The Truth is Rarely Pure, and Never Simple

By: Daniel W. Vasquez[i]

In this investment letter:

- **Financial crisis and economic recession**
- **The January barometers**
- **Post-presidential investment outlook and strategy**
- **Profit is opinion, cash is fact**
- **More Keynes, but with a delicate balance**

Financial Crisis, Economic Recession and Market Performance

No need to belabor the point: It was bad.

However, unlike companies: Societies, countries, cultures, cities, neighborhoods do not go out of business. We live to see another day and we all contribute to the economy, to the betterment of our local community and to the world. We owe it to ourselves to remain humble and pragmatic.

That said, in the interest of candor and closure, here are just a few of the notable, if not notorious, low points of 2008:

- -38.5% decline in the SP500 stock index, the steepest annual drop since 1937;
- -47.6% decline in the SP500 global stock index (excluding U.S.);
- $17 trillion: the amount lost in stock markets around the globe (The US economy is $14 trillion);
- 38: the lowest point ever recorded in the Consumer Confidence Index since its inception in 1964;
- 2.4 million: the estimated number of US jobs lost in 2008;
- 32: the number recessions Lehman Brother survived before failing in September 2008.

So here we are. 2009. Is it all over? Will the new administrations save us? Is there light at the end of the tunnel? Some say yes, others no.

The truth is no one really knows. An economic and financial crystal ball does not exist. Oracles, sages, empirically-sophisticated prognosticators with Ph.D.'s in Finance do not know either. Even Warren Buffet does not know.

This is a brave new world. The US will remain the most powerful country, but will not retain the position of self-proclaimed tutor. The entire global financial architecture and apparatus is getting a facelift and upgrade with new rules, regulations and a shot in the arm of new cash liquidity. The patient (global financial system) is on the gurney and receiving a blood transfusion (new cash liquidity), while removing the toxins (distressed assets) from its system. Capitalism is not dead, but it will certainly not look or feel the same in financial markets. It will take time before the global financial players – new and old – adjust to this new, emerging global environment.

Although we've been living on thirty years of borrowed money and borrowed time and the piper has finally arrived to get paid, there are promising signs. Good will surface from this chapter in economic and financial history: I am certain of it. What good might you ask?

A restoration of frugality, humility and pragmatism is in the offing. There is preliminary empirical and anecdotal evidence of a rise in American savings, which is long overdue; while other countries, like China, are developing their middle class with consumers spending from their savings glut. The U.S. government is not repeating past mistakes and has used all its available tools and measures to flood the market with much needed capital from its relevant agencies: the US Treasury, the Federal Reserve System, and Congress. Global governments and central banks have followed suit, to the chagrin of some (Germany). Sure inflationary threats abound; but the risks of inaction and lack of capital are far greater.

Indeed, global financial markets will surely recover before the US and global economy does.

The January Barometers

To be sure, let's look at the January barometers: 1) first five days and 2) monthly performance. January's first five days of trading is usually an early warning system for the remainder of the year, a canary in the coal mine, if you will. The first five days of stock market performance will give a reasonable indication of how the stock market will perform in 2009. Financial history, for example, has demonstrated that:

- From 1896 to the present when the Dow Jones Industrial Average (DJIA) rose over the first five trading sessions, the year ended higher 68% of the time.
- Conversely, when the DJIA declined over the first five trading sessions, the year ended lower 42% of the time.
- In the last 36 years of up first five days, there were 31 episodes (years) of full-year gains in the DJIA for an 86.1% accuracy ratio and an average 13.7% annual gain across all 36 years.
- Today (January 8, 2009), the fifth trading day of 2009, the SP500 closed at 910. Relative to 2008's close (903), today's close (910) suggests that in 2009 the stock market will be bullish and end the year on an upward trajectory.

Stock market performance for the entire month of January also gives us an even more accurate gauge through 2009. The monthly January barometer states that as the SP500 goes in January 2009, so goes the year. The monthly indicator registered only five major errors since 1950 for a 91.4% accuracy ratio, better than the 86.1% accuracy ratio for the first five days of January barometer.

Investment hint: Watch January's SP500 close (on Friday, January 30, 2009) closely and compare it to the December 31, 2008 close, 903. If the January 2009 close is higher (or lower) than the December 2008 close, then the year will most likely close higher (or lower). You have a 91% chance of accurately gauging where the stock market will end on December 31, 2009: either up or down from 2008. How much above or how much below is another matter.

While this recession is shaping up to be the first synchronized global recession since World War II, we're likely to experience a deep and an extended one, possibly even beyond those of 1973-75 and the early 1980s. But the aggressive economic stimulus action out of Washington will likely mitigate the risk of something dramatically worse. It may be drawn out but not as deep as it could have been.

Seemingly, the markets have already priced in the possibility of a deep and long recession. There is historical precedence for a rally in the market following the sharp declines experienced in 2008. Through the end of November 2008, we experienced a very rare event – a Black Swan, if you will – with the SP500 down 30% in three straight months of declines.

