

A Pessimism Bubble?

In the last decade we've had a dot-com bubble, a real estate bubble, a commodities bubble and a credit bubble. Good riddance to them all. Are we now experiencing a new bubble -- a pessimism bubble?

Bubbles are preceded by manias - the irrational emotions that inflate them. Usually, manias are created by unrealistic optimism about the future price of an asset - by projecting recent price rises into the future. The news is 24/7 about the newest path to quick riches. Banks get into the act by lending recklessly and stoking up the bubble with piles of cash. Those advising caution are derided - "You pessimists are all the same. This time it's different." But imaginary valuations cannot be sustained in a free market. Eventually, all bubbles are exposed as irrational and burst in spectacular fashion.

There's nothing new about this - it's been happening for centuries. But it seems to me that instead of a mania of euphoria we're now experiencing a mania of pessimism. Instead of projecting recent price rises, we are projecting recent stock and home price declines into the future. The only thing going up these days is the unemployment rate. Even good news (92% of Americans still have jobs, we are paying down our debts and have finally become a nation of savers) is interpreted by the apocalyptic media to be bad news. If Americans are saving money and paying off debt this must mean that retail sales will decline further, leading to higher unemployment and Great Depression 2. Under this barrage of fear mongering it's no wonder that so many investors are frightened. Those proclaiming an optimistic view of the future are told - "You Pollyannas are all the same. This time it's different."

Let's look at a few pieces of good news that you may not have read in today's headlines -

- Nationally, housing prices have fallen 27% from their peak, or some two-thirds of the way back to their historical trend line. Lower home prices and low mortgage rates have put the Housing Affordability Index at a 40 year high.
- In 2008, which saw more job losses than any year since 1945, average hourly wages increased almost 4% while inflation was essentially zero.
- In February, we saw the first monthly gain in retail sales since last September and Wal-Mart announced a 15% increase in its annual dividend.
- The price of oil and other commodities has fallen by two-thirds since their 2008 summer peak, which has the effect of a major tax cut.
- The world is awash in liquidity, thanks to monetary easing by the Federal Reserve and other central banks. Monetary policy operates with a lag and last year's easing will eventually stir up economic activity.
- Exxon Mobil has announced that it will spend a record amount of money in 2009 exploring for new oil reserves and developing new energy technologies. These projects will be self-funded from their cash reserves.
- Intel has announced it will spend \$7 billion building a next-generation chip manufacturing plant here in America. They will fund this project out of their cash reserves.
- The technological revolution of the past decade has so permeated our lives that we hardly notice. Yesterday's technological miracles have become today's commodities. Your cell phone has more computing power than all the computers owned by NASA during the Apollo moon missions. Inexpensive computers are multiplying human intelligence and yielding immense dividends by disseminating new information in real time. We live in an age of miracles.

The present economic downturn has been steep, significant, and unexpected. But when pessimism overcomes us -- as it surely has now -- we lose the ability to put events into their historical context. We are not on the precipice of Great Depression 2, but we are in the worst economic downturn since the 1980 - 1982 recession. I remember that recession, since I was an active participant. I was furloughed and the phrase "nothing to do in '82" was often on my lips. It was a time of high inflation, high unemployment and high

interest rates. The "misery index" -- the sum of the inflation and unemployment rates -- exceeded 20%. The economic outlook was bleak.

Gold reached an all time high of \$850 an ounce in 1980 and the gold bugs were everywhere. Had its price kept up with inflation, today's price would be over \$2,100/oz. - more than double its current price. This loss in real value makes me think that gold might not be the best inflation hedge - despite what I see in "Buy Gold Now" advertisements. A better inflation hedge has been the 30 day U.S. Treasury Bill - which on a monthly basis adjusts its yield to reflect rising interest rates during times of inflation. But that's a topic for another day.

