

# Lowly Analyst Free Newsletter

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## The Market

Markets are rallying short-term. The longer term trend is down. In October, the market fell 29% in one week and rose 11% in one day. High grade bonds of General Electric, Occidental Petroleum, and Kraft yielded 7-8%.

The current crisis is due to a lack of confidence, and confidence cannot be restored quickly. The collapse is likely to alter investor behavior for a generation.

Stock markets are complex and unpredictable. Nevertheless, it is instructive to look at the last big collapse in the developed world. In 1990, the Japanese property and stock markets collapsed. The government reacted badly by raising the consumption tax in 1997. The Bank of Japan gave its commercial banks free cash enabling the banks to hold non-performing debt, and, as confidence began to reappear in 2000, the Bank of Japan raised rates prematurely. The economy did not recover until 2003.

Asset Classes: For the past month: Large Value -7%, Large Growth -11%, Micro -21%, Small Growth -22%, Mid Growth -22, Mid Value -23%, Small Value -31%.

Sector ETF's: For the past month: Swiss Frank -4%, Euro -9%, Utilities -11%, RAFI Health Care -12%, Biotechnology -12%, Natural Gas -13%, Covered Calls -14%, Aerospace -14%, Gbl Telecom -15%, Agric Commodities -15%, Consumer Gds -15%, Transportation -16%, Gold -16%, Consumer Srv -17%, Software -18%, Energy -19%, Financial Srv -19%, Silber -19%, Global Carbon -19%, Semiconductors -20%, Industrials -20%, Financials -22%, Technology -23%, RAFI Basic Materials -24%, Oil Equipment & Services -34%, Steel -35%.

Foreign Investing: For the past month: Switzerland -13%, Japan -16%, Malaysia -17%, US -18%, RAFI Dvlpd Mrkts -US 18%, Taiwan -18%, Untd Kingdom -20%, Forgn Lrg Dvlpd -21%, Hong Kong 21%, Europe 350 -21%, World-US, Germany -23%, Chindia -23%, France 23%, Spain 24%, Pac -J 26%, China -27%, Australia -27%, Canada -27%, India -27%, Emerging Mrkts -27%, Singapore -28%, So Korea -28%, So Africa -30%, Latin America 31%, Brazil -33%, Mexico -34%, Russia -35%, Austria -36%.

Bonds:For the past month Pwr Shr Preferred up 6.3%,Lehman NY Munies 4.6%,Money Mrkt 0.2%.

## Why Markets Crash

### 1. Introduction

The most expensive sentence in the English language is: "This time it will be different." This section compares the current crisis to the one of 1929 and shows similarities and differences to help us determine what the outlook for the future will be.

### 2. Efficient Market Theory

Academics in the 1970's theorized that markets are efficient, and that markets price assets instantaneously and fairly at their true value. Many investors and advisors regrettably based their strategy on that assumption.

### 3. Causes of Crashes

Financial markets are complex systems and their crashes rarely have a single cause. Nevertheless, most investors look for single cause, e.g., subprime mortgages.

Unfortunately the world is not that simple. Crashes are caused by changes in market fundamentals, decrease in regulation, excessive optimism, excessive speculation, excessive use of credit, overvaluation of assets, large accumulation of wealth by a few individuals and by institutions, and lack of confidence.

Under these preconditions any small disturbance can trigger a crash.

### 4. Complex Systems

Complex systems are unpredictable, because they are often controlled by the occurrence of unpredictable events like 9/11.

There is increasing recognition that the traditional analytic approach is unsatisfactory because it is based on the assumption of market predictability.

Currently scientists try to understand the nonlinear interactions among the constituents complex systems.

### 5. The crash of 1929

Few economists predicted the 1929 crash. There was a decrease in regulation, excessive optimism (the roaring 20ies), excessive speculation in stocks, diamonds, currencies, and an increase in investing publications.

The crash and the resulting depression started in the US. Most countries also had political changes. There were massive bank failures. Industrial production fell 45% from 1929 to 1932.

Ben Bernanke, the current chairman of the Fed, thinks that excessive debt followed by deflation caused the depression. Outside the banking system private debt expanded for purchasing of consumer goods and expanding business increased 50%. Home building dropped 80% from 1929 to 1930.

Prices and incomes fell 20-50%. US unemployment was 24% in 1933. Debtors income decreased and they defaulted. This turned the 1930 recession into the 1933 depression. Despite the large amount of credit that was available at low rates early in 1930, individuals did not borrow.

The stock market recovered in early 1930 but then continued to fall until 1932. Two of the best years of the stock market were 1933 and 1935.

## 6. The Crash of 2007

The US had generally positive balance of payments until 1982. However, excessive borrowing by business, individuals, and the government. lead to the crash. f 2007.

From 1999 on, emerging nations had positive balances of payments. The US lost both its capability to be energy self sufficient and its economic dominance thus emerging nations and the oil producers gained dominance.

Financial innovations outstripped the management capability of institutions. These innovations enabled new derivatives, e.g. collateralized debt securities.

Regulations decreased, optimism increased, speculation exploded, assets became overvalued, and a few individuals accumulated much wealth. Finally, changes in market fundamentals, like the absence of liquidity, and the decreasing outlook for earnings, provided the trigger for the subprime loan crisis to initiate the crash.

In the week ending Oct 10 the Wilshire 5000 fell 29% to a level first reached in 1997. On October 13<sup>th</sup> the Wilshire rose 11%.

## 7. Government Response

Initially governments did not respond to the unstable conditions that were developing and the potential for a financial crisis. Slowly the governments responded. The developed world took some joint action without involvement of the emerging nations. Governments initially did not acknowledge that we are in a depression.

Government response, however, has been better than in 1929. Governments flooded the market with liquidity increasing the risk of eventual inflation. However, since few lenders are lending, current inflation is moderate. Governments supported failing banks and guaranteed

many obligations of debtors, trying so far unsuccessfully to restore confidence.

The situation is different from 1929. At that time only a small percentage of the population invested in financial markets; only a few individuals were leveraged and had large outstanding balances. Today a large part of the population has investments in retirement accounts. Many have large mortgage and credit card-debt.

Financial markets are unpredictable. The current crash is fundamentally changing investor behavior. The credit crunch will lead to a depression. Municipalities, states, and businesses have difficulty borrowing money; hence they cannot finance new projects or expand. As a consequence more people will lose jobs.

People losing jobs will curtail their purchases thereby causing a snowball effect.

It took 14 years and a war for the US markets to recover from 1929. The current bubble also will take years to recover.

Hopefully we will not make the same unwise decisions like abolishing free trade, increasing government ownership, and restricting free markets.

## 8. Current Investment Strategy

Know your risk tolerance. Do not take more risk than you can tolerate. If you do, you will sell out eventually when the market is down. The market could fall another 40%.

Until the market clearly indicates its direction, do not load up on equities. A few days of market advances do not indicate that the market is going to go up.

You should have a large amount of short term, high grade fixed income securities in a diversified fixed income portfolio. No long term bonds, since they are very volatile and you do not get adequately rewarded for the risk. You should hold some gold funds (not gold mines) and some stocks. Remember, markets are unpredictable. This is a good time to seek professional advice.

## 9. Bottom Line

- Financial markets are complex systems, hence unpredictable.
- Returns from financial markets do not follow a normal distribution. Markets have many more extreme events.
- The world has changed since 1929. The response of Governments has been better. The US still has the strongest economy of the world.
- Monitor the risk of your portfolio and do not exceed a level that you can tolerate.