Since the inception of the stock market, there were only five prior cases when returns were this severe: four during the Great Depression and the 1987crash.

However, meaningful rebounds have typically followed such sharp and deep drops. For example, when the SP500 suffers a loss of greater than 30% in a three-month period, the market bounces back on average:

- 39.9% in 3 months;
- 23.3% in 6 months;
- 16.6% in 9 months;
- 54.9% in 12 months;
- 51% in 18 months;
- 48.4% in 24 months.

While fear and panic in the markets have finally begun to subside, economic and financial history rewards those with the fortitude to invest and rebalance their portfolio tactical allocations now.

Post-Presidential Investment Outlook and Strategy

Typically after a President wins the election the first two years are spent pushing through as much policy as possible. Frequently the market, economy and country experience bear markets, recessions and war. Conversely, as presidents and their parties get anxious about holding on to power, they begin to prime the pump in the third year, fostering bull markets, prosperity and peace.

Annual stock market performance in post-election years (in this case, 2009) tends to fare worst under Republicans than under Democrats. Going back to 1953, there have been 14 presidential administrations:

- The average annual decline in the DJIA under Republican administrations (9 since 1953): -1.2%;
- Under new Democratic administrations (5 since 1953), the DJIA increased an average: +9.7%.

What can we expect in 2009? Usually markets turn favorable before the economy does. It is expected that fiscal stimulus and TARP/TALF monies will not filter through the economy for a minimum of six months, maximum nine to twelve months. Once the economy shows promising signs, growth in earnings and profit margins expand on corporate balance sheets and income statements. As a result, renewed interest in creating new jobs, investing in new equipment and technology triggers the demand for labor and capital across companies and the economy. Competitive companies are then off to the races of global competition with renewed exports of world class products and services. The country pulls itself out of a recession and unlocks its entrepreneurial spirit, fostering new businesses to form. Faith is restored and fiscal stimulus worked. Such are the near ironclad laws of business economics; unfortunately, they take time. At best, we will see this play out beginning summer 2009; at worst, beginning 2010.

So where does one park their money today for when the laws of business economics catch up to our financial expectations and investment desires?

During times of economic duress, certain sectors tend to outperform. EDM clients and investors should consider:

- Defensive sectors, such as health care and consumer staples, that help mitigate extreme economic uncertainty and for the more aggressive investor, industrials offer unique opportunities for rewards.
- Alternative energy and emerging green businesses offer promising investment prospects but have yet to prove worthy of long-term value creation or market success. While sexy, investors should beware of branding schemes to traditional business lines that genuinely are neither alternative nor green in spirit or practice.

- EDM clients and investors may want to consider investments in the following health care, consumer staples, and industrial sector companies when share prices are attractive relative to intrinsic value: Amgen (AMGN), Bristol-Myers Squibb (BMY), Forest Laboratories (FRX), Clorox (CLX), Kroger (KR), Proctor & Gamble (PG), Oshkosh (OSK), Dover (DOV), and EMCOR Group (EME).

More importantly, EDM clients and investors should maintain disciplined, value-based investment principles:

1. Companies with strong dividend and dividend growth policies
2. Attractive pricing relative to company intrinsic value
3. Impressive free cash flow, earnings growth and, more importantly,
4. Strong balance sheets with very little or no debt.

Profit is Opinion, Cash is Fact

Financial engineering and innovation over the past twenty years has given us many advances, tools, statistical methods to mitigate systematic market risk. Improvements have been made and new asset classes, investment strategies and market opportunities have arisen as a result; thusly greatly expanding the global financial pie.

However, financial alchemy has also given us unregulated "shadow" banking systems, derivatives and credit default swaps as "financial weapons of mass destruction," dubious pro forma company valuations, off-shore accounting removed from real company financial statements (think: Enron), value-at-risk models: all used to materially (synthetically?) improve paper profit margins, not real company profit margins. As any good securities analyst worth their salt will tell you, one can easily manipulate quarterly numbers to massage profit margins. This practice is called managing quarterly earnings, not creating and sustaining real, intrinsic, long-term company value: the real drivers of rising share prices over time. Cash, however, is in-maneuverable by financial alchemy. Profit is opinion (possibly poetry), cash is fact.

Companies with little debt, decent earnings growth, healthy (real) profit margins and free cash flow to spare, could offer comfort and upside to EDM clients and investors during this period of economic turmoil. The following companies hold less than 10% long-term debt as a percentage of their total capital.

- EDM clients and investors may want to consider investments in the following companies when share prices are attractive relative to intrinsic value: Accenture (ACN), Applied Materials (AMAT), Automatic Data (ADP), CME Group (CME), Intel (INTC), Microsoft (MSFT), Stryker (SYK) and T. Rowe Price (TROW).

