

## DEJA VU ALL OVER AGAIN

Value investors, sanctimonious lot that we are, especially these days when it's working, tend to be dismissive of macro notions, that is, of broad economic views as a basis for decision making. Most claim these are too unpredictable to be really useful in making money. Peter Lynch has told us that even five minutes of dwelling on the prospects for the economy is five minutes too much. Value investors are supposed to be bottoms up stock pickers not top down forecasters. It's the micro not the macro stupid!

Generally speaking, we agree with the notion that a really cheap stock, with a great balance sheet and growing cash earnings, is all you need to look for. After all, value will out. Inevitably.

But something suggests that we're in a peculiar period when investors need to consider a lot more than mere cheapness. In fact, something suggests this is a highly unusual period when we can't assume anything. History shows that when it comes to markets, don't expect the improbable, expect the impossible. The Nobel laureates at Long Term Capital expected the statistically probable and learned, the hard way, that the law of averages can sometimes throw a mighty curve, the rare event. It's one law that's meant to be broken.

### **Bubble Fallout**

What's causing us to take nothing for granted are the dislocations in the aftermath of what clearly was the greatest financial bubble of history. Not only did valuations get to absurd heights in the mania, but a festering culture of corporate greed encouraged the manipulation of financial reporting in order to overstate earnings and the financial condition of companies. How can value investors recognize value when they're not sure if the reported numbers are reliable? We know that a good investor needs to have a skeptical nature. These days he'd better be from Missouri.

If you can't trust in Arthur Anderson, in whom can you trust? If corporations misrepresent it and auditors sign off on it and regulators allow it and big name analysts at big name firms recommend it, what's an honest value investor to do? If the system is corrupt then we dare not accept what is apparently obvious. Former Wall Street guru, Joe Granville, used to say, "The obvious is often obviously wrong."

What we're being told by the experts is that the recession we just had was barely one at all, 1.2% GDP growth last year. That consumer confidence is at it highest level since August 2001. That unemployment, up to 6%, will stay low. That a strong US dollar policy is a good thing (from US Treasury Secretary, O'Neill). That we're headed for a strong recovery, say, 3.6% this year after a whopping 5.8% Q1. That corporate earnings are bottoming, ready to resume growth "next quarter". That stocks have taken a bashing, but will get back to the bullish stratosphere in the not too distant future.

## **Profits Recession**

Let's get real. Mild recession? Morgan Stanley economist Stephen Roach said recently, "The nearly 20% plunge in S&P operating earnings in 2001 was the worst performance of the entire post-World War II era...(it) occurred in the context of what could have been the shortest and mildest recession of (that) era. It is hard to imagine how businesses would have fared had there actually been a garden variety recession."

Clearly we're in a serious profits recession. Write offs and layoffs continue, companies have lost pricing power and capital spending has plunged as companies adjust to reduced final demand. Fed Chairman himself has suggested that GDP has held up because of inventory replenishment not from any improvement in final sales demand. To be sure, housing has been the bright spot in the economy encouraged by very low mortgage rates. Maybe housing is the next bubble to burst.

In the meantime, the stock market has become a minefield and what were the best, the most reliable, the biggest companies in the world are blowing up. There's a corporate disaster du jour. Bankrupt Enron, Global Crossing and Kmart. Nortel, JDS Uniphase and WorldCom, all down about 95% from their highs. "Widows' and orphans' stocks" like IBM, Lucent, Verizon, Cisco, Nokia, Tyco, Xerox, AOL Time Warner, Oracle, Intel, AT&T, GE and even BCE, all at or near their lows. These used to be what were safe for widows and orphans. These days they're likely what's creating widows and orphans.

