

Market Outlook

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Andre Ratkai, CFA President
Praxis Advisory Group, Inc.

Waiting for the Weatherman

One of the peculiarities of local American news media is the fascination with weather. Almost regardless of the day's earth-shattering news, the weatherman gets top billing in the newscast, and weather fancy themselves local celebrities. They have poured millions into weather technology and go to great lengths to "out-predict" their competition. The fascination with trying to predict the future is no further than your local TV station.

But because weather is a sort of self-correcting system, their predictions aren't predictions at all, simply a reflection of the historical patterns that have played out for eons. In most of the world, weather in one period is "corrected" in another. Rain is followed by sun, good weather follows bad, and it all follows a natural ebb and flow. Yet weathermen want to make it seem as if tomorrow will be like nothing we have ever seen before.

The same is true of Wall Street forecasters and analysts. Despite their abysmal record of the last 10 years, they still get an undue amount of attention. Why? Because we are fascinated by the idea of predicting the future, and the hope of one day getting it right.

Of course, prediction of weather is not as important as adapting to it. Rather than rely on prediction, we are better off taking it as it comes. Having done my share of bicycling in the Colorado mountains, I have seen many sunny mornings give way to afternoon thunderstorms, with their blue-black clouds rolling in over the horizon. These clouds are a clear sign to consider changing one's plans, and, at the first rumble of thunder, get off the mountain!

And I stay safe.

I didn't need to forecast the day's weather to be safe, but rather be willing to change as conditions changed.

Economic and Wall Street forecasters are a lot like TV weathermen. We hang on their every word, we react to every report, but in the end they state the obvious. In effect, they are describing the self-correcting system at work.

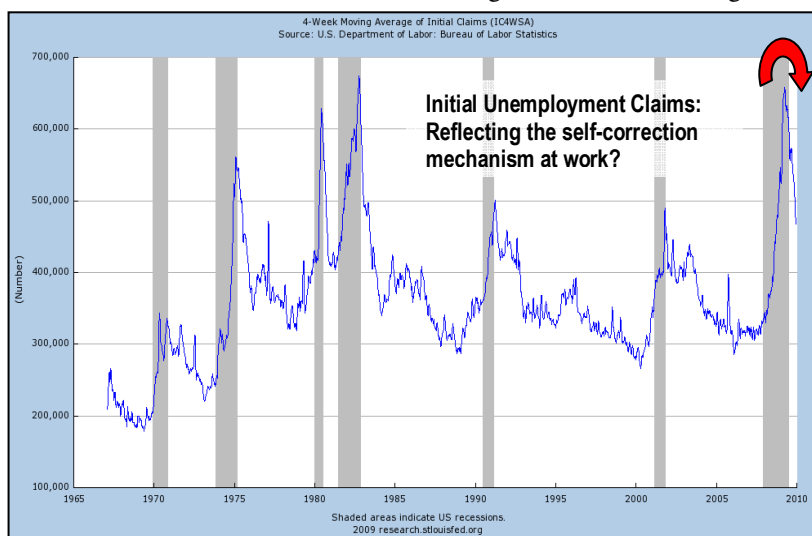
A Self-Righting System?

To my mind, the biggest question we have to answer is whether the (now global) economy is, in fact, a self-correcting system. Is the western idea of business and free enterprise inherently stable? Or have the past 10 years unmasked a fatal flaw in capitalism as we know it (absurdly easy credit)? Can we predict a self-correcting fix, or will tomorrow be like nothing we have ever seen before?

When we talk about the economy, we are talking about *people*. And people remember the past. The rational man that makes decisions solely on today's facts is a myth, because we all look to the past to help us decide about today. Actions or decisions we thought to be mistakes are generally not repeated. Collectively,

the western world has gravitated toward doing more of things that help society, and away from things that harm society.

Moreover, humans aspire to wealth. While the definition of wealth varies from the dirt floors of the third world to the marbled halls of Wall Street, the gravitation toward improving one's material wealth and comfort is universal. Western-style capitalism has pulled more people out of poverty in the last 60 years than any other economic system tried before.



The combination of these two fundamental factors creates a powerful tendency toward growth in modern economies. While countries are all subject to a bewildering array of regulations and political influence, in the end, most economies will tend to grow. It is the natural state of things, in a way, which is what makes the exceptions (i.e. recessions) so worrisome.

These are very profound and basic factors that I believe argue for the self-correcting nature of capitalist economies. While this may seem laughable in light of the unprecedented government aid lavished on the banking and auto industries, it's important to remember that the "benign" government intervention of over-deregulation of the banking industry and artificially low interest rates helped create the toxic debt cocktail we are dealing with today. While many critics point out that the true nature of free market economies have been perverted by the incessant meddling of politicians, our view is that the economy has adjusted *despite* such interference.

