Gloom, Doom and the Hidden Rays of Hope – Part 1

By any reasonable measure, the past three months have been among the gloomiest fiscal quarters on record for the investment markets. The debt ceiling debate, constant dithering in Europe over whether or not Eurozone members should be allowed to default on their sovereign debt, partisan bickering, the downgrade of U.S. government debt, continued unemployment and a general unsettled feeling about the economic recovery have all combined to put investors in a pessimistic mood. When people are pessimistic about the future, they sell--as they did, steadily and persistently, through what will be remembered as the gloomy summer of 2011.

It is hard to remember now that in the first quarter, just a few months ago, the markets were flirting with a full recovery from the 2008 debacle, or that before this quarter started the markets were in positive territory overall for 2011.

The Wilshire 5000 index, which most closely reflects the total U.S. stock inventory, dropped a remarkable 12.85% of its total value for the quarter. This wiped out the gains of the previous two quarters; the index is now down 7.54% for the year. The comparable **Russell 3000** index fell 15.28% in the three months ending September 30, ending the quarter down 9.90% for the year.

The **Wilshire U.S. Large-Cap index** fell 12.03% during the third quarter, and is now down 6.76% for the first three quarters of 2011. The **Russell 1000 large cap index** was down 14.68% for the third quarter; taking it to a negative 9.25% return for the first three quarters of the year. The more widely-followed **S&P 500 index** of the largest companies domiciled in the U.S. was down 13.87% for the quarter, giving it a loss of 8.68% so far this year.

The **Wilshire U.S. Mid-Cap index** dropped 18.93% over the third quarter, and is now down 11.15% for the year. The comparable **Russell Midcap index** fell 18.90%, putting it down 12.34% so far this year.

The **Wilshire U.S. Small-Cap index** plunged 19.34% over the three months ending September 30, and holds a 13.46% loss for the year. **The Russell 2000 small cap index** fell 21.87% in the third quarter, placing it down 17.02% for the year.

The technology-heavy **Nasdaq Composite index** retreated 12.91% in the three month period ending September 30, and is now down 8.95% for the year.

Internationally, the results were much the same--only more so. The **EAFE index**, which represents large cap stocks across the developed world, plunged 19.60% for the quarter, and is down 17.18% for the year. Europe as a whole was down 23.00% for the quarter; the Far East dropped 9.64%, and the EAFE emerging markets index of developing nations fell 22.88%.

Even the assets that are supposed to zig when the stock market zags were down comparably for the quarter. The Wilshire REIT index of real estate investment trusts was down 12.10% for the third quarter; moving it down 2.54% for the year. Commodities told the same story: energy stocks, including petroleum producers, were down 12.99% for the quarter, industrial metals fell 22.46%, and even gold, which finished the quarter up 7.82%, experienced a drop of 11.43% in September.

Just when you thought that yields on government bonds couldn't go any lower, they did: bonds of up to 1-year maturity are essentially paying zero interest, while five-year Treasuries are paying 1% a year, and 10-year Treasury issues lock you in at 2.125% a year.

It is usually more difficult to read the minds of the investing public than the cable financial programs and financial press makes it appear; the headlines one day will say that stocks fell after the Fed issued a warning about the economy, and the next day we will learn that stocks rose because the Fed was so worried about the economy that it might lower interest rates.

However, this summer there was a certain clarity about the cause of the malaise; the S&P 500 was routed to the tune of a 2.2% one-day loss on August 2, right after Congress finally agreed to a messy compromise on the debt ceiling. It was clear that many people were questioning whether our lawmakers have a clear grasp of the financial and economic challenges facing a nation that is still climbing out of the worst recession since the second world war. When they look overseas, they see that European governments are, if possible, even less functional in their approach to repairing the global economy. On August 4, the S&P 500 fell 4.3%; it fell 5.6% on August 6 and another 4.4% on August 8--and those four days represented nearly all of the damage for the quarter.

September, of course, was worse, and the handwriting was on the wall when the S&P 500 experienced its worst first week start in its five-decade history. (Yes, that includes the Fall of 2008.) A brief five-day rally gave us a 4% bump in value, but the end of the month was dismal, with a 2.9% drop on September 21, followed by a 3.2% fall the next trading day. Altogether, the index was down 6% for the month.

Is gloom and doom the real story about the economy, or is it a reflection of unfounded fear? The NumberNomics economic web site notes that the U.S. GDP (the broadest measure of economic activity) actually grew 2.3% for the past three months, a much faster growth rate that the anemic first quarter (0.4%) and only slightly-more-promising second quarter (1.3%). Do those numbers look like they are moving the economy toward a double-dip recession, as many investors seem to fear?

Another fear is that the Eurozone will collapse under the weight of Greek debt. But there is good news on that front as well; the German parliament voted on September 29 to support the expansion of the European Financial Stability Facility by a surprising 315-85 margin. Germany is the 10th--and most important--of the Eurozone members to ratify the bailout agreement.

Meanwhile, supply shortages of oil have eased from the start of the year, causing oil prices to drop. Consumers have paid down enormous amounts of debt over the past three years, bringing them in line with where the consumer debt burden has been for the past 30 years. Corporate profits and cash levels remain at record high levels, almost $2.0T, and there are signs that the unemployment problem is starting to ease--although it will be years before we see unemployment fall to the levels we saw in the early 2000’s and late 90’s. (Most economists state quite unequivocally that we will experience high levels of unemployment for at least another several years and that there is little that policymakers can do to change that.) And it has been lost on the daily headlines that, contrary to what most pundits expected, the US dollar has shown increased strength against every currency, except the Swiss Franc: thus putting the lie to the fear that the downgrade of the US dollar would herald a loss of confidence in the dollar. It has been the largest run-up of the dollar in history.

With all this good news hiding behind headlines about U.S. and European sovereign debt levels, it is hard to predict that the markets will rally decisively. But it is also difficult to bet against a sudden shift in sentiment, especially since there have been so many in the past few years. In other words, we should expect volatility to govern the markets for the foreseeable future. The wisest heads in the investment game tend to see the optimistic side of the situation when the markets are most gloomy, and see the dark clouds gathering when everyone else is enjoying a strong run-up in stocks.

Despite what you hear on the cable financial news channels, nobody really knows how long stocks will remain on sale or how long it will take for the global economy to finally sort itself out. We may be in for more pain as this year winds down. But we DO know, from past experience, that eventually the economy recovers from even the most severe shocks, and (again, eventually) the markets return to health. History tells us that a recovery is inevitable, and it seems to be visibly underway somewhere behind the hubbub of the negative press, partisan bickering and occasional market panics.

When investors figure that out, there will be another bull run and (this we can predict with confidence), people in that happy time will forget all over again that stocks can go down as well as up. That's when you'll hear our lonely voice at IFA talking about the downside risks and how to prepare for the next hiccup in our and the world's economy. And please remember, it's your goals that count not the markets' performance.

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