reckless abandon? Would common sense argue that a generation of increasing debt would be corrected in a mere 12 months? We don't think so. Given that consumption comprises about 70% of the US economy, this is not good news for companies. The pace of any consumer rebound is likely to be slow and lukewarm. The chart above underscores this idea. It shows the year-to-year change (in dollars) of household credit market debt outstanding, from 1953 to 2009. The upward zooming chart of the early 2000s has fallen to slightly below zero, indicating that consumers are paying down their debt rather than adding to it. While past recessions (shaded) have clearly seen declines in this measure, the sheer

scale of today's decline is stunning. To be sure, there is plenty of household debt outstanding, but households today are not using low interest rates as an opportunity to add to their debt load. This, in turn, will keep the largest component of the economy in a slow growth mode.

The tepid outlook for economic recovery is in sharp contrast to the action of the stock markets, where it is clear that the appetite for risk has come back with a vengeance. Analysts have cheered mediocre earnings reports from companies that in more normal times would have been viewed with disdain. In other words, "less bad" is the new "good." Companies are struggling to keep revenues up in the face of slack demand, and those that are truly growing are few and far between. Nonetheless, Wall Street has bid up prices in a manner reminiscent of bubbly markets of the recent past.

The scale of the earnings decline can be seen in the price/earnings ratio of the S&P 500 (below), which is based on trailing 12-month earnings. The extreme p/e valuation (yes, it's about 150) is a result of the dramatic decline of earnings. Compare this to the behavior during the 2001-02 recession. This measure has moved even higher in recent months as the rise in stock prices (the "p") has far exceeded the rise in earnings (the "e"). While analysts argue that a strong rebound is in the cards, we think a strong disappointment is in the cards on the earnings front due to the liquidity, government, and consumer factors listed above.

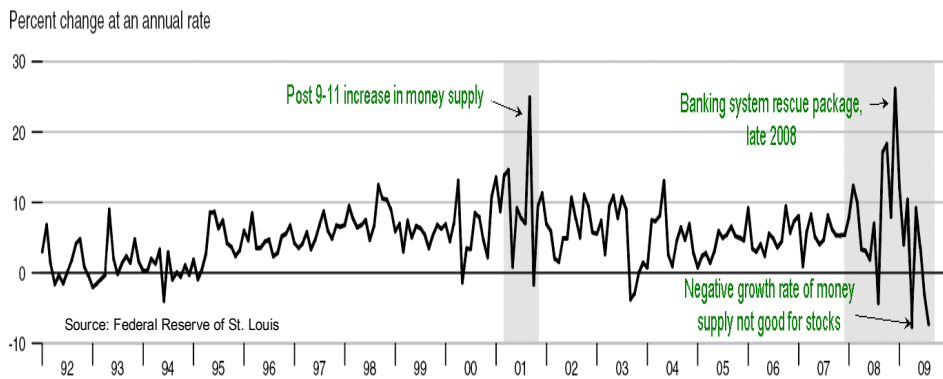
Standard & Poor's 500



Of course, it is the *expectations* of booming earnings that is driving stock prices, and analysts would argue that the chart above is a rearview look at the past, not the future. But there is another factor at play which doesn't get much attention from the popular media, and that is the unprecedented provision of liquidity by the Fed. The essence of the Fed's rescue strategy was to first, back up banks' dud assets with explicit government guarantees, and second, flood the banking system with liquidity to encourage lending. As the chart on page one

shows, consumers have not leveraged up in this recovery. In fact they have done the opposite. So the liquidity the Fed provided has not found its way into real assets (plant, equipment, and construction), but paper assets (stock and bond markets).

M2



Eventually, the Fed will have to "take the punchbowl away," as the old economics maxim goes. Fed chairman Bernanke realizes that he was taking two major gambles with the bank rescue package. First, to throw money at the banking system, and second, to take the money away. In fact, the withdrawal is already happening. The chart above shows the rate of change in the broad M2 money supply. The growth has gone from a 25% rate of change in 2008 to negative 9% rate today. Unless we see the aforementioned boom in earnings, it is hard to see that we will be able to avoid the negative impact from the removal of the punchbowl of liquidity that is currently driving stock prices.

Finally, we have to ask about investor behavior, the psychological component of the markets. At the beginning of the credit boom in the early 1980s, baby boomers were 35-40 years old. They could take the risks, and in fact, were rewarded for taking them during the 1982-2000 bull market. But today, the baby boomers are 60-somethings, and they have suffered through two stock market collapses and seen the value of residential real estate crumble for the first time in their lives. What is the long-term perspective of baby boomers *now*? Probably not very long. I would suspect that they are more than willing to sell into rallies and recapture what gains they can, fearful that they may ride the roller coaster of the markets down again. I think we are seeing their new conservatism in household debt numbers, and this is likely to be a factor in keeping stock prices in a trading range, rather than a bull market.

What happens when the medicines of liquidity, government spending, and hyper-leveraged consumers are taken away? No one knows for sure, but it appears likely the economy will have a tough time delivering on the promises implied in today's overly optimistic stock markets.