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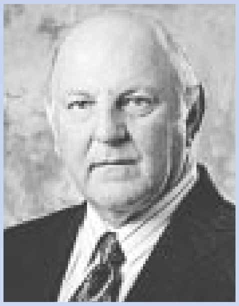
What In The World Is Going On Here?

The stock market's swoon in September became second page news after a global credit freeze sent stocks into a nosedive during the early weeks of October. What had become a disturbing bear market in the United States (a decline of about 20 percent in most market indices during the previous 12 months) became a drubbing rarely seen more than once in an investor's lifetime. Early in October, the Dow Jones Industrial Average suffered its largest weekly percentage decline in its 111-year history.

Market volatility appears to be almost unbounded. Four hundred point intraday swings in the Dow Jones Industrial Average have been commonplace during the last three weeks. A measure of market volatility called the VIX has reached levels never before seen. The greater the magnitude of this indicator the greater are expected stock market moves (to either the upside or the downside). Historically, the VIX wanders in a range of 15 to 30. Major stock market bottoms have tended to occur when the index spikes above 45 after a sharp stock market decline. On October 16, it peaked at an unheard of value of 81.7.

> *"There is a big difference between the realization that bargains exist and the ability to take advantage of them."*

With most major stock markets around the world now trading at levels that are now 40 percent to 50 percent below their year-earlier highs, it's of little wonder that investors of all kinds are disgusted, exhausted, and on the verge of panic. At the extreme, a number of investors are vowing to never, ever, trust the financial markets again. Growing pessimism is becoming pervasive.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Take the *Investors Intelligence* survey of investment newsletter writers for example. Its readings have reached near record proportions. As of October 22, the bulls declined to 22.2 percent, the bears increased to 54.4 percent, and the difference between bulls and bears widened to -32.2 percent. (The greater the divergence between bulls and bears in favor of the bears, the more positive the sign that the market has bottomed.) This divergence is greater than the -30.5 percent reading in June 1970, and greater than 98.4 percent of the weekly readings in the survey's 45-year history.

Investor anxiety resulting from the market meltdown has taken a hefty toll on consumer confidence. The University of Michigan consumer sentiment number has fallen off a cliff, plunging to 57 from a reading over 70 last month and an average of 85 last year. The last time this survey reading was this low the U. S. economy was in the midst of a very serious recession in 1982. Almost one million jobs have been lost during the last 12 months and some economists are expecting another one million will be lost before the current economic recession

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ends. Given that nearly 70 percent of the nation's GDP is represented by consumer spending, these trends are quite disturbing.

Although the recent economic growth statistics don't meet the technical definition of an economic recession (two consecutive quarter declines in GDP), I argue that the U.S. economy has been in a recession since the fourth quarter of 2007 when revised Gross Domestic Product growth was recorded in red ink. Although growth during the first and second quarters of 2008 was positive, all of the GDP gains can be traced to export sales and the economic stimulus checks received this summer. With the stimulus checks spent and the dollar marching to higher ground, you can expect more red ink in the quarters ahead.

What surprised most economists, investment professionals, the U.S. Treasury, and the Federal Reserve was the extent to which banks refused to lend to one another. That credit freeze spread from the banking system to the commercial paper market. The result was that most major corporations could not fund their daily operations with short-term credit. As news of the lack of trust banks had in one another spread, investors began to withdraw their deposits. A pending run on banks pushed the banking system to the brink of near collapse. That threat was averted by a series of actions taken by the Treasury, the Federal Reserve, the FDIC and (finally) the U.S. Congress.

That brings us back to an assessment of the future. What can we expect from here? If you listen to the talking heads on a number of the financial news programs these days, you can expect anything from an immediate turnaround in the stock market to financial Armageddon. In recent days, these pundits have told me to cash in all my stocks and park my money in safer short-term Treasury bills for the next year or two. I have been told to load up on gold because a worldwide financial panic will surely drive the price of an ounce of gold toward $2,000 an ounce. On the other side, I have been told that the stock market has bottomed and that I should load up on stocks. Some have told me that big caps will lead the rebound, others have advised me invest in small cap stocks, which will provide the greatest returns during the market's recovery.

Of course, the truth is that no one knows for certain what will happen to the economy and the stock market near-term. Yet, the financial news is rife with advice that comes from people who believe that their version of the future is a certain outcome. Rather than talk in certainties, the best way to view the future is in probabilistic terms. Here's my probabilistic assessment. It is based on both an analysis of history and on current statistics and facts.

