



JMH Wealth Management, LLC

Think Macro, Act Micro

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The convulsion in global financial markets the past few weeks has sent me back to rereading Reinhart and Rogoff's *This Time is Different*, the impressive analysis of *Eight Centuries of Financial Folly* (read banking, currency and sovereign debt crisis). The authors suggest that the four words that an investor does not want to hear in reference to any market trend or cycle are "this time is different", because simply, it is not! Financial crisis in the form of banking and sovereign debt crisis, and the resultant defaults, have occurred with amazing regularity around the world throughout history. The progression of this contagion is scripted right out of a NFL playbook and the slow deepening of the current global crisis is advancing in a disturbingly familiar way. Further, the notion that these types of crisis tend to be limited to emerging economies, not developed advanced countries, like the U.S., is thoroughly disabused by the data.

Here's the Play. A toxic mix of massive capital inflows, along with deregulation or failed application of existing regulations of the financial sector leads to a credit boom. With too much money sloshing around the financial system, underwriting standards are relaxed which contributes to driving asset prices to supra normal levels. Ultimately, a banking crisis is triggered by the poor quality loans (or other investments) outstanding that forces the government to inject capital into a banking system under duress. Subpar growth for an extended period of time ensues as the economy undergoes a slow deleveraging process and tax revenues decline. The borrowing associated with the infusion of bank capital, plus the substantial additional funds needed to sustain the economy culminate in a massive increase in government debt outstanding. Sound familiar?

Let's look at some of the aspects of the execution of this Play this time around. There was a "global savings glut" as emerging economies amassed huge reserves on the products they sold to a trade imbalanced U.S. and other countries. The inflow of this capital, seeking better returns and diversification, found its way to the U.S. (and other developed countries) where it was lent out to a real estate market that everyone believed always rose in value. Further, the government encouraged the goal of home ownership for every citizen, through a number of policies, regardless of ability to pay. Lending and regulatory guidelines were relaxed or ignored, including the Securities and Exchange Commission decision in 2004 "to allow investment banks to triple their leverage ratios". Meanwhile, Wall Street's chronically broken moral compass spun further out of control, enabling the financial engineering of toxic securities that were sold in daisy chain fashion to investors around the world.

The music eventually stopped as Chuck Prince, formerly CEO of Citigroup at the time, suggested it would and there were not enough chairs to go around, including for Citigroup itself. Losses became

magnified due to the leverage in the system and iconic companies began to fail or were forced to merge in shotgun weddings. As a consequence, the rescue of the banking system was initiated by a variety of governmental alphabet soup mechanisms (TARP, TALF, etc.) that were intended to rebuild bank capital and buy time for a more measured workout of asset problems. The Federal Reserve, a key player in creating the turmoil, now shifted to resuscitation mode and expanded its balance sheet by a couple trillion dollars. Of course, this is all obvious now courtesy of hindsight bias, the cognitive tendency to connect the dots of events in hindsight and yet, it does conform to the pattern of so many other historical financial market crises.

As this Play has been run repeatedly through time, Reinhart and Rogoff provide some other interesting observations on the nature of this type of crisis. "Asset market collapses are deep and prolonged. Declines in real housing prices average 35% stretched out over six years, whereas equity price collapses average 56% over a downturn of about three and a half years. . . . profound declines in output and employment occur. . . . output takes on average 4.4 years to claw its way back to pre crisis levels. . . . the unemployment rate rises an average 7 percentage points. . . . the value of government debt tends to explode." Pretty sobering, but in fact we are well into all of these trends, especially if we date the peak in economic activity in 2007, and measure the change in real estate prices, stock market volatility and unemployment rate increases since then.

The good news is that U.S. companies, and consumers to a lesser extent, have restructured their balance sheets toward lower leverage. Liquidity is at record high levels on corporate balance sheets, debt has been repaid or refinanced at much lower rates, free cash flow has improved substantially, banks have recapitalized, and many home owners have refinanced with record low mortgage rates. Overall, the U.S. is in much better shape to face the bad news ó slow growth will be with us for some time and the Eurozone is a couple of plays behind us on the field.

