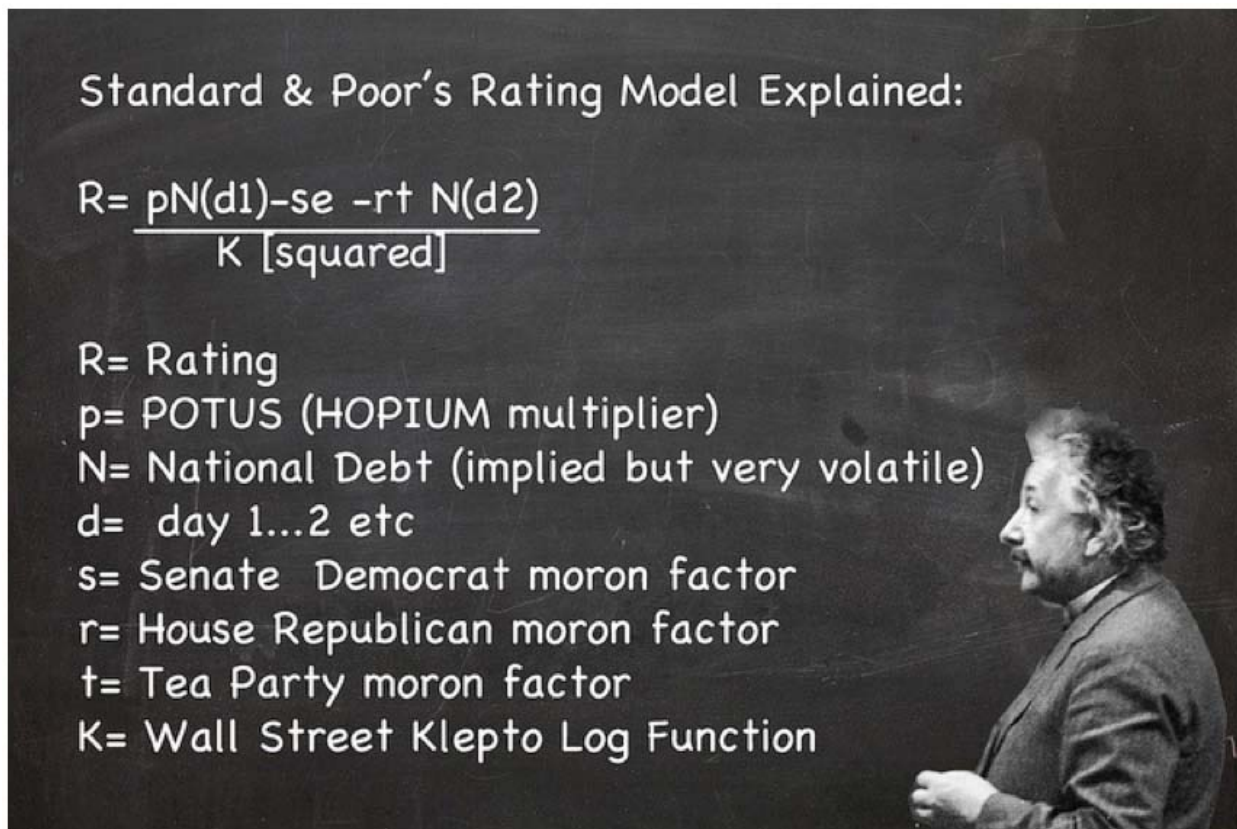




A Q&A About Our Market Confusion

Here's an amusing graphic that sums up, perhaps in exaggerated form, how some people view the mathematics behind the recent U.S. Treasury bond debt downgrade.



Normally, the very last thing we would want to do is call your attention to daily market movements, because all of the worst investment decisions are made with a short-term focus, and yet we can't leave last week's volatility unaddressed.

As you no doubt heard in the media echo chamber, the U.S. markets were up and down, dramatically, on a daily basis last week. By the end of the week, the S&P 500 index was down -1.64% for the week, and down -10.11% for the four weeks ending 08/12/11.

What does this mean? Here are some good questions that you may be asking yourself, and the best answers we can provide at the moment.

