What just happened?

The third quarter saw the markets fall across almost all asset classes. The fall started slowly in July, accelerated into August and intensified during September. During the month of September the drops were swift, deep and across the board. The following chart shows the performance of multiple asset classes for July - September, 2011.

In order to see what just happened we need to take an in-depth look into the events of the past three months. We all know someone who can give an inning by inning description of a baseball game – or a hole by hole review of their golf round. So...let’s take a week by week look at the last quarter to gain an understanding of what just happened? This may take a bit – so fill your coffee cup and sit down while you read what the Wall Street Journal reported for the last 90 days.

There were a number of themes that impacted the markets’ performance. Let’s break them down one theme at a time.

First up, was the U.S. budget / debt ceiling issue. The eyes of the world were on U.S. politicians as the U.S. faced an August 2 deadline to increase the debt ceiling limit or face a potential default on its national debt. What had traditionally been an automatic vote to increase the debt ceiling had turned into a partisan debate on the nation’s tax and spending policies. July started off with news that the House Republicans were in conversation with the President on a “grand debt deal” to cut $4.5 trillion from budget deficits over the next 10 years. The plan would have included “spending cuts for domestic programs, defense and Medicare and Medicaid, as well as boost tax
revenues.” (1) Within days, the headlines informed us that the deal was dead as “debt talks (were) back to square one.” (2) Next, it was reported that “President Obama walks out of talks” (3) as Senate Democrats were not liking the proposed terms of the negotiations. With time winding down the House Republicans could not agree on the spending cut amounts and headlines read “Boehner plan faces rebellion” from tea-party Republicans. (4) But at last, in the final hours, a deal was reached, the debt ceiling was raised in exchange for $2.4 trillion in spending cuts over the next 10 years - $917 billion detailed in the bill and another $1.5 trillion to be determined at a later date by a committee to be named later. (5) The process was not pretty, the negotiations not polished, but in the end the “debt default” was adverted and the debt ceiling was raised. But, at what cost to investors’ confidence?

Next up, were the debt problems playing out in Europe. What had started the year as sovereign debt issues in Ireland, Greece and Portugal were spreading to Italy and to European banks. Headlines reported “Italy, long a bystander to the euro-zone’s debt woes, was thrust into the maelstrom…as investors fled the country’s bonds and Europe’s leaders struggled to keep the crisis from infecting the Continent’s third largest economy.” (6)

Markets began reacting to the “frustration that Europe’s leaders haven’t yet come up with a solution to Greece’s deepening debt problems”. (6) In mid July, European leaders applied another band-aid to the problem by agreeing to “a new $144 billion bailout for Greece and new steps to prevent its debt crisis from metastasizing across the Continent”. (7)

By early August, “just two weeks after Europe’s leaders agreed to a long-awaited second bailout of Greece – considered the Continent’s sick man for more than a year – investors are now turning their attention to Italy, the euro-zones third largest economy. Italy’s debt as a proportion of economic output is second only to Greece’s in Europe, and has been plagued by slow growth for more than a decade.” (8)

Shortly thereafter, “Germany and France presented a broad plan to better coordinate economic policy across the 17 nation euro-zone, amid growing fears that a slowdown in the region could accelerate the debt crisis that has pushed the Continent’s common currency to the brink of collapse.” (9)

There were reports of “growing worry that Europe’s debt crisis could spill into the U.S. banking system…” (10) In September, we were greeted with reports that “international financial markets tumbled as a darkening global economic outlook and deepening fissures in Europe over its debt crisis fueled fears the world economy could slip into a period of prolonged malaise.” (11)

By mid September “nervous corporate clients began looking to banks outside the euro-zone for loans.” (12) As September wound down, markets reacted positively to renewed “hopes European officials would adopt aggressive measures to end the region’s debt crisis.” (13)

On September 30, “Germany’s parliament approved legislation to increase the euro-zone bailout fund’s lending capacity to $596 billion…and make the fund more flexible.” (14)

The jury is still out on whether Europe has the financial capacity and the will power to ride out the debt problems facing the Continent. Unlike the U.S., a large portion of sovereign (country) debt is owned by banks – with French and German banks the largest holders of sovereign debt. Whether these banks have sufficient capital to absorb losses from these loans is a major question mark. Because the euro-zone is an affiliation of separate, independent countries and not one unified
country – solutions are not as easily implemented as they are in the U.S. The most fiscally responsible countries are being asked to bail out fiscally irresponsible countries. Success is being asked to bail out failure. Any solution will take massive amounts of capital – either in the form of more loans to the sovereign governments to pay their maturing debt back or to the banks who will not get repaid – either way Europe has a tough road ahead.

