

Market Outlook

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America's Mid-Life Crisis

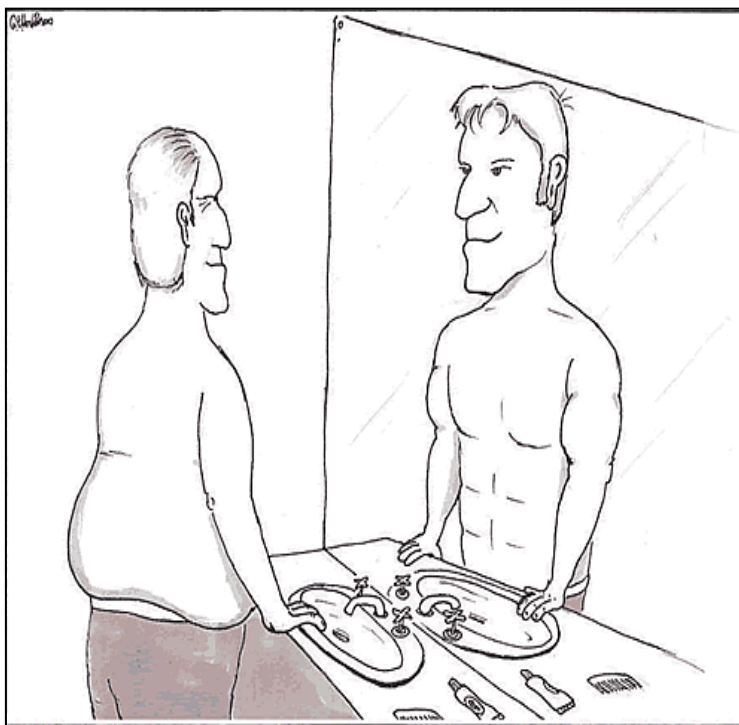
As America lifts itself up off the sick bed of recession and stares into the mirror of reality, the image staring back is a stark one. Dark circles under our eyes belie a fitful 12 months of denial, and then acceptance, of the recession and its causes. A splash of cold water does little to change the reflected vision: haggard, tired, and anxious. Now, over a year since the recession's start, and 18 months since the financial industry's house of cards began to cave in, the reality of what we've done is inescapable. Our pounding headache reminds us that our high life of the past 15 years has depended on too much consumer spending, funded by too much personal debt, and relied too much on the kindness of Chinese lending. America, welcome to your mid-life crisis.

Struggling with yet another dose of pain-relieving fiscal spending and monetary stimulus, the nagging feeling that this time somehow is different cannot be shaken. For we know that whatever the past may have been like, the future will likely be very different.

Investors will have to come to grips with three macro-level changes in order to successfully navigate the environment that is evolving. This evolution is not through a sober and grand design, but through fits and starts as policymakers have responded to the unprecedented collapses thrown before them. Nobody in Washington DC chose to eliminate the major investment banks, nobody chose to bail out Citigroup, or force the shotgun marriage of Bank of America and Merrill Lynch. These were ad hoc responses to the fear that doing otherwise could have been infinitely worse. Now, with dawn

creeping over the horizon and our national self-doubt in full force, the old models of investing will have to adapt.

The first clear change is that of *leverage*. Household and financial leverage has been slowly increasing since the early 1980s. As the punitive interest rates of the Paul Volcker era at the Federal Reserve gave way to the Goldilocks years of Alan Greenspan, Americans were encouraged to take on more debt to finance their consumption. In some ways this was a necessity, as real incomes have stagnated over the past 20 years, making it ever harder to make ends meet. This process kicked into high gear in the early 21st century, as rock-bottom



