VAN HULZEN ASSET MANAGEMENT

Risk Managed Solutions

**SAME PROBLEM, DIFFERENT NAME?**

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*If you do not know where you want to go, any road will get you there.*

*Lewis Carroll*

Greece is the center of the world's attention. Market volatility can be tied very closely to the perceptions around Greece's future. Up days are tied to news of "resolution and bail out" and down days are tied to "defaults and protests and crisis." But how did a country with the economic size of Wisconsin become the center of worldwide attention? And why does it seem so difficult to fix? Certainly, the Greek problem has been priced into a 20% market decline. How does such a small country create such a big loss? Surely, the decline is overblown.

Volatility is a symptom. In the third quarter, stock volatility was nearly 300% of normal. Some intra-day swings, market plunges and melt-up rallies left investors breathless and fatigued. Even some of the best investors in the world found themselves on the wrong side of trades and lost 20%, 30%, or more. Volatility is dangerous because it heightens emotions and exacerbates problems in allocations and decision making. When prices fluctuate wildly, it is symptomatic of imbalances, concerns and changes. Certainly, the day-to-day sales at Target or McDonald's or Starbucks are fairly predictable and stable. So why would the stocks of these companies fluctuate by 10% in a day or 30% in a month or 50% in a year? Sometimes, the price swings are directly due to changes in the company, but stock price movement in recent years suggests that corporate earnings have less to do with stock prices than the (much larger) policy decisions of sovereign nations. Corporations go through business cycles, and price variability is to be expected, but when nations are running unsustainable deficits and world leaders cannot agree on structural reform in the face of the most severe crises, then normal price variability becomes panic-driven selling cycles.

The third quarter's 14.3% loss in the S&P 500, a broadly followed index of large US stocks, capped a decline that started in April and had dropped 21% by the early days of October. In Europe, the losses have been even larger. The MSCI Europe, a widely watched index of large European stocks, fell by 16% in Q3 and has dropped 28% from its spring highs. The strongest of European countries, France and Germany, have fallen by 35% and 34% respectively.

The extent of the decline, along with the shape and path of descent, rekindled bad memories of the 2008 crisis. In Table 1, we compare the similar nature of the market movements leading up to the market peak in 2007, and the initial declines in 2008 to today's market movements.

| S&P 500 Index | Point rise to top | Point decline | Time Duration | Relief rally |
|---|---|---|---|---|
| **Yr 2007** | 357 | 311 | 106 days | +14% |
| **Yr 2011** | 354 | 313 | 106 days | ??? |

It makes sense that market movements have similar characteristics over time. Market prices are derived from the sum total of human decisions. And human beings process information in a certain manner. Technology can change, and inputs can vary and grow but the brain still functions much as it did 10 years ago, a hundred years ago, a thousand years ago. Price charts follow certain recurring patterns and can be a useful signal of collective market psyche.

Last time around, it was Bear Stearns that caught the world's attention and for a brief period of time, a mid-sized investment bank was the center of the financial world's attention. How could one mid-sized company create a worldwide crisis? As we now know, a 25 year binge on credit culminated in the sub-prime meltdown, and the size of the bets that existed between institutions far surpassed the size of the company's themselves. As Bear Stearns was "resolved" and moved beyond the headlines, we found out that larger institutions had been damaged. Ultimately, Lehman Brothers, AIG and other financial companies became "toxic." Markets fell by over 50% and banks were bailed out in the name of the greater good.

Is the decline in equity markets overblown? Certainly Greece does not explain the sheer size of the declines that have occurred since April. Instead, the markets are exhibiting fear and anxiety over something larger. Who is today's Lehman? Who is AIG? Is anyone large enough to bail them out?

If we look deeper into the markets, and we re-visit some of the warning signals from the 2007-08 market period, we can identify some sources of market concern. Just as someone's personal life, one way to deal with big concerns is to buy insurance. We can do some research. What sort of life insurance is being bought? Where are the most fire insurance policies being sold, and on what assets?

The price decline in the Euro suggests that a problem lies within the Euro Zone countries, and market insurance policies (credit default swaps and similar complex instruments) suggest concern over contagion in Italy, Spain and Portugal. Unlike Greece, which is roughly equivalent to Wisconsin, Italy is similar in size to California and Spain to New York. They are nearly 12 times larger than Greece.

The market decline is likely due to worry over Italy and Spain becoming Lehman Brothers in a sovereign debt crisis, akin to the subprime meltdown. Consider the following:

| **2007-08** | **Comparison** | **2011-12** |
|---|---|---|
| Increased volatility | **Early Symptoms** | Increased volatility |
| Corporate profits are strong | **Stock Earnings** | Corporate profits are strong |
| Bear Stearns | **Initial Concern** | Greece |
| Overleveraged banks | **Root Cause** | Overleveraged countries |
| AIG, Lehman Bros, Big Banks | **Larger Problems** | Italy, Spain, European Banks?? |
| Large Banks | **Contagion Level** | Sovereign Nations |
| Sovereign Nations | **Solution** | **???** |

As we look at this comparison, we can begin to make sense of the recent price volatility. If markets are concerned about follow-on contagion, then we do have cause to carefully consider the implications of another credit problem. But, it stands to reason that if we can readily identify problems by looking at recent events, world leaders and policy makers can also see the issues and solve them in time to avoid another crisis.

The combined burden of unemployment, debt and policy structure are proving very heavy, and the world economy is beginning to feel tired and fragile. Unemployment has proven to be very difficult, and not just the headline 9.1% unemployed, but even more concerning is the total underemployed figure of 17%, and the duration of average unemployment, which has reached all-time high of 40.5 weeks.