As these two issues were playing out, world economies were under the microscope as investors were looking for trends in economic news. On July 8, came the announcement that June U.S. employment numbers came in below estimates as only 18,000 jobs were created and the unemployment rate increased to 9.2%. (15)

Within the next two weeks Cisco, Lockheed Martin and Borders Group announced that they were decreasing employment. “The layoffs also reflect the shifting outlook of employers, many of whom had expected the economy to gain speed as the year progressed. Instead, growth has faltered.” (16) By the end of July, Research In Motion, Ltd, maker of the Blackberry, announced that they “will cut 2,000 jobs, almost 11% of its workforce.” (17)

The beginning of August brought the news that International banking giants were reducing their world-wide workforces. HSBC announced a reduction of 30,000 employees; Lloyds Banking Group was planning to cut 15,000 positions while Credit Suisse, Wells Fargo and Goldman Sachs each announced reductions of 1,000 to 2,000 employees. (18)

By mid August, the president of the World Bank declared that “we are entering a new danger zone.” (19) At the same time, reports indicated “the U.S. economy is showing new signs of fatigue, depressing financial markets, discouraging consumers and unsettling businesses.” (20) Bank of America announced it “is cutting 3,500 jobs in the current quarter and is working on a broader restructuring that could eliminate thousands of additional positions after that.” (21)

By the end of August, Federal Reserve Chairman Ben Bernanke admitted “most of the economic policies that support robust economic growth in the long run are outside the province of the central bank.” (22) September began with the report that “factories around the world are throttling back, further darkening the outlook for a faltering global economy.” (23)

Then came the announcement that “job growth grinds to a halt” as “the U.S. economy slammed into a wall in August, failing to add any jobs for the first time in nearly a year.” (24) In response, President Obama proposed a “$447 billion package of spending initiatives and tax cuts to boost economic growth.” (25)

At the same time, Bank of America disclosed that “officials have discussed eliminating roughly 40,000 positions during the first wave of restructuring.” (26) By mid September, it was reported that “the income of the typical American family…has dropped for the third year in a row and is now roughly where it was in 1996 when adjusted for inflation.” (27)

Then, came the news that “after a summer of denial, reality has caught up with Wall Street strategists… many strategists are now cutting their forecasts.” (28) News shortly followed that “economists, builders and mortgage analysts are predicting the weakened U.S. economy will depress housing prices for years, restraining consumer spending, pushing more homeowners into foreclosure and clouding the prospects for a sustained recovery.” (29)
On the same day forecasters announced that “Christmas is already shaping up to be a struggle for the nation’s retailers.” (30) On September 21, the Federal Reserve “launched a new package of measures to support a limping economy.” (31) Two days later the market reacted as “global investors dumped everything from stocks to corporate bonds to foreign currencies…” (32) “Markets, already reeling from economic weakness around the globe, have been further destabilized by a growing sense that governments and central banks are unable to get growth back on track.” (32)

As fear took over “investors fled emerging markets…sending stocks, bonds and currencies lower…in a sign that even fast growing countries are being dragged into the global economic malaise.” (33) A day later the fear trade peaked as “the wave of selling that has washed over financial markets in recent weeks swamped precious metals…sending gold and silver prices plummeting.” (34) In one day the price of gold dropped 5.8% and silver dropped 17.8%. The crash had now claimed almost all asset categories as victims.

These events were played out under the backdrop of an event that had never happened before. On August 5, Standard & Poors downgraded the U.S. credit rating from AAA to AA+. For the first time in the history of rating agencies, U.S. debt had lost its top rating. According to this one rating agency, U.S. debt was no longer worthy of their safest rating! (we’ll get to how this played out a little later!!)

Add in the continuing turmoil in the Middle East and the fall of Libya and one begins to see what just happened.

Be honest - right about now you are asking yourself – where is Jerry going with this? He just dug a pretty deep hole to get out of! I could turn to one of my favorite commentators, Brian Westbury, Chief Economist for First Trust, and call the negative reporters “pouting pundits of pessimism.” (35) Just ignore the commentators and reporters; they only report the bad stuff.

