Madison WEALTH MANAGEMENT

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Deep Sea Fishing in Turbulent Waters

If the financial markets were oceans, the waters of late would be quite turbulent. The immediate issue for the markets is confidence and liquidity. The response to the Bear Stearns crisis seems to make clear that the Federal Reserve and the U.S. Treasury will do whatever it takes to keep the markets functioning. Of course, one wonders what unintended consequences these actions may bring? But for now, the market's liquidity problem is being addressed.

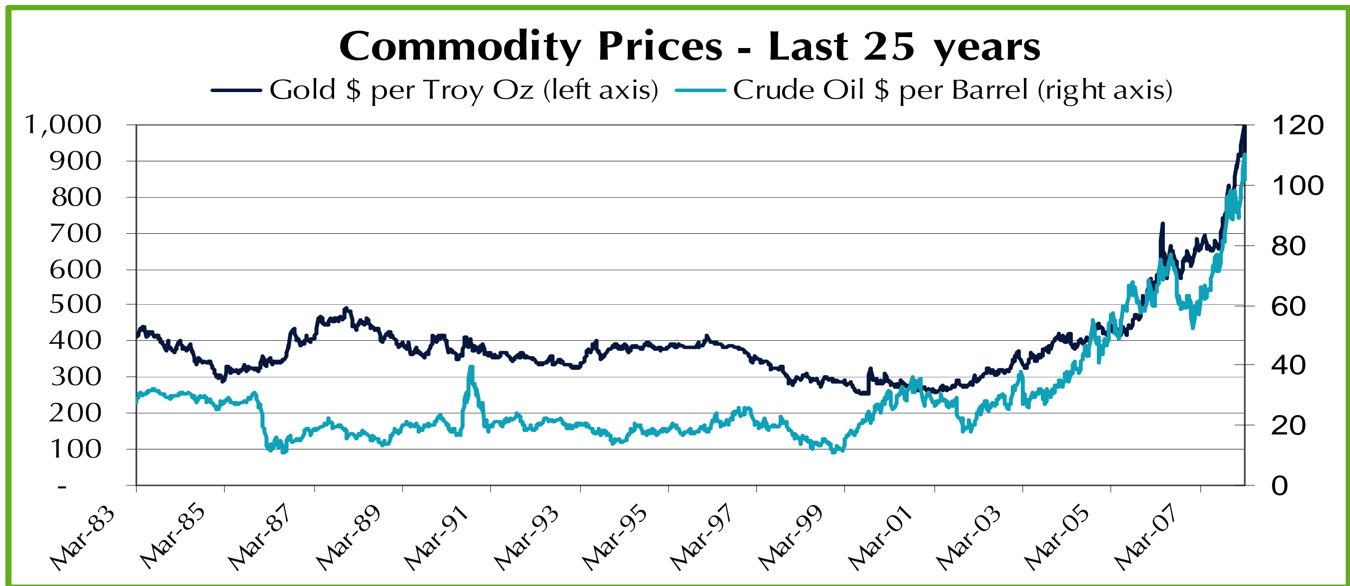
Bill Miller, the manager of the Legg Mason Value Trust provides us with a good historical perspective for the current market environment: "About the only advantage of being old in this business is that you have seen a lot of markets, and sometimes market patterns recur that you believe you have seen before. The past two years are a lot like 1989 and 1990, and I think there is a reasonable probability the next few years will look like what followed those years. The late 1980s saw a merger boom similar to what we have experienced the past few years and a housing boom as well. In 1989, though, the merger boom came to a halt with the failure of the buyout of United Airlines to be completed. The buyout boom had been fueled by financial innovation. Then it was so-called junk bonds, which had been purchased by many savings and loans in an attempt to earn higher returns. Now it is subprime loans repackaged into structured financial products. The Federal Reserve had been tightening credit to guard against rising inflation, which began to impact housing. By 1990, housing was in freefall, the savings and loans were going bankrupt (as the mortgage companies did in 2007), financial stocks were collapsing, oil prices were soaring in 1990 due to a war in the Middle East, the economy tipped over into recession, and the government had to create the Resolution Trust Corporation to stop the hemorrhaging in the real estate finance markets. Eerily similar to today, the situation began to stabilize when Citibank got financing from investors from the Middle East."

Why is it that many foreign investors seem interested in making large purchases in Citigroup and other U.S. financials, while investors here are shunning them? While many of these foreign investors are said to be 'recycling profits' from the oil and other goods they've sold to us, no one is forcing them to make these purchases. In our view, they likely expect to receive good returns on these investments. Miller points out that; "All of the poorest performing parts of the market, housing, financials, and the consumer sector – with the exception of consumer staples – are at valuation levels last seen in late 1990 and early 1991, an exceptionally propitious time to have bought them." Many financial companies need additional capital and some foreign investors seem happy to supply it. In a few years, we wouldn't be surprised to hear a chorus of folks who will be complaining about how those same foreign investors 'stole' U.S. financials.

Many market observers seem obsessed over the question of whether the U.S. economy will go into recession. To us this is an unimportant debate for a couple of reasons. First, many stocks that perform poorly entering a recession are already at recession levels (as Miller pointed out above). Second, if we go into recession, we will come out of it. Moreover, recessions are only called after two consecutive quarters of negative economic growth. Thus by the time a recession is called, we should be on our way out of it.

"History repeats itself; that's one of the things that's wrong with history." Clarence Darrow

"If history repeats itself, and the unexpected always happens, how incapable must Man be of learning from experience." George Bernard Shaw



Over the last 25 years we have had two recessions, and they totaled 17 months. We believe that long-term investors should position their portfolios for the 95% of the time that the economy is growing and not overly focus on the 5% of the time when it isn't. Bill Miller suggests that, "If it were possible to forecast with any degree of accuracy, one might be able to descry a slowing economy from an examination of economic data, and perhaps adjust portfolios accordingly. But unfortunately, as I have often remarked, if it's in the newspapers, it's in the price. The process works the other way: stocks are a leading indicator, so first they go down and then the data comes in."

With consumer confidence at a 35 year low and based on today's market environment, investors might look to seek refuge in investments other than stocks. It might be tempting to buy gold to protect against a decline in the U.S. dollar. It might be tempting to buy commodities to protect against the rising cost of oil, gas, grains and metals. It might be tempting to buy long-term bonds to protect against a continuing decline in the housing market (which could cause the U.S. economy to suffer for years). However, all of those investments have already done extremely well – as demonstrated in the above chart – and are less likely to offer the same upside they've delivered in the last few years. After all, at some point higher commodity prices will alter consumer buying behavior. We believe that investors should have some exposure to all these areas, but we wouldn't recommend chasing after them now. History has shown that investors are often better off to invest in what others shun.

In times of market turmoil, U.S. Treasury bonds are usually a safe haven. This time has been no different. Last summer, the yield on the 10-year Treasury bond was about 5.2%. Now, the 10-year bond yields about 3.5%. It's interesting to note how expensive U.S. Treasury bonds now are. If we consider the annual interest paid on the bond as its "earnings", then the price-to-earnings (P/E) ratio on the bond is 30. For comparison purposes, the P/E ratio for S&P 500 Index is about 14.

For long-term investors holding cash, the two-year Treasury now has a lower yield than the S&P 500. The two-year Treasury yields less than 2%, and thus is valued at over 50x earnings! That's a high price to pay for safety. What's more, inflation, which is currently running at an annual rate of 4%, is causing an erosion of purchasing power. By investing in the S&P 500 an investor can get a higher yield and a free long-term call option on growth. At some point, this subprime crisis will be, like all the other financial crises before it, a distant memory.

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