Growth remains tepid for this stage of an economic recovery, and recent data suggest a slowdown is approaching. Consumer fatigue is evident in all but the most popular brands and applications. US Policy makers and politicians have spent trillions trying to stimulate growth and support asset prices. They have pushed interest rates to zero and tax rates remain at historically low levels. And despite all these efforts, growth is stuck in neutral. In Europe, the perception is that either leaders are inept or the problem is far bigger and more complex than feared. When economic prosperity reigned, the common ground was reinforced and European nations sought to show the world their solidarity. As times have become tougher, the most basic and entrenched differences have begun to surface. A common zone is sounding more and more like distinct nations, each with different needs and problems. Thus far, political and policy actions from Western nations are unremarkable and lack credibility.

Excessive debt continues to exist in households and municipalities and is still growing rapidly at the national level. For the fiscal year ending September 30, the US added $1,228,000,000,000 in debt. That amounts to roughly $3.3 billion per day in debt added during the past fiscal year. The government's Office for Management and Budget (OMB), which has the job of calculating the costs and benefits of various legislation, has calculated the income expected from the new "millionaire tax" proposal (also known as the Buffett tax). The amount that could be collected over the next 10 years would cover approximately 4 months of budget deficits.

What we need is meaningful reform and policy decisions that can fix structural imbalances. Decisive actions that can create confidence for consumers, investors and corporations is the necessary medicine. Meanwhile, the economy is again deteriorating. The price pattern suggests a similar-sized problem as 2007-08, where the sub-prime problems have become sovereign nation debt problems.

We have become a globalized economy, with member nations as building blocks, leveraging off each other and breaking down barriers, building a much larger economic footprint than was previously possible. Countries sought to participate in the growth and to keep up with their neighbor-states. Many issued far more debt than was sustainable. A few decades of relative peace and prosperity brought about a certain type of politician and an unhealthy comfort with debt financing.

As growth waned, the debt issuance grew. Policy makers should have reined in the excess when growth slowed, but instead opted to issue more debt and to stimulate growth again.

Now those global building blocks look a lot like dominoes, all lined up in a row. China's growth has been exciting, but its main consumer (Europe) is flagging. The US recovery has come on the back of massive bailouts (now being met with growing protests), an explosion of the debt load, and a de facto devaluation of the currency (which is now reversing as the Euro plunges). European nations are feeling anything but charitable toward their partners. So far, policymakers of the developed world have not found a remedy. Every possible action has a considerable cost and no solution will be without pain. It is not an easy decision, to be certain, but it will only get more difficult as the world begins again to slow.

Whichever course is chosen (and it may be different courses across various nations), it will have substantial implications for the citizenry. The actions of various governments will be for the perceived "greater good" and will be announced as good for the people, but the actions will not be good for individual persons.

The bottom line is this: The world is awash in debt. Some countries will default outright, restructure and move on. Some will choose a strategic default, devalue their currency, and never technically miss an interest payment, and some will tax their citizens through hundreds of new charges on consumption, ownership and income. Governments will do something, or risk losing control.

It is upon us, as investors to recognize what the market is telling us, to have educated plans for dealing with the world's issues, and for protecting and growing wealth. There is always an opportunity to profit from any finite set of issues. It is not different this time. The Dow Jones Industrial Average will make new all-time highs at some point in the future.

The Dow Jones Industrial Average was at 380 <u>before</u> the market crash of 1929 and the Great Depression that followed. It was at 1100 <u>before</u> the 1970's bear market, it was at 2700 <u>before</u> the 1987 crash, and it was at 14000 <u>before</u> the global credit crisis.

The point is that over the long run, the markets reflect economic growth. There are long periods of time when they move sideways or lower, but equity investing is best rewarded over the long run. Money that is needed for living expenses in the near-term should never enter the stock market. But for those savings that have the time to grow, there will be points over the next few years that could be the best investment "entry" opportunities of our lifetimes. Even now, there are very cheap and compelling stocks that do not reflect the future potential of the underlying companies. Investing is largely a battle within. For all the time and energy we spend figuring out how to allocate assets, we should spend an equal amount of time getting to know our inner investor and understanding our nature. Volatile times will require it.

*Success in investing does not correlate with I.Q.…what you need is the temperament to control the urges that get other people into trouble in investing.*

*Warren Buffett*

**Conclusions**

Market pullbacks of more than 20% create opportunities for those who have liquidity and can deploy capital. Many great companies continue to earn money, increase revenues and pay dividends. Indeed, we find many viable and timely investment choices today and are buying these investments.

<u>Current opportunities:</u>

- large-cap value companies, especially those that pay strong dividends,
- US companies that have predominantly US-based sales,
- global sovereign bonds (Australia, Canada, South Korea) that offer higher yields than US Treasuries,
- intermediate-term corporate bonds

The US Dollar should rise as long as the Euro zone remains in crisis and the Fed does not begin another round of quantitative easing. Commodity (ex-gold and silver) price weakness suggests some relief from inflationary pressures in the short run, and possibly, a slowdown occurring within mainland China.

As we invest capital into various opportunities, we need to remember that macro issues (jobs, debts and policy ineptness), are more and more likely to affect even healthy areas of the economy as time goes by. Until they are resolved, we can make great fundamental-based decisions about stock and bond investments, but larger, global economic problems could cause undervalued investment opportunities to become even cheaper in the short run.