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The Market

The stock market is in a correction. The bond market is flat. Although the GDP of developed countries is still slightly growing, their financial markets are in turmoil. The crisis however, has not affected emerging markets.

The US is in recession: US unemployment is 6.1%, commodity prices fell, gold prices and the dollar increased last month, and consumer price index is up 5.4% for the last 12 months

The lack of US energy self-sufficiency is causing huge transfers of funds from the US to oil producing countries, making the US lose its financial leadership.

The creation of new financial instruments and excessive leverage (mortgages increase leverage), together with the loss of financial leadership, causes substantial dislocation that resulted in huge market volatility.

The current proposed remedy of transferring the leverage from the private sector to the government. is unlikely to solve the underlying problem. The benefits are hypothetical; the costs are real.

Asset Classes: For the past month: Small Value down 3%, Micro -7%, Large Value -7%, Mid Value -9%, Large Growth -11%, Small Growth -11%, Mid Growth -15%.

Sector ETF's: For the past month: Gold up 4%, Financial Svc down 1%, Consumer Goods -2%, Real Estate -3%, Financial -3%, Euro -4%, Biotech -5%, Healthcare -6%, Consmr Svc -9%, Intrntl Telecom -9%, RAFI Utilities -9%, Gbl Telecom -9%, Natural Gas -9%, Transportation -10%, Intrntl Real Estate -10%, Covered Calls -10%, Commodities -10%, Tech -11, Silver -11%, Oil -12%, Energy -13%, Industrials -13%, Agric Commodities -15%, Natural Resources -16%, Software -17%, Oil Equipment & Services -22%, Gbl Materials -22, Steel -34%.

Foreign Investing: For the past month: Japan -7%, Malaysia -7%, So Korea -8%, Switzerland -8%, US -9%, Mexico -11%, So Africa -11%, Foreign Lrg Div -12%, Euro 350 -12%, World-US -13%, Pac-J -13%, Germany -13%, United Kingdom -13%, Canada -13%, Singapore -13%, Australia -14%, Sweden -16%, Hong Kong -17%, Emrg Mrkts -17%, Taiwan -17%, Latin Am -17%, India -17%, China -18%, BRIC -19%, Brazil -23%, Russia -25%.

Changing Financial Markets

1. Introduction

This section is a review of [*When Markets Collide: Investment Strategies for the Age of Global Economic Change*](#), completed in January 2008, before the collapse of Bear Stearns, takeover of Fannie Mae, Freddie Mac, and the collapse of Lehman Brothers. The book details the world's financial changes and what investors should do. The author, Mohamet El-Erian, is one of the most listened to investment managers, by institutional investors, US and foreign governments, institutions, and regulators. He achieved spectacular returns managing Harvard University endowment in the past, and currently as CEO at PIMCO, one of the world's largest investment Companies, where he recently took over from the legendary Bill Gross.

2. New Realities

The markets of the postwar period were dominated by the US. The markets of tomorrow will be dominated by emerging countries like Brazil, Russia, India, China and oil producers.

The US has generally had a positive balance of payments until 1982, and a negative balance of payment ever since. The balance of payments is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. Emerging countries have had a positive balance of payments since 1999.

An equally important change has been the innovation in financial instruments. Complicated derivatives were developed. Assets, such as mortgages, were no longer held by originators, but were sold as separate securities. These securities were themselves split into tranches of different risks and sold to investors at additional profits to the originators. As the profits rolled in leverage was increased for many brokerage firms and banks, up to 60 times their assets.

3. Signal and Noise

Transformations are not easily recognized. Investors first become aware of transformations through sudden anomalies to long-standing relationships that investors take for granted. There is a tendency to dismiss this noise as not containing any information. But this noise can contain a signal that fundamental changes are taking place.

Below are four such changes:

- a. In Feb. 2005 successive and meaningful upward moves in the fed funds' rate were accompanied by downward moves in long-term interest rates in the US.
- b. Typically funds flow from rich developed countries to poor developing countries. In 1999 this flow reversed: developing countries invested in the developed countries. The US at one point consumed over 90% of the worlds savings.
- c. Industrial countries with their sophisticated financial systems rather than emerging countries with a primitive financial system are suffering the bulk of the damage.
- d. In 2007 as uncertainty increased, market volatility decreased.

The following are steps for separating signals from noise:

- Identify the sources of the noise.
- Treat each episode of such noise as potentially containing important signals.
- Be open to finding not only temporary cyclical influences but also to long-term secular ones.
- Only after you have failed to find signals should you dismiss the noise.
- Markets do not reset to the state before the shock.

4. New World

For the first time in 2007 China was the most important contributor to world growth. The contribution of China is three times that of the US. In 2007 China and India each contributed more to global growth than the US, European Union and Japan combined. Emerging countries account for more than half of global growth.

Some consequences of the New World are:

- Emerging markets will shift from relying on exports to their own domestic activities.
- US living standards will decline as we can no longer debt finance consumption.
- Increasing natural resource prices will result in inflation.
- Sovereign wealth funds will shift from US treasury securities toward equity investments.

5. Investment Portfolio for the New Reality

Because of the changes in international markets hold about 15% each in US, developed markets, emerging markets; and private equity and bonds, and 25% in real assets, a vast change from the traditional asset allocation.

Strategic Asset Allocation 2007

Equities	%
US	12-18
Developed	12-18
Emerging	6-18
Private Equity	6-18
Bonds	%
US	4-6
Foreign	6-12
Real Assets	%
Real Estate	3-9
Commodities	7-15
Inflation Protected Bonds	4-6
Infrastructure*	3-7
Water, Agriculture, Carbon Credits	2-14
Recommended Portfolio	%
Expected Nominal Return	8-10
Expected Real Return	5-7
Expected Standard Deviation	8-12

*Infrastructure refers to roads, power grids, water supply, wastewater, flood management systems, and communications.

The recommended portfolio is expected to produce a real return (purchasing power, return after inflation) about 1% less than the postwar period and a standard deviation of about six percent. Presumably this low standard deviation results from his outstanding diversification and risk management since the volatility has increased. For most of us the volatility will be higher than in the recent past. Inflation is estimated to be same as in the past, despite the higher inflation mentioned elsewhere.

6. Risk management

In these times of turbulence you should concentrate on the return of your money, not the return on your money. Periods of change have a higher probability of "[Black Swans](#)", the occurrence of very rare events. Financial returns are not normally distributed. The distributions have much fatter tails. Furthermore in periods of change individuals tend to behave emotionally.

Unfortunately El-Erian does not show how individuals can protect themselves from "[Black Swans](#)".

7. Bottom Line

- Economic leadership will shift from US to Emerging Countries.
- The shift will cause disturbance and volatilities in markets.
- Emerging country growth will cause real asset prices to increase.
- Portfolios should contain significant foreign and real assets.