MV Capital Management Thought Content Series: Markets in Crisis

Mind the Gap

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Anyone who has ever ridden the London Tube can relate: the eel-like form emerges from the tunnel's blackness into the dim hues of the platform area and creaks to a loud stop in front of the passengers assembled at Covent Garden, or Regent's Park or wherever. A deep, stentorian English voice most humorlessly intones the phrase: "Mind the Gap", lingering ever so slightly longer than necessary over the word "mind". The pronouncement is made, of course, so that one takes care to ensure that no brollies, Doc Martins or wheels on the baby's pram get stuck in that considerable space between the platform and the car while boarding.

As we take assessment of where we are in this financial market crisis with the first quarter coming to a close those *basso profundo* tones resonate: Mind the Gap. A not insignificant number of investors have started to position themselves for a crossover, sensing that the market lows we witnessed in the first week of March may signify the low point of the bear market (of course that is far from a universally-held opinion: many others expect to see those lows revisited). Part of this is psychological – the markets have been so nerve-destroying for so many months that energy levels are totally spent and investors are ready to "move on" as the legions of grief counselors might put it. There is a feeling that the bad news can't go on forever, that at some point all the sellers are sold out, that spring is in the air and better days have to be ahead. Cue in Annie and the sun that will assuredly come out tomorrow. And count us at MVCM among those who do believe that the sun will come out tomorrow. The question is: how to navigate the path between today and tomorrow? How long will it be before tomorrow arrives? Mind the Gap.

Let's start with what we know. Known quantities are always easier to deal with than uncertainties. We know that the major stock indexes lost more than 37% in 2008 and are down another 14% or so in the first quarter of 2009. That translates into about a 13.8x forward P/E ratio for the S&P 500 (the forward P/E ratio incorporates analysts' expectations for future earnings periods).

So right off the bat we have two data points that could tell two different stories about what to expect in the Gap. The "how far, how fast" data point tells us that the market has fallen further in the past six months than in any other six month period since 1932. On the other hand the P/E ratio is far from its all time lows – in 1982, just before the onset of the Great Bull of the 1980s and 90s, the P/E ratio on the S&P 500 was 7. The P/E ratio is important: it tells us how much we are willing to pay for a dollar of corporate earnings. Proponents of mean reversion would look at a graph of historical P/E ratios and tell us that we still have further to fall – that even if earnings don't fall more than analysts' expectations (itself a rather dubious assumption) we still could reasonably make a case for the S&P 500 falling below 500.

Then again there is no particular reason why the P/E has to fall to 7, or 10 or any other number to signify the low point for the bear market. After all it rose considerably higher in the manic months of the dot-com boom in the late 1990s than it ever did during the Roaring '20s. The S&P 500 reached a P/E of 44 at the zenith of the madness in 1999, but never made it past the low 30s in the days of flappers and bathtub gin. Every economic cycle is different: we are living neither in 1932 nor in 1982, not in 1927 or in 1998.

So you can see how quickly we have transited from what we know – that the market fell a whole lot from September to March – to what we don't know, i.e. what the magnitude of that fall means for where we are on that journey across the Gap to the sunshine of the next bull market. What we think, though, is that this is a particularly tricky gap to navigate, with a large number of X-factors bouncing around out there that could quickly undo the generally strong underlying trend we have seen in the market over the past three weeks. That impels us to proceed with caution: although we are monitoring the landscape closely for clues that the economy is slowly moving back from the edge of the abyss, we believe the number of present and significant risks remains high and thus we are not making significant changes to the defensive positioning of our portfolios. We see some indicators that can perhaps serve as a basis for cautious optimism in the near-to-mid term and others that call into question what that bull will really look like on the other side of the Gap.

The crisis is an amalgam of three component parts: the credit markets, the real economy and the confidence level of participants: those with a vested interest in the outcome from hedge fund traders to U.S. taxpayers. That third factor – confidence – is a critical ingredient to the health of the other two, for confidence underpins lending and borrowing in the financial markets as well as buying and selling in the production and consumption markets for goods and services. The Consumer Confidence Index, which plunged to an all-time low of 25.3 in February, firmed up a bit to register 26.0 for March (1985=100). Given the incessant deluge of bad economic news since last fall, the notion that confidence is just a wee bit better than its all-time abysmal low point evokes a giddy feeling not unlike dancing around the Maypole in the first flush of a warm spring evening. But other sources carry a similar message: a Washington Post-ABC News poll conducted on March 29 showed a higher number of people who think the country is on the right track (42%) than at any time since April 2004.