But, by now your coffee cup is probably empty – so feel free to get a refill (or switch to something stronger!) and we will begin to sort this out. It is going to take a while so please hang in there.

We start by taking a step back and looking at the news reports in light of an overall investment strategy. We need to separate the news reports into three categories. First, which facts or trends are temporary and should be ridden out with a sound, well thought-out long-term investment strategy. Second, what facts or trends are longer term and therefore, need to be factored into your investment strategy and, if conditions warrant, are adjustments needed to your investment strategy if these facts or trends were not previously factored in. And thirdly, what events are the result of raw investor emotion and feelings of negativity that are not based on sound fundamental long-term facts or trends.

At JVL Associates, LLC we spend a great deal of time and energy developing an investment strategy that should weather the constant storms of investment cycles. We set aside current cash needs so no one has to sell into a down market. Our mix of asset classes is determined by our analysis of world-wide economic and market conditions that are established looking out one to three years. So for us, the question is which of the three categories does the news report fit into?
Let’s start by looking at the whole U.S. budget / debt ceiling debate – did anyone really think this was not going to happen? The deep political divide in our country is based on deep fundamental differences between the parties as each attempts to pull the country in their direction. Please re-read my March, 2011 newsletter and then tell me this was a surprise! America cannot continue to spend like it has over the last three years without consequences. Someone has to stop all this nonsense or we will look like Europe (read the next paragraph!) With the election coming up next year, this type of fundamental debate will be decided at the polls not in the chambers of Congress. The U.S. debt is an issue that must to be factored into a long term investment strategy - the ugly process it takes - is just reporter noise.

Next, let’s evaluate the debt problems in Europe. European countries have made financial promises to their people that they cannot fiscally keep. Cutting back on spending means paying lower social benefits to those who expect the promises to be kept. Proposals to not fulfill these promises are what have caused the unrest in the streets. There are countries (plural) within Europe that will never be able to grow their way out of their debt. These issues are severe and so far, no real long term solutions are being discussed by the European leaders – just more band aids as they fix today’s problems with tomorrow’s loans (more debt) and hope the problems go away for a while. (where did that idea come from? – all eyes have been on Washington DC!)

We will see one of two outcomes – either a large universal plan to bail out countries, banks and investors which will cost trillions (with a T) or an eventual default which will create a domino effect as lending banks and investors are forced to write off their loans. As each of the 17 euro-zone members evaluate how a massive bail-out plan affects their own country the fate of the Euro-zone as a common entity will be in peril. Either one of these two outcomes has a long term effect on an investment strategy. Europe will be in a slow down until these items are worked through the system and this could take years.

Economic data comes throughout the month – some is a more useful indicator of a trend than others, but taken as a whole one can get a general idea of the economy of a country. The U.S. continues to struggle. The third quarter news reports weren’t really “new” news just a continuation of a theme that some had thought would have ended by now. Many economists had believed the U.S. would be growing more rapidly by now.

Readers of my past newsletters know that I have been in the camp that this is not a “normal” recovery. Looking at historical averages of growth coming out of a recession painted a much rosier picture of where the economy should be than where it really is. But, there continues to be three main themes overlaying the U.S. economy.

First, consumers are deleveraging their household balance sheets. They are reducing debt by choice (not borrowing on new debt while paying down existing debt) and thus these dollars that were spent in the past are no longer going toward consumption. Household debt has decreased from 130% of household income at June, 2007 to 115% as of June, 2011. (36) However, continued deleveraging is still needed to bring the rate down to its long term level of 75%.

Second, the job market has not improved. The number of people underemployed is not decreasing thus, there are fewer people to spend and help grow the economy. The U.S. lost 8.5 million jobs during the last recession and has added only 1.3 since the recession ended. (37)

And finally, housing has not come back to levels needed to support a shrinking industry. Many people are concerned with their jobs and therefore less likely to take on the added risk of buying a different home.
These three are all long term trends that some had believed would have dissipated by now. For some investors this realization came in the third quarter and lead to a selloff of “risk assets”. While the general economic conditions of the U.S. is very much a part of a long term investment strategy, the speed and depth of the current sell off is the result of raw investor emotions.