WorldCom Q1 profit was down 78% as long-distance sales slid 7.8% and now its ability to service almost \$28 billion in debt is in question. Scary new lows. And AT&T, the biggest long-distance carrier, lost almost \$1 billion in Q1. IBM, Big Blue, a Q1 earnings decline of 31% resulting from the "soft conditions". New lows. Big Blew indeed. AOL Time Warner, a Q1 loss of \$54.2 billion, the biggest quarterly loss ever. And new lows. A further quarterly loss at Nortel and new lows. See what hath John Roth. And at its former parent, BCE, a 2/3 decline in Q1 earnings followed by an \$8 billion writedown of Teleglobe. Jean Monty, exposed. The full Monty. That prompted a good rally as the market celebrated BCE's throwing in the towel. Right. Expect more new lows.

But wait, it's not over yet. 56% of executives plan to cut work forces this year and almost as many plan to cut capital spending. US durable goods orders for March were worse than expected, down 0.5%, and ex defence, down 1.2%. Average hourly earnings are rising. Other costs, especially health care costs, services and energy costs, are rising, all putting further pressure on margins.

## **More to Come**

The profits bloodbath, as we have previously written, is the result of the aftermath of the great stock market bubble. But as it turns out bubbles seem to beget bubbles. So we probably still have a credit bubble, a derivatives bubble, a housing bubble, a consumer spending bubble, a capacity bubble, a US dollar bubble, a US economy bubble and a bubble in the excessive expectations of investors.

Even though US markets are into the third successive year of losses, itself an unusual occurrence, the stock market bubble is not yet sufficiently deflated. Stock markets are well below the peaks of 2 years ago, especially the NASDAQ composite, down more than 60%, yet valuation levels have only recently come down from the stratosphere. Insiders seem to know this, selling recently at a ratio of 4 times their buying.

The real point here also is that investors' expectations are still inflated. Starting from today's valuation levels, investors will need to have lots go right to make much money, and as we see it, there's still lots that can go wrong. As Yogi Berra put it, "Damn it, I know I'm lost, but I'm making good time." There have been other extended periods, such as 1929 to the early 1950s and again 1966 to the early 1980s, where holders of stocks made little or nothing. No less a pundit than Warren Buffett has said he believes total annual stock market returns over the next 10 years likely won't exceed 7%, the long-term growth rate of corporate profits.

### **The Credit Bubble**

What concerns us most for economic recovery is the drag of the credit bubble. Corporations are excessively leveraged even as their ability to service their debt in this profits recession is impaired. Corporate defaults and debt downgrades are at record highs. Only 8 companies in America are left with triple A rated debt. Debt downgrades mean that corporations already struggling with profitability will need to pay more for the debt and if the rating is low enough, availability of credit can become an issue.

The consumer, who accounts for 2/3 of GDP, is up to his eyeballs in debt and spending all his income encouraged by record low interest rates and by house price inflation, a whopping 9%. When returns from equities disappoint, consumers are naturally drawn to safer tangible assets like houses, especially if they're inflating. The Economist magazine has recently noted that the housing market is the one single factor that has saved the world economy from a deep recession. US home-price growth has added \$2 trillion in wealth to household balance sheets, 20% of the \$10 trillion economy. But household debt ratios are at record highs and homeowner equity as a percent of house price is at a record low. If interest rates rise, affordability will be impaired, housing prices will decline depressing consumer wealth, many losing their equity, and homeowners will cut other spending to maintain mortgage commitments. Goodbye housing bubble.

Government debt too is increasing. Lower profits mean lower tax revenues. Income and capital losses may even mean tax refunds from prior periods. This, just as spending is increasing to fight a war on terrorism and to fund higher unemployment benefits (over 517,000 telecom jobs alone have been cut since the beginning of 2001) even as tax cuts to stimulate consumer spending eats into tax revenues. A return to deficits implies a potential for higher rates and less liquidity, both bad for markets, though the great economist, Lord Keynes, would argue government deficits are just the ticket to counter the slowdown. Meanwhile US national debt has just hit its legislated ceiling. And cities and states like New York and New Jersey could be headed for fiscal trouble.

Credit bubbles normally end with debt repudiation. Writedowns. Loan losses like the banks just took for Global Crossing, Enron and Argentina and are now taking for Teleglobe. And we'll bet mortgage and credit card delinquencies will be on the rise and a high rate of personal bankruptcies and foreclosures will get rid of lots more debt at the bankers' expense.