I begin with three letters V, L, and D. The letters V and L refer to the shape of the current recession. A V recession is one in which GDP plummets during the next three quarters and rebounds sharply during the second half of 2009. An L recession is one in which economic growth tumbles for the next two or three quarters and then limps along for another year or two before beginning a slow ascent to higher levels. The D is an economic collapse of depression proportions.

First the probabilities. Given the actions taken by the governments and central banks around the world, I believe that the probability of a V recession is more likely than one marked by an L. An economic depression is not out of the question, but given that monetary authorities have taken actions that are the exact opposites of those taken during the Great Depression, the probability of the onset of an economic depression is quite low. Although not precise percentages, my outlook for the market is based on a 67 percent chance of a V recession, a 30 percent chance of an L recession, and a 3 percent chance of another Great Depression.

Now the outcomes. The stock market's ultimate bottom will likely be determined by the length of the current economic recession. The longer the recession, the longer the time until the market recovers and the lower it will trend before it bottoms. During the post World War II economic recessions, the stock market bottomed anywhere from half way to three quarters of the way through the downturn. If history repeats itself and the recession began in October 2007 and ends in mid-2009 (a duration of 21 months), you could expect the market to bottom somewhere between November 2008 and February 2009. (This is the V shaped economic scenario.) History indicates that a decline of about 45 percent to 50 percent from a previous top would mark the bottom a recession induced bear market. That would put the S&P 500 Index at about 800, which is a bout10 percent below its current

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level. That level also corresponds to an index with $60 earnings and a price-earnings ratio of 13.3, which I believe are reasonable (although pessimistic) numbers.

If the economy experiences an L shaped recession, you could expect the market to bottom somewhere between January and June 2009. My analysis indicates that the S&P 500 could fall as low as 650 before it reaches bottom. That is about 20 to 25 percent below where it currently stands (900) and would represent a decline of about 55 percent from its all-time high reached earlier this year. I should point out that a decline of this magnitude has not been seen since the stock market declined 80 percent during the bear market of 1929-1932. An economic depression of the 1930's variety (the D scenario) could send the stock market down another 50 percent from here, representing a total decline from top to bottom of 70 percent.

When I combine my outcome scenarios for V, L, and D economies with their respective probabilities, the expected outcome is for the market to bottom with an S&P 500 Index trading around 750 to 760. That would represent another 15 percent decline from its level on October 22 and a total decline of 52 percent from its all-time high.

We know what got us into the recession, falling housing prices, rising commodity prices (especially food and energy), mispricing of risk, and a financial freeze-up. What's going to get us out? There are several reasons to believe that the current recession will be of the V variety. First, the Fed and the Treasury have flooded the financial system with money and will begin to remove so-called "toxic assets" from bank balance sheets. That should alleviate the current credit freeze within a month or two. Second, fears of a global recession have caused commodity prices of all kinds to crash. A barrel of oil, once trading as high as $147 this summer has fallen below $70 and RBOB gasoline ("reformulated gasoline blendstock for oxygen blending", which is a new benchmark gasoline contract o the New York Mercantile Exchange) has declined from $3.20 to $1.55 a gallon. That should put prices at the pump somewhere in the $2.55 to $2.65 a gallon range. By our estimates, that should put $1,200 to $1,600 annually back into the hands of consuming families. That represents an aggregate annual increase in consumer disposable income somewhere between $110 billion and $160 billion. That's an amount equal to last summer's stimulus package (every year). Add to that savings in the cost of food and the reduction in heating bills this winter and the typical consumer could be the catalyst that sets the economy back on a growth track. Finally, there is serious talk in Congress of an additional stimulus package being enacted in the near future.

What about the stock market? All I hear these days is that the market meltdown has produced investment bargains not seen in more than 20 years. If that is the case, why is the market continuing to decline? With all the bargains around, who is selling?

There is a big difference between the realization that bargains exist and the ability to take advantage of them. First, fully invested investors would have to liquidate some of their current positions to invest in other bargain-priced stocks. That activity would bring no net new money to the market. Second, there are retired investors who must continually withdraw capital from their portfolios. People won't stop eating or paying rent just because the value of their investment portfolios has declined. In addition, these folks now have to liquidate nearly twice as many shares as they did last year to produce the same amount of cash. Third, there are those investors who just can't stand any more pain and are liquidating their equity portfolios in favor of cash. These investors in aggregate have caused continued net redemptions from equity mutual funds. These funds are forced to sell to raise cash to pay their redeeming shareholders. (In fact, Trim Tabs, a mutual fund industry watchdog recently reported a weekly drain of nearly $55 billion, representing the largest weekly cash outflow since they have been keeping records.)

