**Fall 2009** **VOLUME 15:3**

# PDV *OBSERVATIONS*

A Quarterly Newsletter for PDV Clients and Friends

## Is the Market Recovery Sustainable?

By Che H. Lee
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To my recollection, never has such a strong market rebound that occurred over the past several months been greeted with as much widespread disbelief, frustration and regret. Since bottoming in March, the market has experienced one of the strongest and swiftest recoveries ever. Yet, the overwhelming sentiment is that the rebound is both unsustainable and unjustified. The masses who sold out during the meltdown phase have sat out this entire sharp rise (evidence of this is discussed below). This adds insult to injury to the herd of investors who sold near or at the bottom only to see the market experience one of the strongest rebounds ever without them. Psychologists would have a field day analyzing the degree and nature of regret prevalent among these people.

One article after another are only too eager to come up with reasons why the market is going back down. We are all familiar with the litany of problems, if only because the media loves to remind us day after day. Many of these are legitimate concerns: high unemployment; huge account and budget deficits; moribund commercial real estate markets; and political gridlock. Much has been written about these issues, so I will not go into them any more in this article, other than to say they surely do present headwinds. But, you should remember that markets discount the future. Markets have historically rebounded in the midst of recessions, high unemployment and negative news. Therefore, the existence of these conditions does not *per se* militate against the market's rise, or prove that the market is destined to come back down.

I will offer a few reasons why the market recovery may in fact be sustainable, contrary to widespread prediction otherwise. The first reason is based on psychology. It is entirely predictable that people don't want to re-engage in an activity that hurt them. The more recent the pain, the more severe the aversion. Cognitive psychologists call this "recency bias." With the sting so fresh in the minds of those who sold out during the market meltdown, these investors are naturally gun-shy about returning to equities.

Indeed, so much selling occurred during the market meltdown that the cash parked on the sidelines in March was at astronomical levels. According to FactSet Research Systems and Investment Company Institute, the ratio of U.S. money market fund assets (a good proxy for cash on the sidelines) to the S&P 500 market value averaged about 18% between 1980 and 2008. At the market bottom in March, that ratio had ballooned to an unprecedented 65%! This was actually bullish for the stock market going forward, because the cash represented dry powder that served as potential future demand for stocks. It is no coincidence that the market started taking off as the ratio began dropping, with the cash going into stocks and other risk assets. Even with the cash being deployed and the market rebounding strongly since March, the current ratio continues to be much higher than the historical average; in fact, it is around the same ratio as that existed in late 2002 ***before a huge bull market began***. Let me hammer this point home. After the huge run in the past few months, the level of cash sitting on the sidelines (reduced since March) as a percentage of stock market value (much higher since March) is *still* only back to the same

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level that existed *before* a huge bull market began in late 2002. This is especially significant if you consider most of the cash that has come off the sidelines has gone into bonds, not stocks. It is reasonable to expect at least some of this will eventually find its way back into stocks, potentially providing the foundation for another leg up for the stock market.

This is all psychologically very predictable, as human nature does not change. Investors hiding in cash eventually get tired of earning no returns, since short-term rates have been near zero for months. They start taking "baby steps" out on the risk spectrum, by reaching for the next safest asset class, which happens to be short-term, creditworthy bonds. Following this would be non-investment grade bonds, and then equities. Empirically, this has been completely borne out in the past few months.

According to Barron's, a record $327 billion came out of money market funds between March 11, 2009 and the end of August, with the outflow continuing. But the asset classes soaking up this cash have been truly telling. Per Morningstar, the vast majority (perhaps as much as 90%) of each dollar of cash that has returned to the financial markets has been invested in a variety of bonds, with only the remainder going into equities. This shows that most people who sold stocks during the meltdown have not re-engaged with the stock market. No wonder they feel confused and frustrated. To believe in the sustainability of the stock market rebound would require that they confront their grave sense of regret of having sold near or at the bottom and then missing the ensuing historic rebound. This is too much for human nature to admit.