Today's unemployment rate of just about 8% may eventually hit the 10.8% peak seen in 1982. I remember leaving the unemployment office that year and reading a newspaper headline announcing that the unemployment rate had surpassed 10%. But we somehow solved the problems of high inflation, high unemployment, high interest rates and an anemic economy. Today, those days are long forgotten by most and just a dim memory to me.

Looking into the future, we have the same two choices we had in 1982. The first is to have a pessimistic attitude, one that is all too common today -- that this time it's different and it's all downhill from here. I don't subscribe to this belief because it cannot be supported by history or my life experience.

The second choice is to have an optimistic attitude, the one that isn't so common today, and believing that this time it isn't different. Just like recessions and stock market declines in the past, the most flexible, dynamic, productive, entrepreneurial, job creating economy that the world has ever known will somehow pull through and continue on its long-term growth trend. Along the way, it will provide a growing population a better quality of life. This is my belief. If you ask me to prove that all will be OK, I can't. I wouldn't even try. But let me use a baseball analogy. We're at bat and 2008 threw us a wicked curveball. Swing and a miss - Strike One! But we're still at bat and the game's not over yet.

Unfortunately, along the way, the forces of "creative destruction" will be in play. New ideas, technologies and innovations will supersede old ones. This will lead to the disappearance of some household names whose product line or business model has become obsolescent. Upstarts will enter the marketplace and challenge incumbents with new products, better technology and a leaner business model. This process is painful for employees and investors of those legacy companies. But creative destruction has always played a key role in America's out-performance of other major economies. When terminally ill companies die and marginal players are absorbed by stronger survivors, consumers are better off and the economic system becomes stronger.

I'm just as susceptible to the pessimism of the day as anyone else, so let me walk you through my own thinking process. My portfolio losses have been disappointing but tolerable. The decline in the value of my home has also been disappointing but I've never entertained the thought of putting it up for sale. I enjoy my home as much today as the day that I bought it. Would I sell it just because the price has declined? You must be kidding. Likewise, I have stayed with my portfolio allocation and my investment strategy. I don't have a dollar invested in stocks that I will need to touch for 15 years. My short term needs will be financed by fixed income assets. And, just like my home, the original reasons for purchasing my equity holdings haven't changed -

- I still own large US companies because I want to own those dividend paying American companies that are household names and provide consumers both here and abroad with the goods and services they demand.
- I still own small US companies because I want to own those small, unheard-of companies that are on the cutting edge of technology. They will bring to market products that I cannot envision today but will be consumer staples a decade from now. Somewhere, the next Microsoft is residing in my small-cap US investments.
- I still own REITs because they provide me the most efficient and cost-effective vehicle to own a diversified portfolio of income producing real estate. I want to own nursing homes, apartments, shopping malls, golf courses, ski resorts, assisted-living facilities and commercial buildings leased to major corporations. America's population is growing and more people are going to be using these facilities in the future. I want to be a participant in the action.

- I still own large international companies because I cannot believe that the global expansion of the free market system is going to stop just because some foolish bankers made imprudent mortgage loans. I want to own the international companies that serve markets unreached by the large US multinational firms.
- I want to own emerging market companies because over the next several decades they have the most promising growth prospects. Many emerging market countries are the globe's commodity providers. The genie is out of the bottle and the universal desire to provide a better life for ourselves and our children is not exclusively a Western value. Many countries that were isolated from the global economy in the latter half of the 20th century have experienced the rebirth of an energetic entrepreneurial spirit. This will bring more competition for Western companies and continued growth for the global economy.
- I still like my investment grade and government bonds and am happy that I never sacrificed quality in an attempt to get higher yield. They have done their job - acting as portfolio shock absorbers during a time of financial disarray.
- I couldn't be happier that I don't own individual stocks. By owning index funds exclusively, I own the thousands of companies that make up the US and global economies. The economy, unlike individual companies, cannot disappear. When prices decline, the economy isn't dying, it's on sale.
- I'm never going to beat myself up with "woulda, coulda, shoulda" because I won't criticize myself for not knowing what I couldn't have known in advance.