Yet with all these problems and an apparent surfeit of monetary liquidity, the bond market acts lousy and the yield curve is so positively sloped it would seem to be forewarning of a significant recovery or higher inflation, neither of which we're told is in the cards.

Which brings us to the derivatives bubble. These represent tens of trillions of dollars of derivatives, held mostly by banks and large financial institutions consisting mostly of interest rate and currency plays—bets on expected volatility and employing huge leverage. When the yield curve is wonky and lots of creditors are in danger of defaulting and asset prices like houses are questionable and the counter party to your offsetting derivative is questionable, it might not take much of a Long Term Capital type miscalculation to set off a conflagration. This when the yield curve must be encouraging lots of short-term borrowing and long-term lending.

Recently, gimongous US mortgage lender Fannie Mae had to assure investors that 99% of its derivatives are with counter parties with credit ratings of single A or better. Even as Alan Greenspan alerts investors not to rely on the credit of the government to support Fannie Mae derivatives. And JP Morgan Chase bank recently needed a conference call to assuage investor concerns as to its \$24 trillion, yikes, notional derivatives book with net balance sheet exposure of \$71 billion compared to shareholders' equity of \$41 billion.

### **The Dollar's Had It**

The US economy itself, fueled by a crazily overvalued stock market and an overvalued dollar, became, in a sense, a bubble too. The US has made up 20% of the world economy and over the last five years has created 40% of the world's growth. The US represents 56% of market capitalization. Net of US investments overseas, the US owes foreigners about \$2 trillion. That can't continue and it won't. The massive US trade deficit (4.5% of GDP) and current account deficits can't continue either, and the US dollar, another bubble at 16-year highs, is starting to decline. Finally. A good thing for the US economy too. US exporters need a lower dollar to compete. Honda just reported a 69% rise in Q4 profit from strong US demand and a weak yen. Even as Ford struggles. So the US imposes 30% steel tariffs to protect its limping steel industry and the EU is readying its response on steel products, citrus, rice, clothing and footwear. Meanwhile the Europeans and Japanese are trying to stem the rise in their currencies. Currency wars and protectionism. Shades of the '30s.

A lower US dollar will help the profit of US multinationals who will report earnings from foreign operations at better rates. And those kinds of stocks, like Kimberly-Clark, are holding in well.

But while a lower dollar may be good for the US economy and the profits of certain sectors, it is not good for US markets as a whole as the capital flows from foreigners, who recycle the dollars earned from exports back into US stocks and bonds, dry up and reverse.

### **1930s Look-alike**

Even though we know what Peter Lynch and others have said about ignoring the macro forecasts, we also know that studies have shown that if you can pick the direction of the overall market or the right group of stocks, it often has more bearing on performance than the individual stock selected.

In that vein, we've tried to ascertain what period in financial history does the current period most resemble. Some say the late '60s when the overvalued Nifty Fifty blew up. Lorne Graham of our firm thinks 1973-4 when he recalls they took stocks out daily one by one behind the barn and shot them till eventually they got them all. Others think the debt crisis of the mid-90s.

We, however, think this period is reminiscent of the 1930s. A financial bubble in the 1920s, not even as big as the one we just had with an investment led boom, new technology (then radio, now computer and telecom technology), a market crash starting in 1929, trade wars and beggar thy neighbour currency devaluations, and a deflationary depression that lasted some years and took huge government intervention to reverse. Rising unemployment, rising right-wing extremism, rising xenophobia, rising anti-Semitism and rising militarism are frighteningly reminiscent of the '30s. As the great historian, Yogi Berra, said, "It's deja vu all over again."

Don't misunderstand, though there are similarities, we don't think the outcome will be even close to the severity or duration of a 1930s' style downturn, but we think that the effect on the economy and investments could be profound, prolonged and warrant caution.

