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Bubble or Bust?

Follow the Bouncing Bubble

The Fed has a goal of growing the economy at a rate that isn't too hot or too cold, or at least it used to. Prior to 1980, the Federal Reserve tried to walk a line between recession and inflation using monetary policy. Starting in the mid 1990s, inflation had declined enough to recede in importance. Then in 1998 a bubble in technology stocks began to form, and around this same time the Fed cut rates to defend the market from the losses associated with the hedge fund Long Term Capital. While a market decline was averted, the already strong tech sector received a disproportionate share of the added liquidity fueling more tech mania into 1999. Unfortunately, the Fed only talked about the tech bubble (since asset inflation is not inflation according to the Fed), waiting to act until after the bubble burst in 2000.

After the tech bubble burst, the Federal Reserve aggressively brought interest rates down again to avoid a recession. This liquidity boost found its way into the nascent bubble that had begun in real estate.

Presently the Federal Reserve is, once again, lowering interest rates. This time to avert the consequences from a bursting real estate bubble (including subprime lending) and hoping to avoid recession again. There is a developing pattern of economic bubbles followed by a financial bust. Characteristics of bubbles include: they last longer than expected, they never end well and it takes longer to recover the old peaks. One only has to recall the stock market crash of 1929, Japanese stocks in 1989, and the NASDAQ frenzy of 2000.

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Now that the real estate bubble has begun to pop, how long will it take to recover and what will be the extent of the damage? Will the Fed's injections of liquidity limit the damage or will it stimulate another nascent bubble?

It is too soon to know how long and how deep the losses will be from subprime. Our best guess is longer and deeper than one might think. Still, the fallout may be selectively concentrated with financials and consumer durables receiving the brunt of the decline. As for the best candidate for the next bubble? We think it is China and all things China-related. The Chinese stock market is hosting a stock market frenzy similar to those in Japan and Taiwan in the 1980s. In 1990, both markets cracked. Taiwan's dropped 79% in *six months* and Japan started a prolonged slump. The Nikkei Average bottomed out *thirteen years* later at 20% of its peak value. Chinese stocks have sextupled (600%) in the last two years. Excessive liquidity growth and bank lending to the consumer sector has created a speculative bubble in property and equity prices. Unfortunately, no one can predict the end of a bubble and since they can last longer than anyone expects, investors should first understand that one exists. As the evidence mounts that the mania is becoming more dangerous than profitable, it will be time to exit positions. Until then, higher volatility will be a part of this unfolding pattern.

Turbulent Third Quarter

Navigating the financial markets in the quarter was like flying a small plane through a wind storm. The stock market finished the quarter with respectable gains, but there was heavy turbulence along the way. In August, credit concerns drove major indexes down more than 10% from new record highs set in July. On August 17th, markets in the Far East were down 5% to 7% and overnight futures in the U.S. portended a potential 500 point plus opening decline on the Dow Industrials. The Fed rushed to the rescue. Prior to the opening, it "shocked" the system by lowering the discount rate by .5%. Another Fed dose came on September 18 with a half-percentage point cut in the even more powerful Federal Funds rate.[1] For the third quarter, the S&P 500 Index finished up 2.0%. The additional liquidity stabilized the credit markets, but it also refueled selective asset speculation. Not all stocks participated in the advance and many declined: financials, consumers, small-cap stocks and the U.S.$ were weak. The areas that were not in need of the liquidity injection, many of the top themes discussed in our July piece, **"Panic Attack"**, accelerated their gains: Asia ex-Japan rose 12.5%, Large-Cap Growth funds were up 6.2% , Technology Funds were up 6.5% , Natural Resource returns averaged 7.6% and Health Funds were up 4%.[2] What could have been a bust for the market's troubled sectors might now be characterized as a bubble of the market's leaders.

Two distinct scenarios will now live side by side as the bull market that began in 2002 moves into the final stages. The one favors the imminent start of a bear market where the weaker sectors of the market fail to respond to the Fed and this eventually undermines other parts of the economy. In the other scenario, the market leaders that have already been performing well make even higher highs due to the increased liquidity in the system while the weaker sectors muddle along. For now, we favor the latter scenario, but we are keenly watching the probabilities on both.

Investors should remain vigilant and flexible, shifting portfolio weightings accordingly.

Current Economy

United States Economy

We do not think a recession is imminent, but we do expect a slowdown. First, strong exports and less reliance on imports, reflecting healthy economies overseas and the weaker U.S. dollar, are boosting production and job creation here. Exports are increasing GDP by 1% offsetting the decrease from housing.[3]

Second, businesses in a whole range of industries outside of the housing sector have nimbly adjusted their production processes, and inventories are very lean. And finally, Fed monetary policy is liquefying the system. Although no recession is imminent, we do think growth over the next year will be below trend line, around the 2% area, due primarily to housing and mortgage problems.