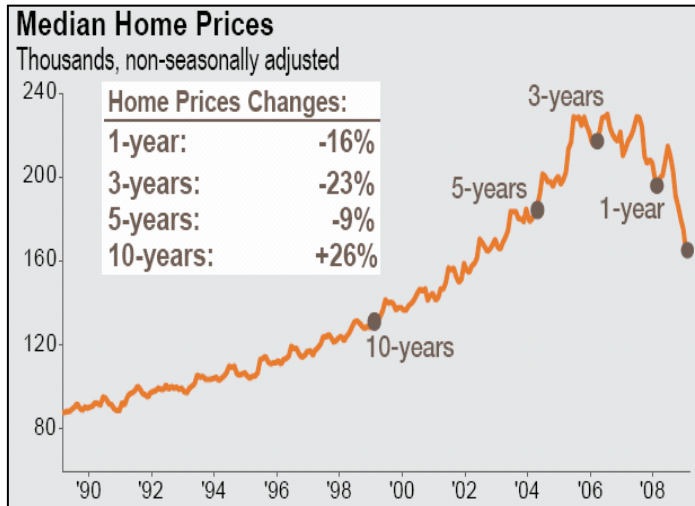
The mid-life crisis: triumph of hope over reality?

mortgage rates, financial innovation, and a total disregard for saving combined to raise debt levels beyond anything seen in the past 50 years. The primary vehicle for this binge was "home, sweet home" as the belief that home prices could only rise eliminated any consideration of downside risk. Home prices rose way beyond their historical up trend, feeding a frenzy of home building, financing on questionable (or non-existent qualifications), and the subsequent packaging of those mortgages by Wall Street into a dizzying array of mortgage-backed securities for all.

The *deleveraging* process is now in full swing, as households and businesses repudiate debt. The trends of the past generation are now operating in reverse, with households saving more and firms looking for genuine growth instead of financially engineering their way to profitability. This implies slower overall economic growth and a premium placed on companies that make useful things, rather than foster creative accounting.

A looming question is whether the efforts of governments globally to stimulate the economy, which are largely debt-based efforts, will work as desired. Can

The implication of this is slower global growth overall, and increased difficulty of US companies to exploit new markets overseas.



No problem if you bought a home 10 years ago

too much debt be cured by the issuance of even more debt? The answer is unclear, but the finance-based economy of the past generation is certainly gone, as is the hyperactive growth it promoted.

Second, “*deglobalization*” may be slowly replacing the globalization trends that have dominated economics since the 1960s. Companies have been quick to move production overseas, seek foreign lands for new markets, and the US financial community has been ardently exporting its financial “expertise” for decades. That may come to a slithering halt as more countries look to trade barriers to protect their industries and quell labor unrest. “Buy American” provisions and British protests against foreign workers are just two of the most salient examples of this trend.

While the conventional wisdom holds that globalization is an inexorable trend, one only has to look to the post WW I period to see what economic introversion was like (and this was before the Great Depression). There is no economic law makes globalization preordained. As the levels of economic stress remain high (and they are much worse overseas than in the US) we can expect an inward focus to take hold and beggar-thy-neighbor policies to gain a sympathetic ear among policy makers.

Finally, prepare for more *government intervention* in the business world. Ronald Reagan was called the Great Communicator, but he could equally be called the Great De-Regulator, for his presidency began the ascent of unfettered markets and the wilting of regulatory primacy. Nowhere was this clearer than in the financial markets, which in recent years resembled a frontier town with Don Knotts playing the inept sheriff. The deregulation zenith (nadir?) was reached in the past decade and had as bookends the repeal of the Glass-Steagall Act (1933 law separating investment and commercial banking), and the infamous Bernie Madoff ponzi scheme, which was enabled by a complete lack of oversight of the hedge fund industry.

Today, the efficient market theory that has dominated finance for a generation is in retreat. In its place, government oversight is introducing a less “efficient,” but perhaps less volatile financial model. Taxpayers now own Fannie Mae, AIG, and have provided a helping hand to GM, Chrysler, and a lengthy list of other companies too proud to admit they have been grossly mismanaged, but not too ashamed to ask for a government bailout.

Academics, politicians, investors, and everyday citizens are questioning the *laissez faire* model that idolized free markets and (the now clearly naive) belief in self-regulation. If the risk-takers were actually allowed to suffer the consequences of their poor decisions perhaps attitudes would be different, but repeated bailouts and the reliance on moral hazard as a business strategy have given politicians the upper hand. Driven by a citizenry that has recognized the unbalanced and disproportionate distribution of incomes, it is now time to “shake hands with the government.”

And for Investors?