Finally, hedge funds have taken it on the chin during the market's sell-off. These funds promised to make money during bull markets and to preserve capital during bear markets. However, for most hedge funds it hasn't turned out that way. The vast majority of hedge funds are down more than 20 percent this year and a large number have losses in excess of 40 percent. Hedge fund clients have begun to ask for the return of their money. As the exit windows approach, hedge fund managers have been forced to raise cash to pay redeeming shareholders, and there are plenty of them. Some of the leveraged hedge funds have just blown up and are being forced to sell stocks to meet margin calls. In these instances, lenders

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force them to dump stocks no matter what price a block sale produces. I also suspect that several hedge funds (those with losses of 30 percent or more) are just going to throw in the towel, sell all of their equity holdings, and return what's left to their investors. Thus, selling pressures could continue for the remainder of the year.

What will ultimately turn the tide? Who will be the buyers that begin to send stock prices higher? There is plenty of cash around. Money market mutual fund assets are at all-time highs. Corporate balance sheets are packed with cash. The increase in the value of the dollar against many foreign currencies makes U.S. denominated investments attractive to foreigners. Who will be the first to jump?

So far, the only visible investor on the scene has been Warren Buffet. He invested $5 billion in Goldman Sachs and another $5 billion in General Electric. Recently, he has been quoted as saying that he gets greedy when other investors are experiencing fear. So far, as of this writing, these two investments appear to have produced approximately $1.2 billion in losses. (I guess that's the price of admission when you are early.) That, in itself has probably caused a number of bottom fishermen to reel in their lines.

Although I am not sure which group of bargain hunters will eventually put a floor in the stock market, I am relatively sure that bargain hunting corporations may be the ones to sustain a stock market rally. These days, it's becoming cheaper to buy a company than to build a new one. In addition, given the modest prices that will be paid, most acquisitions will be accretive to earnings almost immediately (or at least when the economy begins to turn upward.) Consolidation among financial institutions is almost a given. However, I suspect that a large number of acquisitions will be affected in the small cap segment of the market. My reasoning is that these are relatively small acquisitions, and given paucity of debt capital available these days, most acquisitions will have to be made with cash on hand.

Stock market rallies after significant past declines have tended to feed on themselves. If history is any indication, once a meaningful rally has begun, look for it to continue for a lengthy period of time as more and more investors jump back into the market. Returns of 50 percent to more than 100 percent over a two-year stock market recovery have been more the norm rather than the exception.

As my friend Neal Hennessy said recently, "there is only one end of the world, and this isn't it." However, history tells me that it's normal behavior for investors to become overly optimistic in good times and to exhibit irrational fear during economic and financial market meltdowns. So, the prevailing attitudes of today are not much different than they were during 1969-70, 1973-74, 1980-81, 1990, and 2001-02. What one must keep in mind is a historical perspective: that economic recessions end, financial markets stop falling, and rationality returns. After each and every one of these periods economic conditions improved and the stock market marched to higher ground.

I have painted a bleak picture. However, one must consider all possibilities when investing in foreword looking stock and bond markets. Personally, I am more optimistic than the words here might convey. My optimism is based on a number of indicators: (1) fear has become pervasive, (2) the stock market plunge has produced valuation multiples not seen in 27 years, (3) credit markets are beginning to thaw, (4) there is a mountain of cash sitting on the sidelines, and (5) the world's central bankers appear to be on investors' side.

I expect the stock market to bottom in November. I believe that the current economic recession will not last another 12 months or more. Finally, I believe that the U.S. stock market will begin to head to much higher ground early in 2009.

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Mutual Fund Investing involves risk. Principal loss is possible. Investments in smaller companies involve additional risks such as limited liquidity and greater volatility than larger companies. Investments in micro cap companies tend to perform poorly during times of economic stress. The funds may invest in early stage companies which tend to be more volatile and somewhat more speculative than investments in more established companies.

The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividends. You cannot invest directly in an index.

Earnings per share (EPS) is calculated by taking the total earnings divided by the number of shares outstanding. Price to earnings ratio (P/E) is a common tool for comparing the prices of different common stocks and is calculated by dividing the current market price of a stock by the earnings per share.

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