May 11, 2010

What Have We Learned?

Economic Consequences Matter

One of the things we seem often to forget concerning the economy and business is that a strongly pronounced trend is not the same as assurance that it reflects a permanent condition. The most striking example in the recent boom is the attitude of so many participants concerning the value of real estate, most notably residential real estate. We know from study of the past that real estate values have been cyclical. The general trend seems to have been gradually rising (probably consistent with inflation over time) but real estate prices have fluctuated, often over long cycles.

Those who have studied the past even in a relatively casual way had to be aware, because of these fluctuations and because of the underlying factors necessary to support real estate prices such as personal income growth, etc., that we were very likely experiencing some sort of boom or bubble in the early to mid 2000's. It was impossible to predict how high real estate prices would go or how long the rise would last but it should have been possible to predict that at some future point prices would be lower than they were in 2005-2006. This is one example of foreseeable economic consequences that were ignored by the vast majority of participants in the economy.

Another example was the use of excessive leverage (borrowed money) to finance many kinds of economic activity. The evidence was clearly accumulating that unprecedented amounts of leverage were being employed by economic participants prior to the 2007-2009 crash. This leverage showed up in consumer accounts related to home borrowing, home equity loans, credit card debt, etc. But it also showed up in leveraged buyouts and financial institution capital ratios, as well.

Past history told us that the amount of debt was unprecedented relative to incomes and realistic future asset values and, at some point in the future, the soundness of all that debt would be tested. What we didn't know and probably couldn't know, was when.

The inescapable conclusion is that most people who thought with care about the likelihood of a test of the financial system, or at least segments of it, at some future point, would have concluded that trouble lay ahead, although when and from what level was impossible to predict accurately.

Keep it Simple Stupid

We are saturated with TV newscasts, CNBC, newspapers, business magazines, blogs, etc. As a consequence, we have popularized business and economic news 24/7. That means that we always have to be saying something, always have to be making new news. The result is that we are constantly digging out every tremor, wobble, bulletin, no matter how trivial, inconsequential or unrepresentative of the general direction or meaningful trend it may be.

Of course, in actuality, the economy is a vast, lumbering machine, a sort of super tanker, which is difficult and slow to turn, accelerate, stop or otherwise change. That's why we must try to, "keep it simple stupid." The significant movements of the economy are generally not minor tremors or quick reversals of course. They are vast cyclical movements which are slow to reverse or redirect. We need to learn that grasping the broad developments in the economy and, if one is a policy maker, influencing them is what the job is all about. Hopefully, one of the things we have learned in this "great recession" is that it is necessary to keep our focus on the main chance and not be unduly distracted by minor ripples.

It's Not Really Different This Time

It's ironic that in this recent near depression, where the policy actions were in many ways new and certainly much more dramatic than at any time in the past, so many of the characteristics of the boom, the bust and the recovery have been so similar to characteristics of economic cycles of the past. In many respects the degree of these movements has been stronger than previous such movements except for the Great Depression but the nature of the prosperity, the subsequent collapse and the rebound have had very "ordinary" characteristics.

There has been a tendency for many observers to stress that this time it's different. It was supposed to be different in that real estate prices were only going to change in one direction. It was supposed to be different in that leverage which had never been tolerable in the past was now going to be acceptable. It was supposed to be different in that the aggregate risks, which were individually profound, were going to produce resulting risks that were minor. After the crash, the resulting recovery was going to produce the "new normal" of slow growth, according to one prophet.

What we have been learning through this remarkable cycle is that actions which were much like the past have resulted in outcomes which were also much like the past. For example, it's been typical that sharp economic contractions have been followed by sharp economic recoveries. We have been told too often that this time it's different. So far our experience is indicating that the outcome will not be much different than might have been expected based on past experience.

In summary, we should expect similar results in the economy to follow events which have in the past triggered these kinds of results. One difference, however, may be that the Fed and the Administration have hit the economic accelerator much harder than we have ever done before. So far this appears to be resulting in a very strong bounce back for the economy.

If You Jump Out Of An Airplane Without A Parachute, The Landing Is Going To Hurt

It's remarkable how many comments and actions of leaders and key players of financial institutions and related industries demonstrate, on reexamination, that these leaders and players knew they were operating without parachutes.