Part of the reason why this market keeps climbing is because there are still so many who are not adequately invested in equities, and therefore each rise produces another round of regret. Slowly, but surely, more investors are buying equities, as people increasingly cannot stand being left out of the rebound.

Second, part of the disbelief in the market rebound is due to the magnitude and speed of the recovery. But is this a good enough reason by itself to doubt the sustainability of the rebound? We can only answer this question by asking rebound from *what?* In other words, was it completely justified that the market should have dropped as much as it did during the market meltdown? While there is no question that our financial system was gravely threatened last year and our economy took a very serious hit, the indiscriminate and heavy selling of all stocks, including some of the highest quality companies, suggests that the drop to the March bottom was in fact overdone. Though part of the drop was justified by deteriorating fundamentals, it appears some of the drop was due to de-leveraging, forced liquidation, panic etc. If the market should not have dropped so much during the meltdown, then part of the rebound only corrects what was irrational, with the rest possibly justified by fundamentals.

Third, corporate America understandably panicked along with individual investors, cutting costs heavily during the fourth quarter of 2008 and first quarter of 2009, when business and the economy came to a virtual standstill. Along with this, they also raised cash, de-leveraged and drastically cut their capital expenditures. We are about to lap the anniversary of when the world came to a grinding halt. Comparisons with business conditions a year ago will prove salutary as many companies find it relatively easy to show year-over-year growth compared to the state of Armageddon last year. It would not be a surprise to see corporate America generally reporting higher-than-expected profits in the coming months. It is well known that the stock market is a discounting mechanism, moving ahead of economic developments. While we will not know for certain until after the fact, it is quite reasonable and plausible to think that part of the market rebound is justifiably discounting this imminent improvement in profits, as we lap the anniversary of Lehman's bankruptcy and the subsequent falling dominos all over the world. In fact, the ratio of positive to negative earnings surprises has been running above average for the past quarter.

So, despite all the legitimate concerns about our economy and the sustainability of the market rebound, it would be advisable not to dismiss too quickly the possibility that this market recovery will stick.

# Dollar Devaluation

By Louisa Ho, *Portfolio Analyst*
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You cannot open a newspaper, surf the Net or watch television without coming across commentators and economists expressing concern about a sharp fall in the value of the U.S. dollar. Should you be worried?

Our ballooning national debt is widely cited as one of the most damaging factors to the U.S. dollar. Related to this is our serious budget deficit problem. With reduced tax receipts and ever-growing spending, the U.S. budget deficit is projected to be $1.58 trillion for 2009, which equals about 11.2% of our gross domestic product (the highest level since 1945). Since government spending will keep surging on account of the current political and economic climate, it is not difficult to picture both the deficit and national debt staying at elevated levels for years to come.

To fund deficit spending and keep interest costs down, the U.S. depends heavily on the willingness of other countries to buy and hold U.S. Treasury securities. This reliance on foreigners becomes more pronounced as our government continues to spend more than it takes in. As with any fiscally irresponsible debtor, foreign (and domestic) creditors will increasingly demand higher rates for lending or perhaps drastically cut back on lending at some point. Many are therefore justifiably worried that the time will come when our foreign creditors will stop obliging us. Over time, less demand for U.S. Treasuries will devalue our currency and raise interest rates, resulting in a whole host of political and economic problems.

China represents one of our most important foreign creditors, whose long-term demand for U.S. Treasuries critically impacts our currency and level of interest rates. Over the past several years, our currency has periodically sold off every time China publicly voiced its concerns about soaring U.S. spending, huge budget deficits, and the potential for higher inflation down the road. The prospect of China potentially dumping Treasuries en masse seriously undermines confidence in the U.S. dollar.

