DocOnomics
Financial and Investment Insights for the Physician

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Many of you will remember the old Smith Barney ad, "We make money the old fashioned way. We earn it." Contrast that with the US Government's business strategy for the last half-decade, "We make money the easy way. We print it."

Making money is important to all of us. For much of our investing careers, we have been treated to the bright lights of a bull market. Today, we find that the lights in the financial operating room are flickering.

For much of 2008, investing has been an exercise in futility. In particular, the last 90 days have been one of the worst investment periods in memory. Steep losses have been experienced across the entire investment spectrum. During this period, the benchmark Dow has dropped approx 30%. World markets are in shambles. This isn't what we signed up for but we must continue to play the hands that we have been dealt since the markets began to roll over in 2007.

OPERATING UNDER A DARK CLOUD

What has gone wrong?

The feared meltdown of the opaque and gargantuan derivatives chain is in full swing. This officially began in mid-2007 with the collapse of two large hedge funds managed by Bear Stearns. The failures were attributed to a rising wave of defaulting loans to borrowers with substandard credit. Through the years, the unregulated hedge fund industry had partnered with Fannie Mae, Freddie Mac and ratings agencies to create a multi-trillion dollar global investment market for high-yield securities backed by subprime loans. Billions in fees were booked from these worldwide sales efforts.

The derivatives defaults have been spreading like a powerful virus with no known cure. There have been unprecedented casualties on Wall Street and within the banking industry, mortgage industry and insurance industry. But this is not just a US phenomenon. The derivatives virus has traveled around the globe and has wiped out major financial institutions in Europe and Asia and practically bankrupted entire nations. Among those countries now on financial life support are Argentina, Hungary, Greece, Iceland, Pakistan and Ukraine. There are others ready to join the list.

Due to the unregulated nature of the hedge fund industry, large pools of investment capital were formed on average with 3% equity and 97% borrowed funds from Wall Street firms and other non-bank lenders. This was practically the same financing structure that was being offered to non-qualified buyers of real estate, automobiles and durable consumer goods! These hedge funds were loading up and speculating on everything under the sun, e.g., high-yield junk bonds, emerging markets, foreign currencies, oil, gold, etc. When the investment balloons started to pop after the Bear Stearns hedge fund problems, the lenders began to panic and started calling in their loans. This unleashed a crushing wave of forced investment liquidations that is still in progress. Almost nobody has been spared the rod of one of the worst national policy blunders ever, i.e., not regulating lending standards among non-banks and not regulating derivatives trading.

The derivatives virus has mutated in strange and unpredictable ways. Oil prices have collapsed over 60% in less than 6 months. This decline is an order of magnitude that has never been witnessed in such a short period of time. Other commodity prices have followed suit. The US Dollar has strengthened by 20% during the same time frame. This is almost unthinkable given the rapidly spiraling debt and deficit conditions of the US Government and the trillions being created out of thin air to bail out private sector financial firms and the mortgage market. However, panic flights of capital can produce highly irrational trends of unknown durations. In this case, the flight has been into the perceived safety of US Treasuries.

At the beginning of 2008, we saw the smoke billowing in the distance but could not have anticipated the chain reactions and perverse price movements that have occurred. This proves beyond a doubt that we are in uncharted waters. The investment losses that we all have sustained from the 2007 peaks are testimony to the near complete dysfunction in the global financial markets. We have never experienced anything like this in our lifetimes. We are in the midst of the proverbial 100-year financial flood and we are left to wonder on a daily basis if the governments of the world can produce enough sandbags to contain the cresting waters.

What will happen next?

Simply, we do not know. This is the most basic notion of risk. If we admit that we are not smart enough or connected enough to know what will happen next, we must be prepared for a variety of possible outcomes. In times like these, it pays to be neither an optimist nor a pessimist. It is best to be a realist. Believe what you see with your own eyes, not what you see in official print.