Possibly the most infamous of these comments was the one by Chuck Prince, then CEO of Citigroup, who made reference to the need to keep dancing as long as the music is playing. In retrospect, it now seems obvious that these important actors in the tragedy we witnessed from 2004-2009 were at least generally aware that in their headlong drive to win the game, they had abandoned most or all of their and their organization's safety net.

Those of us who are or have been leaders are expected to understand that one should never leave one's organization without a cushion, a fall-back position, a Plan B, etc. None of us expects or is expected to run a business or other organizational activity with uncontrolled exposure to risk.

Lately, there has been more attention to what I believe some have called, "behavioral economics." It seems that this means that all human enterprise is subject, at bottom, to the risk of emotional excesses under certain conditions. Even risk measurements based entirely on conceptual models are, in the end, vulnerable to the accusation of having abandoned the parachute.

It's been pointed out now many times that events which have a once in a 100-year probability are rarely supported by assurances that something which is unlikely is impossible. The event which is so rare can occur because conditions for its occurrence have been created by chance or in some cases because conditions for its occurrence have been triggered by the very belief that it's essentially impossible.

There is no substitute for a cushion of surplus safety to guard against an unacceptable risk or for human judgment which goes beyond the whirring of a computer based on the inevitable simplifying assumptions of a model.

We are probably effectively insulated against a near-term recurrence of this madness for a while but we need to have learned, hopefully for some time to come, that success breeds optimism and confidence, and continuing success often breeds hubris.

Trees Don't Really Grow To The Sky Or "All Fall Down." Contrarians Rule

I suppose we'll never know until it's too late if there can be a boom that never ends or a crash which never hits bottom and reverses but it is still the best assumption to believe that perfect or utterly disastrous outcomes do not occur or persist.

It's tough to call a top or a bottom in the economy, an industry or the market but usually when the panic ensues, either upside or downside, it's best to bet against the prevailing trend. Purchases made during the October 2008 crash did face a lower low in March 2009 but only briefly. By the end of March 2009 most stocks bought near the initial bottom in October 2008 showed a profit. While the bottom in March undercut the October bottom, it was not by much or for long.

The lesson usually is that the world is not coming to an end, just as at tops it's very unlikely that we are truly in a "new era." We all need to be wary of moments of extreme sentiment in the market and while it's harder to measure moments of extreme sentiment in the economy, they are equally misleading.

While it's not always sound to be a contrarian, in extreme moments it almost always is. It feels as if the risks are enormous but the combination of extreme prices and violent emotions almost always gives the contrarian an opportunity to get out whole later if he changes his mind. These are opportunities that should be seized, if only in moderation. Selling Bank of America at $3 a share in March of 2009 when it had fallen from over $50 during the previous two years was unlikely to be a sensible move. Buying it had a reasonable chance of success.

The Harder The Fall The Bigger The Bounce

The phrase which has become popular since the financial crisis is "the new normal." It has been used to characterize the future course of the US economy as being one of persistent slow growth resulting from the needed correction of excessive leverage on the part of consumers and residential real estate owners after the almost uncontrolled spending spree of the early to mid-2000's. There is certainly reason to believe that the excesses of that period will need to be gradually corrected during the ensuing economic recovery. My objection to this concept is that the issue doesn't seem to be that simple.

Nor is the expectation of moderate growth in the economy necessarily a limiting factor on the performance of the US stock market. At least two elements of the argument may challenge this simplistic analysis:

1. There is a tendency for an economic recovery to be in many respects a mirror image of the scale and volatility of the decline which preceded it.

2. The quality of the economic foundation for the recovery being accompanied by continuing unwinding of debt and related elements of financial conservatism could easily support higher earnings multiples on equities.

3. A third element which could have significance on US common stock performance might easily be the severe employment cutbacks accomplished by US industry and a relatively slow recovery in domestic employment which may have a dramatic effect on profit margins over the next several years.

All of this leads me to conclude that it is premature to prejudge the shape of the recovery, especially with respect to overall profits or P/E ratios and therefore common stock prices.