And what about the debt downgrade – how did that work out? Downgrading the U.S. debt should have driven people out of, and away from, U.S. obligations. Instead, investors fled into them driving the rates on U.S. government bonds to all time lows. Let me say it another way – let’s suppose JD Power announced that they had lowered the safety rating on XYZ car. You would expect that sales of XYZ car would fall – but instead they skyrocket! What does that say about (a) the credibility of JD Power or (b) the perceived safety of other cars? The reaction to the downgrade had the opposite affect it should have – investors flocked to this downgraded debt as a safety measure against all other investment assets. In fact, at the end of September the dividend yield on the S&P 500 (2.3%) was greater than the yield on the 10 year U.S. Treasury Bond (1.92%) (38) This is the result of irrational fear and a temporary lack of confidence in the entire investment universe.

And finally, the unrest in the Middle East and the fall of Libya has created long term opportunities in the energy sector. These will be long term plays and should be factored into a good investment strategy.

I’ve kept you a long time – but I ask that you to take one more refill and let’s get to the conclusion.

But what about that third category – when raw investor emotion and feelings of negativity take over? What do you do when “everyone” else is scared? What is the plan when investors are scared and “just want out”?

First, remember that getting out is only one half of the equation – how will you know when to get back in? It has been said that no one rings a bell when the market hits the bottom. Selling to avoid a temporary drop means you have to know when to re-enter to come out ahead.

Secondly, we don’t know ahead of time how big the drop will be. While 2008 is fresh in our minds we must keep it in perspective and remember that it was the second largest calendar year drop in history. 2011 is not over yet, which may or may not be a good thing!

Who remembers March 10, 2009? That was the day the bear market ended. No one rang a bell, no one reported that the bear market had ended – it just did! And then it began the two year climb of over 100% from its lows (based on the S&P 500). It took only 13 days to climb 22%, 4 months later it was up 40%, and the bull market lasted for two years – all the while the economy was sluggishly coming out of a recession. The news reporters were not reporting great news, yet the markets climbed. As I write this newsletter, as of October 15, the S&P 500 is up over 11% from its recent low.

Fidelity Investments published a chart that shows that since 1980, within a given calendar year, the average drop from market high to market low was 14.3% while over the same time period the
market has increased in 24 of those 31 years. In 17 of the years the intra-year drop was at least 10%. In 8 of those years the market dropped more than 10% within the year while ending up more than 10% for the entire year. (39) Large intra-year decreases are not that uncommon.

What about the fall of commodities and precious metals. Investor fear causes a flight from risk to safety and thus these investments fell fast and hard. While the slowing developed economies will dampen the growth in the emerging market countries the need for commodities is long term. I continue to be optimistic on these asset classes in spite of the temporary setbacks.

Let me conclude with an analogy I use often – investing is a video, not a snap shot. Quarterly reports are snapshots of a point in time – could be valuable but could also be the snapshot of you taken at 6 o’clock in the morning, just as you were waking up – not necessarily a pretty picture! This video is not done – it has more time to play out.

At JVL Associates, LLC we take great pride in understanding both the snapshots and the video. We look at the short term performance of assets classes, as well as their longer term prospects. Both have their place – our job is to evaluate what part they play in an overall long-term investment strategy. The following chart is a great picture of where I believe we are in a long term secular investment cycle. We will continue this sideways movement for a period of time before the next secular bull market takes over. It may take time and our investment philosophy takes this view into account.

(40)
This does not mean that there will not be large increases and decreases in the market during this sideways period – see below. I believe we just experienced one of those decreases.

If you know of someone who could benefit from our analysis please feel free to give us a call.

And finally - on a personal note – I recently tore my Achilles tendon during a triathlon and just had surgery to repair it. Since it is my right foot, I will not be driving until the end of the year. I have found that a lack of mobility for the next 10 weeks can be somewhat frustrating. Being patiently reliant on others is a good lesson for me to learn, but not the easiest for my independent spirit! Please bear with me – the video has more races to come!

I value your feedback – if you would like to discuss anything in this letter in more detail please give me a call. I can’t go anywhere so I am just waiting by the phone.

By: Jerry VanderLugt CPA CFP®
References

References, continued...


[36] Oppenheimer Funds, "U.S. Households Remain Heavily Indebted", Market Charts as of 9/30/11, Q3

[37] Oppenheimer Funds, "Weak Labor Market", Market Charts as of 9/30/11, Q3

[38] Oppenheimer Funds, "Equity Divided Yield vs. Treasury Yields", Market Charts as of 9/30/11, Q3