One money manager we admire believes the outcome will be a deflationary depression, a "Kondratieff winter", after Nikolai Kondratieff, the Russian economist, who in the 1920s predicted long-term 54-year cycles to forecast booms and busts. Another strategist we like looks at the same set of circumstances and forecasts a Weimar-type hyperinflation. Bad money running into good assets and good stocks too. Yogi said, "If you come to a fork in the road, take it." Well, like Yogi, we're not sure which fork will be right, but we are sure there's risk to investors.

Deflation or inflation? There are signs of both, but for which force to take hold of the economy probably depends on the policy responses of governments and central banks. Higher prices could result from rising expectations based on the effects of excessive money printing to revive a moribund economy, a lower US dollar which makes imports more expensive, high oil and gas prices and an upturn in commodity prices after a 20-year bear market. Deflation could be driven by a further slowdown in final demand, global competition, trade and currency wars and continued lack of pricing power.

### **Caution Warranted**

If the potential is there for serious economic dislocation, for a deflationary slowdown, or significantly higher inflation, for trade wars, a declining US dollar, the end of a credit bubble, a derivatives' bubble and a housing bubble, a proliferation of bankruptcies, defaults of sovereign debt, the most positively sloped yield curve in history, and to boot, a war on terrorism and turmoil in the Middle East, it's clearly a time for investors to be ultra cautious.

We pride ourselves on being risk averse, but these days the focus on preservation of capital has got to be paramount. These are the rainy days. Value investors tend to be attracted to controversial stocks because they're likely to be the bargains as other, less astute, investors dump them. But with the ugly macro forces at work today and reported numbers, on their face, may be unreliable, we're going with ultra caution. Where there is smoke, there may be fire.

Our portfolios are defensive. We're seriously overweighted in golds, a winner in any scenario. We own safe dependables like Kimberly-Clark whose earnings will benefit from a dollar decline. Baby bells that get thrown out with the telecom bathwater, like SBC Inc. with mainly a less stressed local phone business, a superior balance sheet and a healthy dividend. We also want to own companies that have little or no debt, lots of cash and growing earnings. Survivors. Maybe even beneficiaries. InterTAN, Cryptologic, Hurricane Hydrocarbons, Pan Ocean, NewAlta, Mosaic and Gemstar-TV Guide. Stocks that are uncorrelated with the market like Goldfarb and SMK Speedy which are in liquidation mode. Some safe high yielding instruments, Hurricane debentures, Hi-Alta convertibles, Acclaim Energy Royalty Trust, Residential Real Estate Units. And if there's nothing to do, we won't be uncomfortable holding cash.

For our long/short accounts, in order to hedge risk, we've sold short overvalued stocks like Nortel, Marvell, Xilinx, Applied Materials, United Airlines, Research In Motion, Broadcom and others to the total extent of about 30%.

We haven't used leverage and we haven't made concentrated bets. We haven't tried to shoot the lights out. But, interestingly, we have. The March quarter was excellent as was the one year ended then, and despite a slow start in the aftermath of the Asian flu of 1998, our track record since we started our business in September 1998 is up there with the best of them.

So we remain bearish; we think the market's going lower and that the economy could weaken. To what extent, we still don't know. But we think this current market capitulation phase should be quick and ugly and be followed by another strong recovery from its very oversold condition. This corrective phase with its inherent market volatility will throw off opportunities, both long and short. We want to capitalize on them but always with an exit strategy. And we have a unique and, we think, spectacular tool in our SVA work to "time" what we do, to pick our spots and our stop loss points.

We don't know when the corrective phase will end. There will be fits and starts and tradeable rallies. Maybe further economic weakness still lurks ahead as rates rise and consumers, especially overmortgaged homeowners, are squeezed. But, ultimately, the correction will end and the economy and business will be the better for it. So will the stock market. There's trillions of dollars of liquidity sitting on the sidelines unsure of where to go. Until then, to be sure, we're keeping one eye on individual stocks, but the other on the overall market in a high-risk economic environment. Lord Keynes said, "The market can stay irrational longer than you can stay solvent."

More importantly, Yogi said, "It ain't over till it's over."

We promise we won't forget either.

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