MV Capital Management Thought Content Series: Markets in Transition

In the War Room

May 25, 2010

It is 3:00 a.m. and all is quiet in the sleeping hamlets of Washington DC, New York City, and Palm Beach. But on the other side of the world markets are in real-time freefall: Japan's Nikkei down another 3%, Hong Kong and Shanghai extending their double-digit losses for the year-to-date. Mid-morning in Europe is no less frenetic, with the Euro threatening to chart new lows and the shaky Mediterranean markets hanging on by a thread as their next debt obligations loom. The Korean peninsula is a cacophony of bombast, bluster and bluffing as tensions escalate over the North's latest act of aggression. Off the coast of Louisiana gushing oil spills into the moonlight Gulf as it relentlessly closes in on the fragile marshlands that are home to so much of our nation's seafood industry and the livelihood of thousands of families. Other X-factors are out there somewhere: which ones are going to make the news today?

No wonder we feel like it has already been a full day of work by the time the opening bell on the New York Stock Exchange rings at 9:30 a.m. Unfortunately this has become the norm rather than the exception.

With this posting we invite you to take a seat at the table where our colleagues and we are discussing the latest batch of current events, asking questions and challenging each other's views to come up with a consensus on what it all means and what, if any, action we should take. We've got plenty of strong coffee – help yourselves!

What is the difference between 5/2010 and 10/2008?

As we see it, the major difference is that in fall '08 (and extending into winter '09) there was a very real probability of the entire global financial apparatus imploding. If short-term credit and money markets aren't functioning then the most basic activities of business and commerce (such as issuing payroll checks) will also not function. The catalyst for this implosion would be the chain-reaction failures of systemically critical financial institutions. Today, while that risk has certainly not gone away it is also not "clear and present". To be sure the exposure of European banks to their region's shakiest credits is of no small concern – and that concern is reflected in their higher borrowing costs. LIBOR, the overnight rate banks in Europe pay each other for lines of credit, is double the rate earlier this year – about 0.5% compared to 0.25%. But at the height of the 2008 meltdown LIBOR was over 4% - that is as useful a data point as any to underscore the difference of magnitude, at least at present.

What is the current market drop in context?

U.S. major market indices have now followed overseas markets into correction territory. A "correction" is when the market retreats by 10% or more from its recent high point, which in this case was late April. Corrections are common features of both bull and bear market cycles. This is the first correction since the market started the current bull cycle in 4/2009.

Why is the market correcting now?

Any time that a market makes substantial gains investors are going to look for excuses to take money off the table and book profits. There's been enough volatility stemming from the European crisis, financial tightening in China and reminders that the U.S. employment & foreclosure problems have not gone away (even though the economy is still in good recovery mode) – so a number of investors have decided that now was the time to come off the table for a bit. Additionally there is some uncertainty about the potential impact of pending new financial regulations in the U.S. – though on balance the reaction to this is probably somewhat more positive than negative, as not all that many people genuinely believe that the best of all possible worlds contains a thoroughly unreformed Wall Street.

Are investors sending a thumbs-down signal to the EU recovery package?

The EU package announced May 6 sparked stock market rallies because it seemed likely to keep immediate liquidity fears off the table. We think that is still a more likely outcome than the specter of widespread defaults. We have not seen failures at government bond auctions among the troubled nations like Spain and Portugal, and we believe the EU (and Germany in particular) is committed to maintaining the stability and integrity of the Euro. Having said that, though, we noted in our recent commentary piece "Volatility: The Sequel" that the liquidity bailout does not address the fundamental economic weakness in these shaky markets. Europeans are going to react badly to austerity programs that threaten their comfortable standard of living - and that should mean ongoing weakness in Europe relative to the U.S. (another of our major themes). Remaining underweight EU for an intermediate-term horizon is probably a good idea for now.

Can EU weakness tank the global recovery?

It can certainly do some damage depending how the crisis unfolds. The EU is a critically important trading partner for the world's other major markets (U.S., Japan and China), so anything that impacts consumer and production markets in Europe is going to have a potential ripple effect elsewhere. However this weakness is likely to become more evident over time rather than an overnight cataclysm. The likelihood of EU woes triggering a double-dip recession in 2010 in the U.S. is, in our opinion, relatively low at this point. At the same time, though, we are keeping a close eye on those borrowing rates. What we do remember about the 2008 meltdown is that it was preceded in 2007 by a crisis in subprime mortgages. At the time, everyone from Ben Bernanke on down dismissed the notion that a seemingly non-dominant sliver of the financial markets could bring down the rest of the system. We now know that such blithe assumptions can be foolish – so although we are not reading flashing-red signals in the borrowing rates being posted today we are certainly not taking our eyes off them.

What about beyond 2010?

Certainly there are intermediate-term concerns about all markets. The recovery we are in right now may well turn out to be a weak recovery. It's hard to see a full-throated return to economic strength on the back of a jobless recovery and a household debt hangover that will impede consumer spending. We are still in a "gap" market environment where the economy is in transition from one model of capitalism (the globalization/financial leverage model) that worked for the last 25 years to another - we don't know what that next one is going to look like. In the meantime we have to accept the reality of higher than normal volatility with lower than normal returns. No fun - but those are the realities we have today.

What should we do?

In the time that it took to write this the Dow Jones average fell 50 points, then rallied 150 points to offset most of its losses for the day. In an environment like this characterized by wild intraday swings up and down the best thing to do is to not lose sight of the larger picture. Predicting market outcomes in the short term is a fool’s errand. The likelihood of the market losing (or gaining) 10% or 20% in a single session is extremely low. As professional money managers our job is not to guess when those Black Swan days will be and take aggressive bets to look like heroes. Our job is to make prudent decisions based on the data points we have in front of us to evaluate. By definition this means we are always making decisions in the absence of full and complete information. It also means that we are constantly on guard to refrain from letting our emotions get the better of us, from capitulating to fear (or greed, as the case may be). Sometimes the irrationalities of short-term trends can work in favor of long-term strategies – markets can oversell and leave valuations cheaper than they would otherwise be – and if you believe in the case for a long-term strategy this can present an opportunity to build in pieces of a portfolio on favorable terms.

It is also worth remembering that human civilization *doesn't* collapse with far more frequency than it *does* collapse. When those red screens urgently flash their mounting losses you can always count on some latter-day financial prophet to appear, dispelling end-of-days warnings of doom and gloom. Maybe one day that prophet will be right – but as for us, we're going to continue trusting our analysis of the empirical evidence and our strong belief that people eventually figure it out and get it right.

With warm regards,

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