We think most investors are underestimating the duration of the housing slowdown. Over the last year, many experts have been proclaiming a housing revival is just around the corner, not recognizing that when a bubble pops it takes a long time to recover. We expect housing to bottom in 2010-2012. For more speculative locations it will likely take much longer. In Houston, for example, the first Texas city to fall after the 80's oil bust, the home-price index peaked in 1983. The index returned to the peak in 1997, 14 years later.[4] Speculative areas in California, Florida, Nevada and Arizona could be in for 15% to 25% price declines and an eight to fourteen-year wait for full recovery. Bay Area existing home sales plunged 46% over the last year. September's median price was 18% below May's peak.[5]

World Economy

The consensus view is that the US economy will avoid recession primarily due to the strength of the global economy. Although we currently agree with this viewpoint, there are some large elephants in the room.

First, the International Monetary Fund recently lowered its outlook for world output from 5.3% in 2007 to 4.8% in 2008; reduced growth not only for the U.S., but also for Europe and Japan account for the change.[6]

Second, a significant market correction in China or the Emerging Markets could slow economic growth and also trigger a global equity decline.

Finally, we remain concerned with deteriorating geopolitical situations. In addition to Iraq, Pakistan and Afghanistan, there is great cause for concern around increasing tensions with Iran. The Bush administration recently imposed a series of new sanctions on Iran in an effort to limit the regime's nuclear program and "increase the costs to Iran of its irresponsible behavior." The sanctions occurred after Russia's President Putin, visited Tehran. His proposals to Iran included certain guarantees against a U.S. attack.[7] As January 2009 gets closer, the Bush administration will have to make a decision about whether to attack Iran's nuclear infrastructure.

Asset Allocation

U.S. Stock and Bonds

Choppy markets will continue through the end of the year. This is not a time to be fully invested in the U.S. market and it is not a time where "the market will bail you out" no matter what you own. It will be harder and harder as time goes by to achieve consistent returns in this environment. The end of a Bull Market is characterized by participation in fewer and fewer groups and by fewer and fewer stocks. Small-cap, mid-cap and value stocks have underperformed big cap growth stocks. If you are in financial or real estate related stocks, you would think you are in a bear market. Natural resource stocks would have you believe the sky's the limit. We are adopting a flexible investment approach, keeping some cash in reserve and concentrating on the themes that are still attracting capital, such as big-cap growth, selected health and technology, biotech and selective consumer and telecommunication stocks. We are vigilant bulls at this stage of the rally. Our emphasis is on preserving capital rather than attempting to maximize gains.

Short-term rates are coming down and long-term rates are trending up, quality spreads are widening, but not yet extreme. We like high-quality cash and short-term bonds in the fixed income portfolio. We also like TIPS (treasury inflation protected securities) as a hedge against higher inflation and a falling dollar.

International

Recognizing that valuations are getting stretched in China and Emerging Markets, we continue to recommend an over weight position. When valuations are at an extreme, a bear market is possible even when the underlying economy is performing well. (There were just such bears in China earlier this decade and in Gulf countries over the past two years.) Last quarter, Chinese Funds were up 21.9% and Emerging Market Funds were up 11.7%[8] and both are presently making new highs. We are watching these areas carefully and are prepared to exit when appropriate. These returns are spectacular relative to their growth rates, even so, emerging market valuations have only just achieved a slight premium to the slower growing U.S. Given the likelihood of a mania in the making, valuations should move to extremes before a top is in place.

Natural Resources and Energy

In our April piece **"Higher Oil Prices"**, we argued that oil could hit $100 per barrel sometime in the next eighteen months. It is now $92 per barrel. We think these prices are sustainable for a least three reasons: First, inventories remain below average levels. Second, the cost floor is rising. Exploration and development costs have increased from $4 per barrel to $16 per barrel.[9] Third, governments are becoming more involved in the energy business. Nations like Russia and Venezuela are increasing their ownership stakes in their domestic energy companies, which will hamper outside investors. Alternative energy stocks are also becoming more attractive as alternative energy sources are no longer much more expensive than oil. We continue to materially over weight the Natural Resources and Energy area.

Real Estate

Maintain minimum exposure. It's going to take longer than you think to recover.

Summary

The U.S. market is in the bottom of the eighth inning of a bull that began in 2002. Investors should be very selective in their U.S. exposure. We recommend overweighting energy, natural resources and international markets, while avoiding real estate.

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