The first question that investors must grapple with is whether the historical relationships that have defined financial analysis for decades can be relied upon in the future. Today’s analysts, for instance, are obsessed with earnings and earnings growth, as recent market action attests. Companies that “beat the street” estimate of earnings have rallied smartly, even though their absolute earnings may be down 90% from a year ago. All this proves is that the same analysts who were too sanguine last year are too pessimistic today.

Very few analysts focused on the balance sheets of companies (especially banks), where the debt bomb ticked away until it finally exploded. That is where the real damage was done, and yet the culture of earnings analysis seems to continue unabated. Banks were given a “free pass” in March by the Financial Accounting Standards Board (FASB) that allowed them to forego the mark-to-market accounting on their dud loans and mortgage-backed derivatives. Surprisingly good first quarter earnings magically resulted, the stocks rallied, and the fairy tale continued. Unfortunately, the dud loans that were the root of the problem are still on the books of these firms, with few buyers in sight. Analysts are fooling themselves into believing that as long as a firm can “beat” Wall Street’s earnings guess, then all is right with the world.

A corollary point is that companies that produce goods, or own assets in the ground (e.g. copper, oil) will be in demand, and that financial engineering firms, hedge funds, and leveraged buyout shops will continue to be shunned. Investors going forward will seek firms that can add value to our society (biotech), provide solutions to pressing problems (hybrid autos), or fulfill a pressing global demand for resources (oil, fertilizer, food).

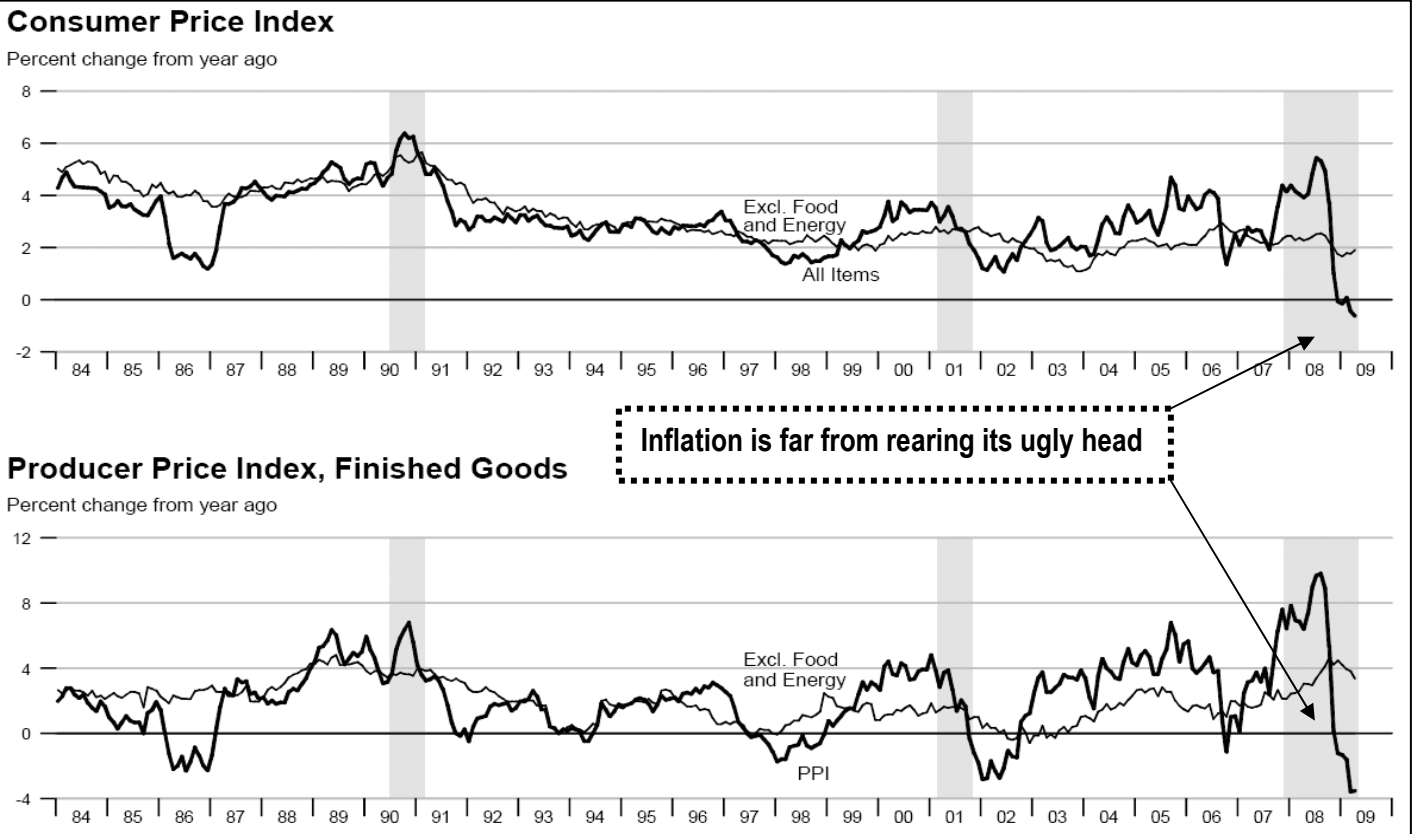
We believe that investors should focus on stocks with