News: We Have Learned Something From Our Policy Mistakes

Probably the most remarkable and significant developments of this economic crisis are the brilliant monetary and fiscal responses which have been developed and introduced by the Federal Reserve, the US Treasury and the present Administration. Even the past Administration, which undoubtedly carries its share of blame along with the Fed for the origins of the calamity, deserves some praise for its response once the crisis hit.

It's my belief that there has been far too little recognition of the scope and significance of these policy actions. If there is a single key reason to come out of this crisis with a sense of optimism and encouragement about the future of US economic policy, it is the dramatic and largely correct steps which government took in the face of an incipient financial and economic collapse which could easily have rivaled the Great Depression of the 1930's.

The stock market, as usual, is attempting to predict the future of the US economy. It is certainly not always correct in these predictions but it is always willing to ignore yesterday's news and today's rhetoric in staking its claim to tomorrow's outcomes. The dramatic recovery of the market since the collapse reflects great optimism.

It's my belief that the performance of the market since early March 2009 is reflecting two unfolding realities:

1. After a century of inability to comprehend and constructively influence outcomes after economic dislocations, the Fed and Administration seem finally to have learned how to effectively address a severe economic downturn, especially one importantly influenced by a financial collapse.

2. The profound power of the response (especially the monetary response) has, or seems to have, been proportional to the scope of the problem. The result is likely to be a dynamic recovery over the intermediate term.

In the course of this incredible period certain economists have emerged as notable "patron saints" of the resulting policy actions. Although it is far from clear that fiscal policy has been as timely or effective as monetary policy, John Maynard Keynes has reascended to the firmament as the justifiably praised author of the first thought revolution in depression fighting economic policy. We have been treated to a new biography or profile of Keynes about every two months since the crisis erupted.

We have also had our "Minsky moment" named for Marvin Minsky, the Washington University economist, who in 1986 published his seminal, Stabilzing an Unstable Economy and who advocated the simple but profound truth that economic developments tend to lead inevitably to unstable outcomes because of human nature which results in a build-up of excess confidence and risk appetite as an economic boom matures.

Economics is Not Steady State. Success Leads to Excess Which Leads to Failure

The Minksy moment and the work of other behavioral economists seems by now to have led us to a fascinating realization that modeling economics, finance and business on simplified, somewhat theoretical and entirely rational models is far from perfect. The collapse of Long Term Capital Management in 1998, the failure of many risk models in the recent crisis and the subsequent failure of many portfolio models in 2008 – 2009, has taught us (or reminded us since we already really knew it) of the following:

1. Just because certain events are rare doesn't mean they are impossible. Just because an event should occur only once in a hundred years based on probability calculations doesn't mean it can't happen tomorrow.

2. Economic, financial and business participants can't be counted on to always be rational in their actions. Emotions do play a role and at certain times in the cycle the impact of emotions can be substantial.

3. The sequence of events in a business cycle tends to be a self reinforcing feedback loop in that favorable outcomes trigger growing confidence which in turn triggers greater risk taking and can eventually lead to failures. Conversely, unfavorable outcomes can lead to extreme fear and ultimately excessive conservatism and risk taking opportunity.

4. The system needs to have the possibility of government regulatory, monetary and fiscal policy involvement in order to stay on an acceptable risk track.

Therefore, government involvement in business regulation and economics can't be completely dismissed. The right balance and correct specific actions can be difficult to achieve but the notion of complete absence of government participation is unrealistic at best and outright dangerous at worst. It is not productive for market participants to howl at any government involvement. It is more useful for participants to consider what and how much involvement is likely to produce the best outcome. This involvement should most likely be at the edges of acceptable outcomes, hopefully to avoid the need for "bailouts" but not to eschew them when absolutely necessary.

There Are No Fool-Proof Investment Systems or Techniques

Evidence seems to support the contention that for investments which involve risk, there are no fool-proof investment approaches. It is possible, as in the case of short-term, high quality fixed-income paper to reduce risk to a very low, essentially non-existent, level. What this means is that the investor will receive the risk-free rate of return which is normally low and frequently negligible. Once risks comparable to equities or low quality bonds are accepted, the challenge becomes much greater and the chance of disappointment becomes much more real.