Among the other two parts of the crisis equation it was the credit markets – specifically the perception that the situation for financial institutions may not be as life-endingly bad as might have been thought – that jolted the stock market to life earlier in March. At MVCM we have long maintained that any near-term sustainable improvement of fortunes in the equity markets will likely require the leadership of the financial sector, so any sign that things may not be as terrible for banks as contemplated would be a good sign indeed. The markets greeted the latest plan from Tim Geithner's Treasury Department with – well, jubilation would be too tame a word. The plan itself does not appear to be so radically different from the one the markets greeted with a chorus of Bronx cheers just a few weeks earlier, and it has drawn pointed criticism from some experts in the field, including Nobel Prize-winning economists Paul Krugman and Joseph Stiglitz among others. Still, investors liked what they saw. The crux of the plan is: will the combination of a public-private partnership between the government and profit-seeking investors, with the FDIC providing liquidity so that equity partners get their 7-1 leverage tailwinds, get these toxic (oops, sorry, "legacy") assets off the books of financial institutions so that they can go back to the business of lending money?

And that brings us to the third component of the crisis – the real economy. Credit markets have to get flowing because credit is the lifeblood of economic transactions, but even if the Treasury plan gets the banks back into business, what kind of a business will it be? This goes to the heart of the longer-term question about what exactly our economy is going to look like on the other side of the Gap. In 1982 financial institutions accounted for about 16% of the profits of the S&P 500 – a level that varied by only a little in any given year from 1948 on. By 2007, however, the sector had grown to account for 44% of S&P 500 profits. Now bank profits have all but disappeared. The interesting question is: what part of our current banking system can survive on a diet of 16% of S&P 500 profits over the long term? Households and businesses will surely pick up the pace of borrowing and lending from their recent flatlining – but the days of the 50-1 leveraged economy are very unlikely to come back any time as far as the eye can see.

It is startling how much the economic cycle starting in the early 1980s departed from very predictable long-term trends. Personal consumption was 65% of GDP for practically the entire post-World War II period up to 1982, and the financial system had a defined role to play in that economy, represented by about 16% of the profits. From 1982 all that changed – consumption went from 65% to 72% and the banks led the charge by inventing all sorts of new ways to borrow money. That new model in the end proved to be unsustainable.

The juxtaposition of Wall Street and Detroit in the hot seats for a seemingly endless succession of Congressional hearings makes for some interesting contextual history. After all, once upon a time "Detroit" was a byword for American ingenuity. For many years – decades even – the American car industry was our great national showcase, a big, muscular symbol of American can-do. The industry had already started into its long-term decline when the dawn of the Age of Wall Street came in the 1980s. Banks were the new car companies and Wall Street was the new Detroit – a shining symbol of American ingenuity and innovation. In the 1990s Hermès tie-clad American bankers strode the globe, lecturing emerging market financiers and politicians in their shabby off-the-rack suits about the impeccable excellence of the American financial system. Just do as we do, and all will be well, they told the assembled throngs in Moscow and Mumbai, Buenos Aires and Beijing.

Now times have changed, and our financial system is literally in hock to those same emerging markets. In the hyperleveraged world of the past 25 years New York and London served as the axis of finance and the crucible of its most (at the time) impressive innovations. In a world where cash is king, though, that center of influence shifts to where the cash is. The Liquidity Triangle runs roughly from the Gulf Cooperation Council (GCC) countries of the Middle East to North Asia (Beijing and Tokyo) and then down to the South China Sea with its growth hubs of Singapore, Kuala Lumpur and perhaps even Jakarta. We see a future with significant portions of Asia-centric financial instruments in our portfolios.

But that is a conversation for a different day. We are not there yet – we are still Minding the Gap. Rest assured we are minding it with great care and diligence.

With warm regards,

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