low debt, as that will be afforded a premium in the years ahead. The ability to grow with minimal debt, and earn a high return on *total* capital (equity plus debt) will prove an essential characteristic of future long-term winners.

The question of historical relationships also makes asset allocation based approaches to investing suspect. This strategy looks at the risks and returns of an asset class (say, small cap stocks), compares them to other classes (e.g. blue chip stocks) and then attempts to optimize them in a way that gives investors a probable return for the risk incurred.

This approach was blown away by the bear market, as all asset classes suffered tremendously. Even high grade bonds (except Treasury bonds) declined double-digit percentages. Hardly anyone alive today has seen such highly synchronized declines, bearing out the old maxim that “the only thing that goes up in a bear market are the correlations among securities!”

Our belief is that individual security selection is more important than ever. Successful investing will not just be a matter of taking a position in blue chips, but more a question of which blue chips? Which small cap fund? Which energy stock? The answers to these will carry the greatest weight in performance, and advisors that are



counting on a return to historical norms to bail them out will find they have done their clients a profound disservice.

Finally, the question of inflation is being brought up almost daily, not because of its presence, but because of its expectation. The tremendous stimulus programs of governments worldwide have naturally drawn comparisons to the awful inflationary spiral of the 1970s. This was encapsulated in Milton Friedman’s famous notion that inflation is caused by “too much money chasing too few goods.” Given that “trillions” of dollars seems to be the standard quantity used when discussing the banking system and its salvation, it’s no wonder that inflation inevitably leads to mind. It certainly sounds like too much money.

Yet the inflation of the past 20 years has been in the price of assets, not consumer prices. From internet and tech stocks (late 1990s) to oil (mid 2000s) to home prices (most recently), it was the prices of assets that reflected all that money chasing around. Of course, a rise in assets makes us feel wealthier, so that is acceptable inflation. It has also been our undoing as so much debt was tied to the Internet Bubble (margin debt on stocks) and then to home prices which could not sustain their inflation. The collapse of these bubbles created a reverse wealth effect, making us feel poorer, and reigning in consumer spending.

It is important to remember that we now live in a world of excess capacity, unlike the 1970s. Back then, we didn’t have Chinese factories churning out HDTVs, Mexican auto plants making Chevrolets, or Chilean farms growing our grapes. The whole process of globalization, discussed above, has been very beneficial for consumer price inflation. Perhaps deglobalization will have the opposite effect.

Our sense is that asset inflation is likely to recur before consumer price inflation. We therefore have taken positions in commodity type securities such as gold, oil, and agricultural products. These are showing good price and relative strength performance, and despite the fact that their basic product prices have fallen dramatically as the recession hit, they have the benefit of tangibility and a demand that is not likely to evaporate.

How we handle America’s mid-life crisis will have a profound influence on our children’s lives. If we use this opportunity to truly reduce energy dependence on foreign oil, rebuild our transportation and utility infrastructure, and reward businesses that produce solutions rather than overpaid, ineffective and vainglorious CEOs, then it may all be worth it. But one thing is for sure: we can’t reclaim the past, but only go forward with all that we have learned.

**Spot the bull market:
Gold and S&P 500 since 12-31-1999**

