

Aliens meet the markets

US markets hit lows not seen in over a decade

March 6, 2009 – Speaking at a conference at George Washington University last April, world-renowned physicist Stephen Hawking said that alien life forms certainly exist, though not necessarily as we might imagine them. Because primitive life is very common and intelligent life fairly rare, any alien life we might run across in our explorations is likely to be of the former variety. But he also added that alien DNA will be quite different from our own. “Watch out if you would meet an alien. You could be infected with a disease with which you have no resistance,” he said.

Writing almost a year later in the 2008 edition of his annual letter to shareholders, Warren Buffett, the famed CEO of investment holding company Berkshire Hathaway Inc., said much the same thing about the collapse of the US mortgage market, which precipitated the global credit crisis and ushered in the recession:

“Indeed, the stupefying losses in mortgage-related securities came in large part because of flawed, history-based models used by salesmen, rating agencies and investors. These parties looked at loss experience over periods when home prices rose only moderately and speculation in houses was negligible. They then made this experience a yardstick for evaluating future losses. They blissfully ignored the fact that house prices had recently skyrocketed, loan practices had deteriorated and many buyers had opted for houses they couldn’t afford. In short, universe “past” and universe “current” had very different characteristics. But lenders, government and media largely failed to recognize this all-important fact.

“Investors should be skeptical of history-based models. Constructed by a nerdy-sounding priesthood using esoteric terms such as beta, gamma, sigma and the like, these models tend to look impressive. Too often, though, investors forget to examine the assumptions behind the symbols. Our advice: Beware of geeks bearing formulas.”

He might have added that if you don't, you could be infected with a disease against which you have no resistance. Because that's precisely what has happened. And we didn't have to travel to strange new worlds to find it.

Berkshire Hathaway itself fell victim to the infection, as Mr. Buffett freely admits, owing primarily to some "dumb" things he said he did in 2008, including an ill-advised investment in oil company ConocoPhillips and in two Irish banks. As a result, Berkshire's net income, while still a positive \$4.99 billion (US\$3,224 per share) in 2008, was down 62% from the US\$13.21 billion (US\$8,548) it made in 2007.

Per share book value declined 9.6% in 2008, only the second such decline in the company's history since Buffett took over in 1965.

Berkshire, of course, isn't the only one suffering. And it's far, far from being the worst. Name just about any big US financial company, and you'll want to go and see one of the recent crop of teen slasher horror flicks just for a little levity. American International Group Inc. (AIG), for example, posted the biggest quarterly corporate loss in US *history* as it announced it lost US\$61.7 billion in the fourth quarter of 2008. The US government promptly threw even more good money after bad and extended another US\$30 billion in aid to AIG. The company reportedly has US\$1 trillion in worldwide assets on its balance sheet, and US taxpayers are continually assured that any failure to continue to prop up the zombie company would have untold catastrophic consequences for life on this and every other planet – and perhaps even for some primitive alien life forms currently residing in the US Congress.

AIG seems to have been the nerve centre for those geek-driven financial models, complex derivatives and financial instruments it developed to spread the risk of US mortgages far and wide around the globe. To American politicians, it's not so much the derivatives that have metastasized around the world that are cause for concern; rather, it's the millions of insurance policies, annuities, mutual funds, and pensions held for ordinary Americans that present the biggest problem. Democrats are worried. Who wouldn't be? Fail those millions of Americans, and you may as well kiss your Congressional majorities good-bye in two years' time, followed closely into oblivion by what would very quickly have become the worst single-term presidency since Warren Harding. No, AIG will not fail. It will become a vote-delivering agency of the US government, like, say, Fannie Mae and Freddie Mac.

