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The Long Weak Cycle Continues

At the end of the 1900s, debt burdens in the United States had climbed to unprecedented levels relative to the size of the U.S. economy. Speculators had bid stock valuations to heights never before approached. Fear had been cast aside, and an ever more prosperous future was almost universally anticipated. In varying but lesser degrees, this script had played out domestically several times over the prior two centuries. Similar conditions had characterized the end of seven earlier periods of economic and stock market expansion. In each instance, euphoric peaks led to lengthy periods of correction both in economies and in markets. As the turn of the century drew near, we spelled out in considerable detail why then current conditions were almost certainly leading us into the next long weak economic and stock market cycle.

While we had no way to know how long such a cycle would last, the seven completed weak cycles in the nineteenth and twentieth centuries averaged just under a decade and a half in length. In the twentieth century, the cycles extended a bit beyond the average, with the shortest lasting sixteen years. Since the excesses built up through the 1980s and 1990s topped all that had come before, it was logical to expect at least a normal or longer corrective cycle.

So far the weak cycle is unfolding within normal boundaries. We have experienced two monumental stock market declines accompanying two recessions. These cyclical bear markets have been followed by two powerful, Fed-fueled cyclical bull markets. The net of a dozen years of fluctuating markets is that stock prices are today where they were in 1999.

Unfortunately, most investors are too impatient to identify very long-term trends and to invest in concert with them. Wall Street firms certainly will never talk about negative patterns that could last a decade or two. Imagine what would happen to a firm's profitability if it correctly forecast that stocks would provide little or no return over the next decade and a half or so. Such firms obviously have to keep investors active. Whatever their longer-term beliefs, they must offer opportunities for short-term profit. And that matches the investing desires of most clients. Recognizing that there's always a bull market in something, Wall Street firms play to the investors' desire to pick the winners, even when most assets are declining. Of course, the ideal scenario is to be bearish and cautious when markets are declining and bullish and aggressive when markets are rising. When major market moves last for two or more years at a time, that seems reasonably easy to do. To verify how difficult it is in practice, however, all one has to do is review the performance of investment managers in the twenty-first century-to-date. Few have made much; many have lost money. We are pleased that over that time span our clients have made about 70% before fees, which vary based on portfolio size. And the long weak cycle is still unfolding.

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Every long weak cycle since 1800 has contained one more major decline (cyclical bear market) than major rally (cyclical bull market). So far this current cycle has seen two of each. This cycle could end with one more major decline, but in light of its eleven-year length to-date, it is certainly possible that it could incorporate two more major declines bracketing another strong rally.

Of most immediate concern is whether or not the cyclical bull market that began in March 2009 has further to run. As I pointed out in some detail in my May 27 blog post at www.missiontrust.com/blog, the average length of cyclical bull markets within secular bear markets (long weak cycles) has been 26 months. That pattern would almost perfectly align with the market peak reached in early May. No market has to conform to historical averages, but such data can provide helpful guidelines for reasonable expectations.

When we look at the current situation, we see a confluence of conflicting factors. Corporate earnings continue to grow strongly, and emerging economies are providing demand for many of the world's goods and services. Governments and central banks are working overtime to provide stimulus to keep business humming. On the other hand, the reason they have to provide such stimulus is that the world's crushing debt burden is throwing sand into the gears of much of the world's economy. Several countries are insolvent and are being kept alive with outside funding. Several others are suffering from severe liquidity squeezes and likewise require prodigious amounts of rescue money. Major banks around the world hold the debt obligations of these struggling sovereigns. Should the ongoing rescue efforts fail--and they certainly could--the world might again regress to the dire straits in which it found itself at the height of the 2007-09 financial crisis. At that point the gears of the world economy essentially ground to a halt, only to be reenergized by the greatest bailout in history. Should faith in the banking system be sufficiently shaken again, the likelihood of a second successful bailout would be significantly lower.