The Eurozone is clearly in a much tougher spot than we are and many of their problems appear more intractable. The debt levels of many countries are simply too high and default seems inevitable. The quicker they face that reality, the faster they will begin the long process of rebuilding their economies and implementing a more sustainable social contract. Their banks are woefully undercapitalized if assets were truly marked to market values, and the European Central Bank and various finance ministers need to face that reality head on. Critical to their ultimate recovery, the European Union will have to resolve the thorny issue of how to control fiscal policies in a patchwork of countries bound by a monetary union.

The best recovery strategy for all is growth, not austerity. Policies that foster growth will lead to lower unemployment, rebuild tax bases, facilitate the repayment of debt, promote a housing recovery, etc. We're probably not going to be able to contract our way out of this mess and unfortunately, it's hard to find a country or policy strategy anywhere in the world that is expansionary. Policy makers need to rethink their strategy and policy options, soon.

That's the macro view. Now how do we act at the micro level?

Reflecting my assessment of what is happening globally and, somewhat in anticipation of what has unfolded, client portfolios have been positioned in the following manner:

- The maturity and duration of bond portfolios are relatively short, with bonds due to mature predominantly within four years. With interest rates at or near record low levels, interest rate risk is huge. I want to protect the principal of portfolios as much as possible.
- Corporate bonds dominate bond portfolios, with a few holdings of treasury inflation protected securities (TIPS). The fact that I can analyze corporate cash flow and repayment more easily than government or municipal bonds leads me to favor corporates. Now is the time to focus more on the return of your money, than the return on your money.
- No common stock exchange traded funds (ETFs) are held due to liquidity, market manipulation, and systemic risk issues, along with overall risk control concerns.
- Stock portfolios are composed of individual companies, not mutual funds or ETFs, enabling risk to be more easily controlled by company selection and sector targeting.
- The financial sector represents 15% and 23% of the S&P 500 Index and the MSCI EAFE Index (developed international stock benchmark), respectively, versus my client portfolio weight of around less than 3%. We are heavily underweight the troubled global financial sector.
- Companies are screened and selected for free cash flow and low debt levels, among other attributes, believing that companies with those characteristics have considerable financial flexibility to react to changing economic and competitive conditions.
- U.S. companies dominant client portfolios, reflecting my assessment that domestic companies have already done the hard work and bolstered their financial strength more than overseas companies. The U.S. is also further along the recovery curve than the Eurozone, for example, notwithstanding the high likelihood that we could double dip due to political bickering freezing economic activity just enough to stall out the economy.
- Extra cash is on hand in most portfolios awaiting deployment, as individual company stock prices revert to more attractive levels in the general market decline. It should be noted that some of that cash has been opportunistically put to use through selective purchases.
- Patience is being exercised, believing that the financial markets generally provide enough volatility to create investment opportunities for long term investors.

Unquestionably, the global economy is in the midst of more than the typical business cycle crisis. Hard decisions will have to be made and the risk of policy missteps is large, both domestically and overseas. There are no silver bullets. Pragmatic fiscal and monetary policies will be needed to facilitate the recovery and intelligent political compromise will be critical to the success of any plan. Indeed, this time is not different and we have been here before, unfortunately, on a fairly regular basis. Granted, this crisis is a bit more steroid laced due to leverage and a host of other factors, including considerable ethical lapses in the conduct of business. Recovery will continue to be slow and that will be a challenge to an impatient world looking for easy and quick solutions. If political leaders stand up around the world and act like adults, we can work through this crisis just like all the other prior ones, and become simply the latest chapter in the next edition of *This Time is Different*.

Thanks for reading this and I hope you will call or email me with any questions or comments.

Jeffrey