In recent years, some investment managers, often using quantitative or computer driven techniques, have been able to materially enhance their odds of achieving superior outcomes. In addition, there are investors who support their investment activities with substantial levels of fundamental expertise and research knowledge.

A whole industry, often called "efficient market theorists," has devoted itself to attacking the true advantages bestowed upon investors by supposedly superior research techniques and information. To many, the advantages of quantitative and computer-aided research is also overstated and/or impermanent. Evidence seems to indicate that, at the very least, it is difficult to sustain over long periods of time the performance advantages of powerful computing and other quantitative techniques.

One of the side effects of the recent financial crisis and its accompanying dramatic impact on the markets has been to wash away a whole new group of investment theories and techniques. It is probably fair to say that the notion of building a durable performance advantage in a portfolio through these quantitative techniques has been further eroded as an aftermath of the last few years. Substituting automated sure-fire systems for insight and judgment has probably never been more under siege.

Climbing a Wall of Worry

There is an old expression, "a bull market climbs a wall of worry." A reasonable explanation of that expression probably means that an extended rising market tends to be self-correcting over

the longer term. Put another way, once a rising market suspends all skepticism and disbelief and spikes upward one is usually approaching the late and exuberant stage of the advance.

It takes patience and experience for an investor to respect and appreciate the frequent corrections which tend to occur in a sustained and balanced advancing market. Most of us would prefer to see a rising market in which we are "believers" simply take off and validate our bullishness suddenly and dramatically. It takes long experience and reasonable patience to accept the idea that a rising market which needs to overcome recurring anxieties is in the end a stronger and more durable one.

Interestingly enough, despite the remarkable distance this recovering (dare we say bull?) market has covered, it has been continually interrupted and restrained by repeated bouts of hesitancy concerning the economy and valuation issues. This continuing anxiety is probably enhancing the outlook for a very durable market advance.

Beware of Yesterday's News

A constant during recovery phases in the market and the economy is that the news being reported lags the latest economic trends, extrapolations and projections being observed and made by those who are making investment decisions and committing capital. In order to support investment decisions, it is absolutely necessary to have a healthy skepticism regarding current economic data. It always lags at turning points and it is probably only meaningful during the heart of an expansion or contraction in the economy.

By mid 2009 the US economy had almost certainly moved off its bottom while negative data continued to pour in. By now clear indications of improving conditions are being recorded but they continue to lag current expectations for the future.

In addition, the continuing negative employment and jobs data reflect the fact that job growth is always a lagging indicator in an economic recovery. By the time employment data looks rosy, we will have reached a mature stage of the recovery and the stock market may well be discounting the problems which accompany a boom economy which is beginning to contend with excess demand and potential inflationary pressures.

For the investor there is no substitute for "tomorrow's news." It's necessary for us to intuit what is just happening or about to happen. Knowing what has already happened is using data too old to be significantly impacting the market.

We Did Something New and Better. We Have Learned Something From The Past.

In my view, the headline news of the crash and recovery is that economic policy makers in the US have really done something to effectively stop an incipient depression and trigger a dramatic

economic recovery. It amazes me that there has not been more obvious grasp and appreciation of this dominant fact of the recent economic experience. Nothing is more important than our finally having achieved policy success that eluded us throughout the entire 20th century.

Of course, we haven't solved human tendencies to make political and economic mistakes nor have we defeated the tendency which Minsky observed in all of us to carry successful economic performance to excess. But we have, for the first time, put together monetary and fiscal actions sufficient to abort an economic panic and resultant collapse. In my view this is the most important aspect of what the Federal Reserve and the Administration have accomplished in the last eighteen months.

The significance of these successes is such that they could usher in a new level of valuation in the equity markets. If this is so, then the possibility of a new Bull market, by that I mean higher levels than achieved before the crash, is very real.

None of this means that we may not face a resurgence of inflation or speculative excess at some point, but it seems unlikely that such a resurgence will come in the next two years. Nor does it mean that we won't endanger the system again by pressing success too far through political or business aggressiveness, but it does mean that we have written a new chapter, a new exciting chapter, in our ability to grasp and manipulate economic policy.

May 11, 2010 Norton H. Reamer