- Some, like Automatic Data (ADP) and Intel (INTC), also offer attractive dividend yields, complementing their strong balance sheets. (See: previous November 2008 letter for the virtue of value and dividend-based investing)

More Keynes, But With a Delicate Balance

Like all prophets, Keynes offered ambiguous lessons to his followers. Few still believe in the fiscal fine-tuning that his disciples propounded in the decades after World War II. But nobody believes in the monetary targeting proposed by his celebrated intellectual adversary, Milton Friedman, either – or his modern day bishop, Ben Bernanke.

In the 1930s, two opposing ideological visions were on offer: the Austrian and the socialist. The Austrians – Ludwig von Mises and Friedrich von Hayek (the intellectual Godfathers of Free Market Fundamentalism) – argued that a purging of the excesses of the totalitarian regimes of the 1920s was required. Socialists argued that socialism needed to replace failed capitalism, outright. These views were grounded in alternative secular religions: the former in the view that individual self-seeking behavior guaranteed a stable economic order; the latter in the idea that the identical motivation could lead only to exploitation, instability and crisis. Indeed, there is a wide gap between self-interest and greed.

Keynes's genius was to insist we should approach an economic system not as a morality play but as a technical challenge. He wished to preserve a market economy, without believing that free-market fundamentalism makes everything for the best in the best of all possible worlds.

This same moralistic debate is with us, once again. Contemporary "liquidationists" insist that a collapse would lead to rebirth of a purified, fundamentalist free-market economy. Their leftwing opponents argue that the era of markets is over. Both are wrong. (And even I wish to see the punishment of financial alchemists who claimed that ever more debt turns economic lead into gold.)

Yet Keynes would have insisted that such approaches are foolish. Markets are neither infallible nor dispensable. But they can also go seriously awry and so must be managed with care. The election of Mr. Obama surely reflects a desire for just such pragmatism. So the task for this new administration is to lead the US and the world towards a pragmatic resolution of the global economic crisis we all now confront.

The urgent task is to return the world economy to health and gently remove the patient from the gurney. The shorter-term challenge is to sustain aggregate demand and keep the blood transfusion flowing, as Keynes would have recommended. The longer-term challenge is to force a rebalancing of global demand. Deficit countries, like the US, cannot be expected to spend their way into bankruptcy, while surplus countries, like China, condemn as profligacy the spending from which their exporters benefit so much. In the necessary attempt to reconstruct the global economic order, on which the new administration must focus, this will be a central issue.

No less pragmatic must be the attempt to construct a new system of global financial regulation and an approach to monetary policy that curbs excess credit booms and asset bubbles. New umpires, new referees are in order. No permanent answer exists. But recognition of the systemic frailty of a complex financial system would be a good start.

As was the case in the 1930s, we also have a choice: it is to deal with these challenges co-operatively and pragmatically or let ideological dogma and selfishness obstruct us.

The objective is also clear: to preserve an open and at least reasonably stable world economy that offers opportunity to as much of humanity as possible. We have done a disturbingly poor job of this in recent years. We must do better. We can do so, provided we approach the task in a spirit of humility and pragmatism, shorn of ideological dogma.

I am almost certain Mr. Obama and Mr. Keynes would have gotten this delicate balance right in planning a future trajectory in these uncertain times.

As Oscar Wilde might have said, in economics, the truth is rarely pure and never simple. That is, for me, the biggest lesson of this crisis.

Next investor letter: Special Report on Global Economies of Color

For more information, contact EDM Investments at (510) 836-0260 or www.edmcapitalpartners.com.

[i] Mr. Daniel W. Vasquez is Founder, Managing Economist and Chief Investment Strategist of EDM Investments (www.edmcapitalpartners.com). Mr. Vasquez has over a decade of investment experience with Hamilton Lane Advisors (Private Equity/Venture Capital), Morgan Stanley (Global Wealth Management) and JP Morgan (Public Finance). As a Harvard Business School researcher, he worked with the California State Treasurer in creating The California Initiative – a CalPERS-sponsored $1 billion private equity investment vehicle deploying capital in California's underserved emerging domestic market ("EDMs"). While at Harvard, Mr. Vasquez was the lead researcher to identify and define inner city economies across America for the Initiative for a Competitive Inner City in Boston and the US Department of Commerce. He was also an economic researcher at The Conference Board, where he worked on the Consumer Confidence Index and the Leading Economic Indicators. Mr. Vasquez began his career as a Legislative Aide in the United States Senate, where he worked on banking, civil rights, environmental, immigration, trade and economic policy for a California Senator. He has published academic monographs in the areas of business and economic competitiveness of ethnic markets and corporate strategy. Mr. Vasquez is a licensed Registered Investment Advisor, General Securities Representative, and Managed Futures Funds Representative. He is on the Board of Directors of the Canal Alliance in San Rafael, Centro Legal de la Raza in Oakland, and the Wall Street Wizards. He is a member of the National Association of Business Economics and the National Association of Securities Professionals. A trained Economist, he was educated at UC Berkeley, Princeton, Chicago, and Harvard universities.