MARKET NEWSLETTER

There is no shortage of punditry when reading the financial press. However, most of it is marketing on behalf of some vested interest rather than recent or historical fact. That is why it is necessary to develop a comfort level with commentators who have the bona fides to place events into context.

My favorite financial historians or commentators are: Niall Ferguson, historian and professor at Harvard, Oxford, and Stanford; Nouriel Roubini, professor of economic history at the Stern School of Business at New York University; David Rosenberg, chief economist and strategist at Gluskin+Scheff, previously at Merrill Lynch; and Bill Gross, who manages the world's largest fixed income investment program at PIMCO. Their investment information is freely available and they have enviable track records in anticipating and recording seminal changes to economic activity.

This particular newsletter is important to me – it will probably be the last one that I write as a financial commentator. I believe that it is important to place the present time into recent economic history. In this regard I am reminded of two famous quotations. The first is by George Santayama, "Those who cannot remember the past are condemned to repeat it." The second is by Mark Twain who remarked, "History does not repeat itself, but it does rhyme." I am reminded because one hears more and more a reference to our present economic conditions as "The Great Recession" as opposed to the historical "Great Depression" of the 1930's. It seemed to me that it would be worthwhile to view the similarities and differences of the two periods.

The Great Depression

In the United States, the "Great Depression" took place in the 1930's after the 1929 Stock Market Crash. It was the "roaring '20's" that set the stage for the crash. The 1920's were characterized, economically, by "easy money"; that is a banking system that allowed easy credit, which of course is what greases the wheels of commerce. This was also where the stock market was allowed to overheat by the use of margin by banks and brokerages.

Margin refers to the funds that are borrowed against stock and bond positions already held. Prior to the crash of 1929 margin of 90% was allowed. This means that if an investor wished to own $100,000 in stocks he/she need only deposit $10,000 and the bank would lend $90,000. Moreover, by 1929 the stock market had risen so strongly and for such a period of time that it seemed to most investors that investing in the "market" was a natural and normal thing to do.

There is an insidious aspect to margin that, while known to speculators, after some time gets forgotten as a concern. With margin, the ability to borrow is based on the value of the portfolio and not just the original cash investment. So if we use the previous example of the investor using maximum margin we see that she owns $100,000 of stocks with a $10,000 initial investment. If the portfolio rises 20% it is now worth $120,000. But the investor has only borrowed $90,000 and is really entitled to borrow $108,000. It doesn't really matter if these funds were actually all employed. The point is that investors were encouraged by the use of easy credit to keep the stock market on boil.

We all know that trees do not grow to the sky and that bull markets do not continue forever. But the use of margin has a dark side as well. When share values declined, the banks were still able to lend only 90% of the portfolio value. Should the value decline 10%, from $120,000 to $108,000 the investor must have $10,800 worth of his funds in the account. She has two choices: either contribute $800 or else sell some of the investments. The sale of investments lowers the value of the portfolio and so the investor actually has to sell more than $800. This is not really a problem when few investors are caught in this vortex because there are probably enough buyers to absorb the selling. But if the use of margin is widespread and the selling becomes intense, panic ensues.

This was the actual result in October of 1929. The United States government then overreacted and enacted legislation that affected worldwide trading. The actions and their consequences are very complex but the main result was a decline in credit availability and a consequent reduction in economic activity. The result produced “The Great Depression.” The event that largely reversed the lethargic economic activity of the 1930’s was the Second World War.

The Great Recession

We turn now to “The Great Recession” for comparison. The theories of John Maynard Keynes took root during the Depression and “Keynesian” economics still wields a powerful influence in economics. Essentially, his theories proposed that governments should intercede in leveling the swings in the business cycle which transited from strong to weak. When the economy was overheating Monetary Policy by the Central Bank should make borrowing more costly and therefore reduce economic activity. Concurrently, Fiscal Policy by the Central Government would increase taxes so that excess funds would be drained from the economy thus attenuating the growth. Then, when economic conditions were weak, interest rates could be reduced and tax rates could fall thereby creating economic growth.

