

# Inside Business

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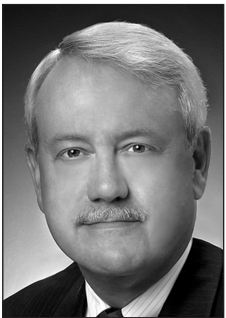
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**The Experts:** Investing

## Historic opportunities are ahead of us

The story of the fourth quarter could have been written in the third quarter, on Sept. 15. Some say that day was the end of the Reagan Era, deregulation, and supply-side economics, and the day John McCain effectively lost the election. It was also the day that storied investment banking house Lehman Brothers failed, proving some firms really are "too big to fail."

Economists have taught us that depressions can be caused by increasing taxes, increasing tariffs or decreasing money supply. The fall of Lehman caused a huge decrease in money supply and greatly accelerated the deleveraging process and the stunning stock market collapse.



Jim Flinchum

A look at the four primary stock averages

clearly illustrates this collapse:

|              | 4th Quarter | Year   |
|--------------|-------------|--------|
| Dow          | -13.8%      | -34.0% |
| S&P 500      | -16.4%      | -38.5% |
| Nasdaq       | -17.4%      | -40.5% |
| Russell 2000 | -20.7%      | -33.8% |

There was virtually no place to hide. The only companies in Dow that didn't lose value were Wal-Mart and McDonald's. The only asset classes that didn't lose value were gold and Treasuries.

When it was over, Wachovia and Merrill Lynch had joined Bear Stearns in the grave. It wasn't just bad, but historically bad! Belatedly, the government informed us the recession actually started a year sooner, in December 2007.

As bad as that was, the rest of the world was in worse shape. International stocks have soundly beaten the U.S. for the last four years but trailed badly in 2008, as follows:

|              |        |
|--------------|--------|
| Russia       | -66.6% |
| China        | -64.8% |
| Saudi Arabia | -57.3% |
| Israel       | -52.6% |
| France       | -44.2% |
| Japan        | -42.9% |
| Germany      | -41.7% |
| Canada       | -37.5% |

From its high in October of 2007, the more broadly based Wilshire 5000 Index lost a heartbreaking 54 percent of market value to its trough, which translates into \$10.4 trillion of losses

for Americans. If increasing government spending of an extra trillion dollars could replace that \$10.4 trillion, it would be a good deal, but that is one big "if."

From a historical perspective, this was the worst fourth quarter since 1987, and 2008 was the worst full year since 1931, when the Dow lost 52 percent. Even worse, it lost another 23 percent the next year in 1932 before reversing suddenly and quickly.

Both Morgan Stanley and JP Morgan have predicted that our national income, or GDP, decreased 6 percent in the fourth quarter, which would be the biggest decline in 26 years. Factory orders have already declined four straight months to a 28-year low.

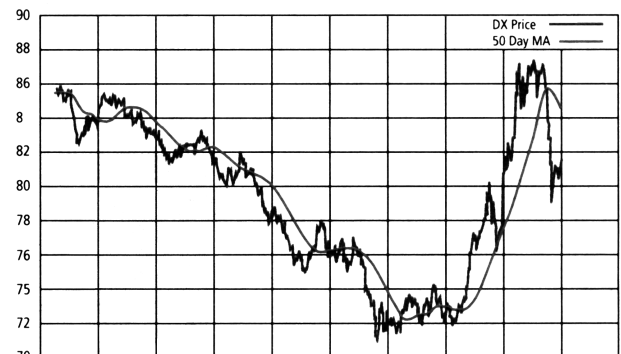
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### New York Board of Trade U.S. \$ Index

