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Capital Ideas

I'm So Tired, I Haven't Slept A Wink

I'm so tired, this market really stinks! I have never been much of a cheerleader, and, fifteen months into this recession, I am tired. Are you?

That is a joke. Everyone is worn out. We had a nice little bump in March, but the Dow is still down 43% from its high of 14,093 in October 2007.

Wow! The good old days! I remember October of '07 like it was just seventeen months ago. Housing prices were firm. You could buy a car with 0% financing (just try to get one of those 0% advertised deals now). The prices on televisions were falling—and it was a good thing. We still measured fixed income by comparison to the Lehman Brothers Aggregate index. Our retirement savings looked ok, (not great because we had not contributed enough), but with a dozen years of 20% annual returns….

Oh, well. All good things come to an end. And we know that recessions end, too. When this one ends we will still have need to save for those things we were saving for before. We will just need to adjust our goals, however. The market is not going back to 14,000 any time soon. Real 20% returns are the stuff of fairy tales and recessions.

That's right. High returns during a bear market. In the last 17 months the S&P 500 has had three different bull markets of 18.5%, 21.4%, and, currently, 26.6%. Doesn't that make you feel rich? The S&P 500 is down about 46% peak to date, but we have had three 18%+ bull markets.

How can that be? I call it bear market math and it can be scary. For example, let's say your portfolio is down 50% (of course, it is not if we have been managing it). What would it take to get back to break even? Your portfolio would need to gain 100% to get square. It is easiest to think of this in terms of $100. If you have $100 and you lose $50, you will need $50 more to get back to $100. So, let's take that 18.5% bull. 18.5% of $50 is $9.25. That gives you $59.25. The next bull was 21.4%. 21.4% of $59.25 is $12.68. So now you have $72.93. Finally we have the 26.6% bull. That adds another $19.40 for a total $92.33. So now you are only down 7.67%! Right? Wrong. These were "three different bull markets." The periods between these bulls were ugly.

But, you get the idea. When you see on the evening news that the Dow is up 20%, it is great but you have to look at it in the context of a bear market. That is not 20% on your peak account value (which was no more "real" than the trough account value). It is 20% from the last bottom.

This bear has wiped out a decade of gains. It is a shame life does not give us another decade to make up the lost time for our portfolios. But, that is just the way it is. It is not good. It is not bad. It just is.

So now we look ahead.

If all is gloom and doom, then market performance is of no consequence. If you truly believe that the market will never recover and all is lost, then you best hope we change our form of government from capitalist (almost) to socialist. Why would I say something so ridiculous? Because, if corporations can no longer raise capital in the private markets, then the sole provider of capital will of necessity be the government. Who would be foolish enough to buy corporate stock or lend to corporations (buy bonds) if there is no hope for return on investment?

I don't know about you, but that is not something I want to see. We have enough government involvement in our lives now. We will see more in the not-so-distant future (nationalized health care, more onerous tax burdens to pay for these bailouts). I just prefer to keep it at as low of a level as possible.

So what are reasonable expectations? First, this bear is not done running. Bear market rallies are common. Human nature dictates that we will see nothing but roses when the market is rising. We will mistake an upward move in an index as the end of the economic worries. The media tell us this is true. Haven't you heard recently that the market will recover in advance of the economy? But what is the clue that the market has recovered? Remember that we were six months into the bear market before it was officially deemed a bear market.

As the market rises in a bear market rally, there are factors that push the market higher than it should be at the time. The primary factor is emotion. We are all die-hard optimists. We want the market to be "better." But there are other factors such as short covering that have more to do with self-preservation than any desire for the market to advance.

So when will this end? If I knew that, we could own the world. No one can tell you the answer—except, perhaps, Bernie Madoff.

My best guess is that we will be "officially" on the road to recovery as of the fourth quarter of this year. Of course, we won't know that until near the end of the first quarter of 2010.

Why would I say that? Is there a mystical algorithm that computes the end of a bear market?

Nah. We just look at year-over-year comparisons of market indices. The fourth quarter 2008 results (corporate earnings, sales, and so forth) were so dismal that it will be difficult for the fourth quarter of 2009 to be worse. This quarter and next will be judged by the comparable quarters last year. While the second and third quarters of 2008 were not great in absolute terms, they will look great in comparison to what we are experiencing now. So, expect some more gloom and doom until the first of next year.

This does not mean that the world is coming to an end. It does not mean that all is well. There are still plenty issues that we still need to work through. However, there is nothing to indicate that we will see more disasters as we had with Lehman, Bear Stearns, Merrill, and the rest. More layoffs, yes. More bankruptcies, yes. Higher unemployment; that goes with the layoffs. But we should not see the economy teetering on the brink.

So, when the market takes another dive, understand that it is just a part of the healing. We will survive and, eventually, prosper. It just takes time to recover from a near-death illness.

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