We are in difficult and uncertain economic times and it's time to get back to the basics. Your financial plan has four funding components. Your portfolio is the most obvious. Unfortunately, it's the one that sometimes seems to have a mind of its own and is hardest to control. Fortunately, you have complete control over the other three -

1. Your human capital. The human capital you bring every day to the marketplace provides the means by which you earn an income sufficient to attain long-term financial goals. If times are tough, you may have to work longer than you had planned, pick up extra work or go back to school. It's not the end of the world.
2. Living within your means. This is an old-fashioned concept that's been out of favor for the last couple of decades. The old adage that it's wise to give 10%, save 10%, and live on the rest is as true today as it ever was. The charade that rising home and stock prices would rescue us from the consequences of overspending has been exposed for the ridiculous idea that it was.
3. Staying committed to funding your long-term investment plan. Does your financial plan contain a strategy for holding equity assets for the long-term? If your long term strategy is sound and recent events caused you to stop funding your plan, perhaps you need to revisit the topic of your risk tolerance. There is a human tendency to place too much emphasis on recent events to the exclusion of the long term view. Becoming too conservative today could have a significant negative effect on long term returns.

Just as in 1982, we seem to be in that part of the market cycle where the problems seem overwhelming and any positive news is ignored. In the past, times like this have been very good times to invest. Be sure you first consider your risk tolerance, financial needs and time horizon. I agree with Warren Buffett, who in his February letter to Berkshire Hathaway's shareholders said -

Amid this bad news, however, never forget that our country has faced far worse travails in the past. In the 20th century alone, we dealt with two great wars (one of which we initially appeared to be losing); a dozen or so panics and recessions; virulent inflation that led to a 21 1/2% prime rate in 1980; and the Great Depression of the 1930s when unemployment ranged between 15% and 25% for many years. Americans have had no shortage of challenges. Without fail, however, we've overcome them all. In the face of those obstacles -- and many others -- the real standard of living for Americans improved nearly 7 fold during the 1900s, while the Dow Jones Industrials rose from 66 to 11,497. Compare the record of this period with the dozens of centuries during which humans secured only tiny gains, if any, in how they lived. Though the path has not been smooth, our economic system has worked extraordinarily well over time. It has unleashed human potential as no other system has and it will continue to do so. America's best days lie ahead.

CNBC vs. Jon Stewart

I find it fascinating that CNBC has been exposed as the #1 enabler of business as usual on Wall Street by a comic who hosts a pretend daily news show. Jon Stewart has rightly criticized CNBC for being blind to Wall Street's corruption and for giving its viewers advice that changes on a weekly, if not a daily basis. Jim Cramer is the Grand Poobah of CNBC. Network advertisements for his *Mad Money* show proclaim "In Cramer We Trust." Cramer showed up in costume on Stewart's *The Daily Show* this past week - sleeves rolled up and ready to go to work for us little guys. But removed from his element and forced to answer questions about his network and his past predictions, he morphed into a double talking deity with no clothes. Cramer is America's most ardent apostle of the false religion of market timing and stock picking. He is the personification of Wall Street - smart and self-promoting, a teller of the truth - but not the whole truth. Bravo, Jon.

A Picture Is Worth A Thousand Words

In last month's issue, I compared economic analysts to fortunetellers peering into crystal balls. And, just like Hussey, I'm still a big fan of diversification.



Disclaimer - The information in this article is educational in nature and should not be considered as personal investment, tax or legal advice. Each reader must determine how the content of this newsletter should be applied to their investment portfolio. This newsletter is not a solicitation to sell investment advisory services where such an offer would not be legal. Investing in stocks and mutual funds involves risk and the potential loss of principal. Historical data is from sources believed to be reliable. Past performance is not a guarantee of future returns.