Today, we have few clues as to what large-scale moves will be made by our new President and how long they will take to produce results. In November 1932, the American public elected Franklin D. Roosevelt and never could have foreseen the extreme actions that his Administration would be forced to take from 1933-36 not to mention the long-term consequences of those actions.

Since we must be prepared for a variety of possible outcomes, let us draw your attention to two potential scenarios that we must incorporate into our analysis and planning.

The first scenario is an announcement in 2010-11 that we officially entered a Depression in 2008-09. Remember that in 1930, the weakened economy was not being called a Depression. It was being referred to as a slowdown after many years of rapid economic growth and a soaring stock market. The term Depression did not emerge until 1932-33. Governments tend not to change their stripes. In recent years, we don't recall once being warned by our government that things were getting worse. All we can remember hearing is that things were stabilizing.

The second scenario is the US Dollar being stripped of its status as the world's official reserve currency. It is not beyond reason to conjecture that the US Dollar will cease to be universally acceptable in global trade because the US Government is now recognized by its trading partners as the world's largest counterfeiting operation. What it can't legitimately earn, it prints. This has been going on for the better part of 50 years.

These possible outcomes lead us to various investment strategies and tactics. The Depression outcome means that cash equivalents and fixed/guaranteed returns will outperform most everything. The curtailment of our country's credit privileges will lead to a severe devaluation of the US Dollar, which will usher in dramatic losses of purchasing power. This outcome means that we must invest in non US Dollar alternatives and areas that are characterized by relative scarcity. These would include things that are grown (food), extracted (non-renewable energy, industrial metals and water) or fixed in supply (land and buildings in desirable locations.)

In the fullness of time, other timely investment opportunities will be revealed to us. These will be tied to areas that will benefit from government spending initiatives and policy directives. Some will be good opportunities for the long haul (renewable and clean energy) and some will be ill-conceived and have a relatively short life (diverting food crops into ethanol.)

Meanwhile, we shall continue to be held hostage by the forced debt liquidations in progress. The governments of the world are pumping trillions into the system in order to keep the economic patient from falling into a coma. If the injections do not work fast enough, we could enter a Depression that will lead to failure of free enterprise when governments accelerate the seizure of large chunks of their respective economies. This is a world that is difficult to envision but we must have a rudimentary contingency plan in the back of our mind.

If the monetary injections are successful, much of the world could experience very sharp inflation as the supply of money made available to businesses and consumers dwarfs the incremental growth in demand for goods and services. This also could occur if availability of key goods and services is curtailed by an act of war or act of nature. For example, a major military event in the Middle East or a devastating earthquake in an oil-producing region could send energy prices skyward.

What should we do?

Since we are in a highly unusual and highly unpredictable economic period, we should not be positioning our investments at one extreme. We need to be positioned for a variety of possible outcomes. Granted, we clearly are in a bear market. The jury is still out on whether this bear market began in 2000 or 2007. This will make a big difference in identifying the terminal point of the bear market. We are left to speculate whether we are closer to the end than the beginning, somewhere in the middle or just getting started.

In any bear market, significant rallies can erupt from extreme oversold conditions so it always is prudent to have some skin in the game. However, the trend of a bear market is down, not up. Therefore, in bear market rallies it is better to go for singles than for home runs. Trying to recapture prior losses in one swing of the bat is raw speculation and can result in a very long walk back to the dugout.

Since 2007, millions of investors have lost large amounts of their personal wealth that never will be recovered. Part of the problem is that much of what remains in many investment portfolios must now be liquidated in order to substitute for lost or declining employment income. When markets recover, these individuals will not be in a position to participate.

This highlights a most important principle. One's most valuable asset is the ability to generate income. Without personal income, everything else can break down fairly rapidly. Please do what you can to protect your income stream. If your income declines for any reason, make an effort to reduce expenses. If your income rises, congratulations! Save the extra money for future priority needs (specialized medical care) or compelling investment opportunities. Never fail to appreciate the importance of your personal income and the need to make periodic adjustments to your consumption habits.

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