However, you should not accept without challenge the simplistic connections drawn by the media, commentators, and economists who espouse their sound-bites for 30 seconds of fame***. The reality is that the strength of our currency depends on a number of complicated and interconnected factors***. It is easy to draw *linear, one-dimensional* conclusions, when the media focuses on just one or a few of these factors. With so many factors in play, the relative weight of each factor undeterminable, and a change in one or more of these factors disturbing the equilibrium of all the factors as a group, the above legitimate concerns do not inevitably lead to a significantly weaker U.S. dollar. Here are a few reasons why.

First, currencies must be viewed in relative rather than absolute terms. The concept of a strong or weak U.S. dollar only has meaning *relative to some other currency*. This means the strength of the U.S. dollar depends on how our economic growth rates, political stability, level of interest rates, rule of law, trade flows etc., compare with the same conditions prevailing in other countries.

Let's start by considering the state of the U.S. economy relative to that of our primary trading partners. The U.S. is certainly facing many economic challenges, but so is the rest of the world. We are not alone in elevated spending. As wounded as our economy is right now, many other countries are in worse shape. Perhaps this is why the U.S. dollar, while falling around 13% since March against a basket of seven currencies, is still relatively higher than before the most recent spurt of overspending began. What is also rarely mentioned is the fact that the U.S. dollar had experienced a multi-month robust run up to March.

As for China's threat to dump U.S. Treasuries, you should recognize that a significantly devalued U.S. dollar is not in China's best interest. If China sells a substantial amount of Treasuries, it would decimate the value of its remaining holdings. It is widely believed that about 70% of China's $2+ trillion foreign currency reserves are currently held in dollar-denominated assets. At the same time, notwithstanding the success of its stimulus plan for improving the domestic economy, China remains an export-driven economy and continues to rely heavily on exports to the U.S and other major economies. Significantly devaluing the U.S. dollar would raise the price of China goods in dollar terms and hurt their demand. The reality is that the two economies are deeply interconnected, and China cannot dump U.S. Treasuries without seriously harming its own economy. For the foreseeable future, there is just no acceptable substitute to the U.S. dollar as the primary reserve currency.

China's attack from time to time on the U.S. dollar smells of political rhetoric. This may indeed be a case of action speaking more loudly than words. Empirically, China's holding of U.S. Treasuries has continued growing, with its purchases little changed in recent months. According to the most recent data from the U.S. Department of Treasury, China bought a net $15.3 billion of U.S Treasuries in July, increasing its total holdings to about $800 billion. That represents an increase of 52% in a 12-month period, during which time China surpassed Japan as the largest holder of U.S. debt. The fact is that investors are not abandoning our currency in any significant way. China and Japan, our biggest foreign creditors, are still buying U.S. Treasuries. And recent data from the International Monetary Fund show that more than 65% of the world's reserves are still held in U.S. dollar. While undoubtedly the Fed's quantitative easing has played a part in keeping interest rates low, most countries appear to view the U.S. relatively as a safe haven, continuing to buy our Treasuries at historically low yields.

As you can see, there are many offsets that impact the strength of our currency. We have discussed a few of the most significant factors that might mitigate the adverse effects of our growing national debt and budget deficit on the U.S. dollar. Still, if our currency does weaken significantly, you may already be partially hedged, depending on what investments you own. The following are some types of investments that will provide a hedge against a significantly weaker U.S. dollar:

- Stocks of U.S. companies that do substantial business overseas. These companies are likely to report higher profits, since their foreign profits must be translated back into a weakening U.S. dollar, boosting their reported profits in dollar terms. Higher reported profits tend to result in higher prices for these stocks.

- Foreign mutual funds that primarily invest in the stocks of companies based overseas. As explained above, foreign-based companies that denominate their profits in stronger foreign currencies need to have these profits translated back into the weaker U.S. dollar before the mutual funds report their results, boosting asset values and fund distributions. Such investments benefit from a significantly weaker U.S. dollar.

- Treasury Inflation-Protected Securities ("TIPS"). Typically, a significantly weaker U.S. dollar will be accompanied by inflation. TIPS will appreciate if inflation materializes.