Though the Canadian government isn't as hell-bent on socializing the entire economy as the current U.S. administration seems to be, that's not to say it couldn't or wouldn't given the same trying circumstances. Canada's gross domestic product shrank at an annual rate of 3.4% in the final quarter of 2008, as exports fell for the sixth straight quarter and household spending contracted 0.8%. With inflation nearly invisible, the Bank of Canada responded by lopping another 50 basis points off its benchmark lending rate, dropping it to 0.5%, and embarking on a program of "quantitative easing" (buying corporate assets directly, with big stacks of freshly printed money hot off the presses).

The grim data come as the government prepares to roll out a \$40 billion, two-year stimulus package, which is already being viewed – mostly by would-be recipients of the stimulus, such as the US-based auto industry and its symbiotic unions – as being too small.

In the US, fourth-quarter GDP shrank at a 6.2% annual rate, while February unemployment soared to 8.1%, as another 651,000 jobs disappeared. US productivity resumed its downward march, falling at an 8.7% annual rate in the fourth quarter. And the ISM Purchasing Managers Index remained anchored at 35.8 in February.

Over in Europe, manufacturing activity had its worst month in 10 years, as the eurozone's Purchasing Managers Index fell to 33.5 in February, with the UK and other non-euro countries posting similar dismal activity. Fourth-quarter eurozone GDP contracted a 1.5%, or an annualized 6%, rate, the worst on record. The European Central Bank cut its key lending rate to 1.5%. The Bank of England cut its rate to a record low 0.5%, and implemented its own program of quantitative easing.

If you believe that all this incipient nationalization of heretofore private assets is creating two classes of citizens, you're absolutely right. Warren Buffett makes no bones about it in his annual letter. He argues that "highly-rated companies, such as Berkshire, are experiencing borrowing costs that, in relation to Treasury rates, are at record levels.

"This unprecedented 'spread' in the cost of money makes it unprofitable for any lender who doesn't enjoy government-guaranteed funds to go up against those with a favored status. Government is determining the "haves" and "have-nots." That is why companies are rushing to convert to bank holding companies, not a course feasible for Berkshire.

"Though Berkshire's credit is pristine – we are one of only seven AAA corporations in the country – our cost of borrowing is now *far* higher than competitors with shaky balance sheets but government backing. At the moment, it is much better to be a financial cripple with a government guarantee than a Gibraltar without one."

Of all the risks, pitfalls, and moral hazards lurking out there in these unusual times that could affect market valuations, the politicization of large parts of the private sphere (especially in the financial sector) is the most dangerous, simply because it creates a dichotomy of haves and have-nots, distorting all valuations as a result. This alone could delay, dampen, or suppress any stock market recovery for long after one would reasonably be expected in advance of an economic turnaround.

Last week's onslaught of bad economic news in the US and around the world triggered another massive fight or flight response from investors, who chose to flee, inundating their brokers with sell orders. Stock market indexes plummeted to new lows, as the Dow

Jones Industrial Average slid right through the 7,000 level, to a low of 6,594 last week. It hasn't visited that neighborhood since April 1997. The DJIA lost 6.2% week over week, for its fourth consecutive weekly loss. The Dow Industrials are down 53% from their October 2007 high.

The S&P 500 Composite Index dipped to a 52-week low of 666 on Friday, and it hasn't seen the number of that beast since 1996, when former Federal Reserve Board Governor Alan Greenspan worried about "irrational exuberance." The S&P 500 lost 7% since the previous Friday's close. It's down an eye-popping 56% since its October 2007 high.

A small show of strength in the energy and base metals sectors was not enough to overcome the black hole pull of financials, as the S&P/TSX Composite Index fell 6.5% on the week. Toronto's benchmark index is now down 50% from last June's record high.

At this stage of a bear market, it's exceedingly difficult to say whether markets are "fairly" valued. With earnings forecasts dropping and price-earnings ratios for major indexes like the S&P 500 well below trend by some measures, the point of maximum pessimism might well be around here somewhere. But it's a moving target, with pervasive and substantial downside risk, because that alien DNA is still infecting the markets. ■

Please [click here](#) to visit our website for more timely information on the markets, financial planning, and new products from R.N. Croft Financial Group Inc.