Why the wild swings? What was different, for example, about last Tuesday (when the stock market was dramatically up) from last Monday (when the market was dramatically down)?

Very little from the standpoint of fundamentals. The economy is no stronger or weaker from one day to the next, corporate profits didn't make any radical adjustments, and the underlying worth of the business enterprises and debt obligations that you own have been pretty much the same throughout these Summer doldrums.

The main difference can be found in investor emotion, which is not predictable by any measure that we've been able to find. The Federal Reserve Board gave the optimists something to cheer about when it announced that it would maintain low rates -- which tend to stimulate the economy by encouraging banks to lend and companies to borrow (and build factories, and hire workers) -- through mid-2013. That means that even though the federal government's expenditures won't be stimulating the economy during this time of highly-partisan belt-tightening negotiations, at least higher interest rates won't slam the economy into recession.

What about the ratings downgrade? Won't that hurt the economy and the markets?

Over the last week, economists and veteran market watchers have been mocking the Standard & Poors rating agency. The kindest things they are saying is that the other rating agencies -- Moodys and Fitch -- have continued to give U.S. Treasury debt their highest safety ratings. Warren Buffet recently came out with a statement that U.S. government debt is the safest on the planet, and should be given a AAAA rating (which doesn't exist), rather than a downgrade.

Those who are less kind are pointing out that the downgrade came from the same Standard & Poors that rated boatloads of subprime debt as 'AAA', fueling the fire that resulted in the 2008 financial crisis. During that same period, it raised the credit rating of Bear Stearns an astounding 5 notches to AA- in March of 2008 -- the same month that the brokerage firm declared bankruptcy. Lehman Brothers, as a company, held an S&P rating of 'A' the week they went under, and the rating agency reaffirmed its 'AAA' rating on some of the company's securities just three days before it filed for bankruptcy and basically defaulted on everything. It made similar mistakes with Merrill Lynch and Morgan Stanley (rated A and A+ respectively the week they had to be bailed out), and completely missed the problems with the Republic of Iceland.

Meanwhile, despite the downgrade, the prices of Treasury securities surged, sending the 10-year yield to an all-time low of 2.03% before it settled at 2.24% at the end of the week. Sophisticated investors around the world seem not to be worried that the U.S. will default on its debts.

Is this a good time to sell? Or to buy?

Some economists are saying that the market was oversold last week -- which means that stocks, in general, were selling at a discount to their true value. But we aren't as confident that we know the true value of stocks in an uncertain economy, and it seems clear that emotions are ruling the recent market moves. It is possible that the emotions will take the markets further down, and it seems equally possible that the optimism we saw on certain trading days will continue.

It is worth remembering that in the first half of last year the market experienced a 17% decline (which was greater than the current downturn), and yet finished the year ahead by double-digits.

The point for real investors (as opposed to gamblers in the investment marketplace) is that stocks are now attractively priced relative to bond yields, which is almost always a better time to buy than to sell. There seems to be no purely economic reason for the selloff -- after all, corporate profits are still high, the U.S. economy is recovering (albeit slower than some of us would like), and consumer balance sheets are greatly improved over three years ago.

What should I do about these uncertain markets?

We recommend that you not make any dramatic moves. Your account statements are reflecting the recent drop in market value, but this is a "paper loss" only. If you were to sell right now, you would be locking in a real loss. As we have discussed in the past, investing is a long-term process, and generally full of unpredictability and surprises. If you look back three years ago, the Dow had dropped to around 6,000. At the end of the day last Friday, August 12th, it was at 11,269 -- almost double the low of a few years ago. Think back to all the scary headlines about double-dip recessions, sovereign debt crises in Europe, unemployment and all the rest, and you realize that the headlines were telling you to sell when it was much more profitable to hang on.

Is this time different?

Probably not. This appears to be a classic emotion-driven downturn, made worse by a breathless media that always seems to amplify the mood of the moment. History has shown that these times of panic are dangerous to long-term returns; they are fundamentally an urgent invitation to sell at a market bottom to somebody with a clearer head and stronger nerves.

-- Bob Veres. Posted 08/15/11.