NYBOT :DX Max Daily

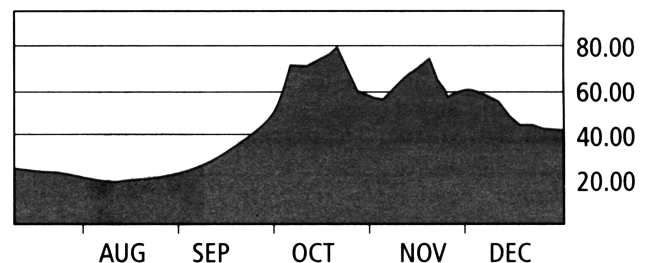
NYBOT U.S. \$ INDEX

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Oct.-2006 Jan.-2007 Apr.-2007 Jul.-2007 Oct.-2007 Jan.-2008 Apr.-2008 Jul.-2008 Oct.-2008 Jan.-2009 Apr.-2009

### Volatility index



...continued

The most tragic sign of the lousy times was the record-breaking loss of jobs. Last year, 2.6 million people lost their jobs, with 1.9 million lost in the last four months alone. Eleven million people are out of work, the most since 1983, and another 20 million are underemployed. Economists like to talk about the allocation of resources, and 31 million people are a huge amount of resources to waste.

### Encouraging economic signs

There were, however, some encouraging economic signs in the fourth quarter. The TED Spread, which is the difference between Treasury bills and Eurodollar, improved considerably from about 4.5 to a much more normal 1.4. The narrowing spread indicates that confidence is improving in the financial markets in general and the U.S. government in particular, as well as how well the financial plumbing is working. The credit crisis is getting better. Now, if we can do something about that newer crisis of confidence.

Another promising event was the dramatic movement in the value of the dollar. Having declined in value for several years, it rose rapidly in October but for the wrong reasons. As markets plunged worldwide, the dollar was considered the only "safe" currency, relatively speaking. The December decline in the dollar is actually a good market indicator because it shows investors are confident enough to again venture into other currencies, as shown in the New York Board of Trade U.S. \$ Index chart above.

It seems counterintuitive to suggest that a decline in the dollar was a healthy indicator of the world economy, but this time it is.

We also saw the painful volatility ease considerably. Called the "fear index," the Volatility Index (shown in bottom chart above) spiked right after the Lehman collapse but has retreated steadily.

There is clearly a connection between reduced fear and a stabilizing market. December was the first month since the Lehman collapse when the markets did not lose value.

One of the first rules of investing is "Don't fight the Fed," which is determined to get the country out of the economic ditch. In December, it started buying mortgage-backed securities on the open market, and the falling mortgage rates show it is working. While interest rates are now extremely low, the Fed still has a great many more weapons, such as buying other types of assets or extending guaranties.

### How we're managing it

My investment firm will be watching some of the old Wall Street rules of thumb, such as the "January Effect," which suggest small-cap stocks outperform large- or mid-cap stocks. Also, some believe that the month of January predicts the whole year. Regardless, we are comforted that the selling pressure from mutual funds and hedge funds has lessened, which should eliminate a real weight on the market's performance.

Knowing that there's a big difference between the economic cycle and the financial cycle, we think the worst of the financial cycle is behind us and expect to be fully invested again by March/April. Because we expect the current deflation to become inflation by year-end, we will slowly increase exposure to precious metals like gold and other hard assets on dips. We will not be buying real estate trusts anytime soon but may at year-end. Nor will we buy any international banks until it's clear who is exposed in the desperately over-built Dubai commercial real estate market.

We will not be buying Treasuries, especially long-term ones. Their safety is greatly overrated, unless held to maturity. Corporate bonds are looking more attractive, as they seem to have factored in the inevitable increase in defaults as we progress through this recession. Municipal bonds are attractive but only for the most highly rated ones, unless the Obama stimulus plan extends Federal guaranties to municipal obligations.

There is an estimated \$9 trillion of cash sitting on the sidelines, waiting to return to the market. At the low point of the 2002 recession, 28 percent of all liquid assets were in money market accounts. Today, 43 percent sits there, waiting.

Fortunately, historic times also produce historic opportunities. A new era has now begun.

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