Central Bankers have seldom been successful in their aspirations to push and pull the levers of the business cycle at the proper moments. One of my previous letters noted the problems that occurred on the watch of Alan Greenspan, Chairman of the Federal Reserve Board in the U.S. At the time he was Chairman, he was given the sobriquet “the Maestro” for his apparent unique ability to conduct the economy and keep in on an even keel. But, in retrospect, we have found that he allowed the same excess credit to be extended to the economy in the early years of this century as that which occurred in the 1920’s. The cause was not excess margin on stocks, however. Instead, excess credit was provided to prospective homeowners, and to homeowners, in order to buy homes or to use their homes as ATMs (Automatic Teller Machines) by borrowing against them. Thus far the Great Recession looks the similar to the Great Depression.

Consequences

How did this happen? The short answer is that Greenspan, and others, convinced the Congress to repeal a law that separated the functions of Merchant Banks, Lending Banks and Insurers. The Merchant Bankers, operating largely without oversight, developed opaque derivative instruments largely involving mortgage products that previously were the responsibility of Lending Banks. The products were sold as Triple A or top-drawer investments when, in fact, they had little chance of returning the invested capital to the buyer.

Ben Bernanke, Mr. Greenspan's successor, was a student of the Great Depression and he wasn't about to allow the aftermath of the market crash. He realized that the largest banks and insurance companies in the U.S. would collapse from bad mortgages and derivatives associated with them and that these bad loans were also infecting most of the banks in developed nations He lowered interest rates to near zero and, together with the Treasury Department, provided emergency loans to these institutions as well as loans to car manufacturers; and placed moratoria on most mortgage foreclosures. In spite of all of those actions the U.S. unemployment rate is over 10% and would be 16% if discouraged workers and those working part-time because they can't find full time employment were counted.

The effects on nation states have become dire. Iceland would be bankrupt except for mercy being shown by the United Kingdom and Dutch governments; Ireland, which was the most impressive economy in the European Community, is now heavily indebted and one of the weakest EC members; Greece is undergoing a bailout of their debts by the IMF and the EC with no certainty of escaping a sovereign default; and three other EC members, Italy, Spain and Portugal are in similar straits; Japan has been in a deflationary economic condition for more than fifteen years; and virtually every developed nation has had to increase their debt levels considerably in order to rescue their economies from a deflationary condition.

Investing in "Great Recessionary" times

I know that many of you are unhappy with the amount of cash that your portfolio is carrying. The range is from 29 to 59% and the average is 44%. This must be especially galling when the increase in the Canadian index from the bottom is approaching 60%. We are now reading that the economy is improving and that interest rates will begin to rise. That would be the normal reaction as the economy comes out of recession. This is not a normal recession. The unemployment rate is much higher than normal. The debt levels are extremely elevated and as the economy recovers an increase in interest rates will quickly reduce economic activity. And it is very important that the excess funds that have been forced into the economy be removed lest inflation appear.

Economies are very likely to grow much slower than normal. This will cause unemployment to stay elevated. The strong economic growth exhibited by China and India cannot be expected to have significant effects on developed economies. If growth rates are low then earnings will be muted and price/earnings multiples will also be lower than normal. I will repeat my previous messages: Fixed Income investments should constitute the bulk of your holdings. The least risky are the 1-5 year laddered investments because as interest rates rise gradually the longer dated bonds will tend to decline.
The majority of your equity holdings should be dividend-paying companies with a record of annually increasing dividends (referred to by many commentators as dividend aristocrats).

I have indicated that at year-end I will cease providing assistance to investors. There are two main reasons. I have become very disillusioned with the rules of the game. The merchant banks: Goldman Sachs, JP Morgan, Morgan Stanley, Merrill Lynch etc., the businesses most responsible for the economic misfortune the world finds itself in and which required bailouts in order to survive are back earning record profits and paying huge bonuses once again. These earnings did nothing for the economy. There was an intention to monitor and eliminate these excesses. The financial lobby is overcoming these efforts. I refuse to participate in a game with a stacked deck.

Secondly, with the economy in the state it is and governments needing to intercede so often and massively, the market is becoming very risky. I find it difficult to protect you as investors and also to protect myself from circumstances that are unknowable and unseen. In short, it has become too stressful.

During the next nine months I will make suggestions regarding what you might do and where you might go for assistance. I will also have suggestions as to the reading material you might pursue.

Wayne D. Armitstead **April 2010**