Relearning Lessons of Leverage

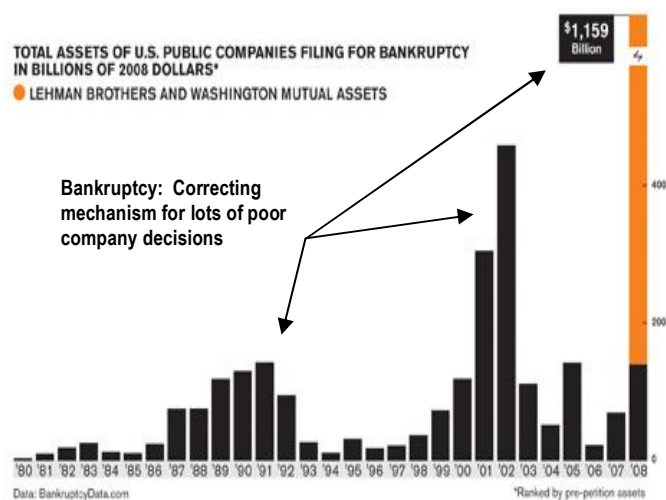
The recession we are fighting today is a new and different animal for most of us, as its roots lie in a massive expansion of debt. This is not the typical textbook recession of the post WW II period, but something that is rarely experienced. But it *has* been experienced before, and one can look back to many instances of credit overextension that have led to financial and economic crises. The Mississippi Bubble (France, 1700s), the railway boom and bust (Britain, 1800s), the Panic of 1903 (US) and the Great Depression all had common elements in their rise and fall, the primary one being the unchecked extension of credit leading to a debt collapse.

Looking back at these examples, and few common threads appear. First is that human nature has been remarkably constant through time. We have unfortunately repeated the mistakes of overborrowing, despite having well-known examples of its dangers. Moreover, debt booms and busts have occurred globally; this not a US phenomenon. We don't consider the wearisome tendency to repeat such mistakes as a positive cultural trait, but expect it occurs because younger generations don't have the same collective memory as the generation that suffered through the collapse at the time. So it happens rarely, bearing out philosopher George Santayana's famous remark "Those who do not learn from history are doomed to repeat it."

The most important thread is that debt collapses have to be worked through, and there is no quick fix to the problem. There are four ways credit busts are brought back into balance: Repayment, Refinancing, Repudiation, and Reflation.

Repayment is the best of all worlds, where the borrower simply continues to pay the loan off according to the original schedule. The borrower keeps his good credit standing, the lender gets his predictable cash flow, and all is right with the world.

Refinancing takes the old debt, presumably too burdensome, and



repackages it into a more palatable form. This may mean longer time to repay, a lower interest rate, or both. This is what the

Federal Reserve has hoped to accomplish by keeping interest rates at astonishingly low rates. To a certain extent this has worked, as corporations have rushed to take advantage of the increased appetite for debt. Through October, issuers had sold more than \$1 trillion in U.S. corporate bonds in 2009, the fastest pace on record.

Repudiation, or default, is the extreme resolution for debt that is unable to be serviced. The borrower simply stops paying the debt, the home is foreclosed, or in the case of Washington Mutual, Circuit City, and Lehman Brothers, the company ceases to exist. This is the most disruptive solution for borrower, lender, and the economy alike.

Reflation refers to the idea that inflation reduces the value of debt repayments over time, as inflation reduces each coupon's purchasing power. Governments have every incentive to engineer a little inflation in order to reduce the "real" (i.e. inflation-adjusted) burden of repayment over the years.

In truth, all these "self-correcting" mechanisms will take place simultaneously. Given the scale of the debt boom, however, there is a lot of correction that must take place. Common sense argues that the process will take a long time. Since every financial news story seems to contain the phrase "*worst/lowest/etc since the Great Depression...*" most Americans look to that time as a model for what to expect. We think the better model is Japan, which saw a tremendous real estate bubble in the late 1980s, a collapse of asset prices in the early 1990s, and a banking system that was saddled with many dud loans. Since that time the economy has drifted along, meandering back and forth across the line marking growth and recession. While there are many significant differences between Japan and the US, it bears remembering that low interest rates and heavy government fiscal stimulus have done little to bring back Japan's glory days of the 1980s.

Pick A Forecast

In America, the investment world has broken into two camps, defined by their outlooks. The "Business As Usual" camp believes low interest rates will work as before, stimulating borrowing and spending, and we'll get out of the recession the usual way. The "New Normal" camp, led by Bill Gross of PIMCO, believes the burden of deleveraging and the cultural memory of the pain the debt collapse inflicted will keep a lid on consumer and business spending. Instead of "irrational exuberance," they expect "rational moderation" will rule the next few years.

We don't think it is likely to be "business as usual," but we do know that companies are eager to do business. Approaching the investment world from a focus on individual securities, rather than wishfully relying on broad historical relationships to come true, is probably the most effective way to deal with the trying and uncertain environment ahead. And just as with the weather, it will take patience to wait this storm out, so we can enjoy sunnier days ahead.