The rating agencies that evaluate the probability that debt will be fully repaid have accorded several European peripheral countries junk bond ratings. In the past week they have also put the United States' formerly sacrosanct AAA rating under review for possible downgrade. The immediate reaction from European politicians and central bankers has been to castigate the rating agencies for calling toxic debt toxic. The agencies are merely holding up a mirror to reality. Many of these countries are in serious danger of near-term default. They are in a Catch-22 situation. To get further bailout money, they must approve and implement serious austerity measures. Unfortunately, under the mandated austerity budgets, there is virtually no way that the endangered countries will be able to grow their economies fast enough to service their debts.
In this country, no politician is offering a plan that would actually solve our debt problem. Even the most aggressive proposals would leave us with huge deficits and growing debt a decade from now. We have wedged ourselves into a corner from which we have no good options. We find

ourselves in the same Catch-22 situation as does Europe. Any appreciable cuts in spending will diminish the GDP growth necessary to generate enough revenue to reduce debt in the long run.

Most readers can sympathize with pleas for not cutting into what different constituencies identify as critically needed government programs: health, Social Security, defense, veterans, education, etc. Talk about cutting or eliminating such programs is cast as unfeeling and immoral. On the other hand, we have long ignored the immorality of satisfying our current needs with money from future generations who have no voice in today's deliberations. Agreement on these hot-button issues may be extremely difficult to reach, which will severely complicate all attempts to come to a meaningful debt reduction solution.

Stock market activity in recent weeks demonstrates clearly how responsive traders are to prospects for further government rescue or stimulus. Prices moved up or down in direct correlation to the perceived progress toward an agreement in the Greek debt crisis, in hopes that contagion to other European countries and major European banks can be avoided for now. Over the next two weeks, we are likely to experience a similar traders' watch on the prospects of Congress reaching agreement about raising the U.S. debt limit.

So far there has been remarkable complacency in the markets in the face of conditions that could lead to the banking system's collapse, as nearly happened but for a successful government rescue in the 2007-09 financial crisis. If European sovereign debt ends up being marked to market rather than being accorded an artificial value of par, the European banking system--and by extension major banks around the world--are at risk of insolvency. The market seems to appreciate the risks at the bank level, as prices of leading banks have been pummeled in recent months. The broader effect on the financial system at large, however, is so far invisible. Investors seem to be counting on governments and central banks again "kicking the can down road" and sovereign insolvencies again being deferred.

Perhaps deferring a recognition of reality will be successful for a while longer. Can betting on that outcome, however, be called investment, or should it be recognized as the speculation that it is? Should circumstances force us to face reality and a failed banking system now, could anyone credibly ask: "Who could have seen that coming?" That was the rhetorical question asked by many who were penalized for large equity positions in the 2007-09 collapse, which was precipitated by excessive debt that we had warned about for years.

As with equities, today's fixed income situation presents a serious quandary, albeit a different one. Our U.S. Treasury bond yields are near historic lows, despite our country's serious debt problems, while yields on endangered European debtor countries' bonds are skyrocketing. How much of the U.S.'s low rates can be attributed to the Fed's having purchased 60-70% of new Treasury issues over the last few quarters? What will happen to interest rates in the Fed's absence now that QE2 is finished? Can we rely on investors' perception of the U.S as a safe haven if our legislators are unable to cobble together a politically acceptable debt ceiling agreement and the U.S. falls into default, even for a brief period? What would happen to interest rates if Standard & Poor's follows through on its threat to downgrade U.S. debt, should Congress not reduce the projected deficit by a sufficient amount? What happens if Europe experiences a debt default, which leads to European bank insolvencies and in turn to insolvencies of financial institutions around the world? Would central banks crank up the printing presses to bail out the banking system again? Would China and other emerging country buyers of western debt shy away from such bonds if debtor countries continued to devalue their currencies through money creation?

Inflation has been rising, which logically leads to rising interest rates. It's happening, however, in a weakening world economic environment, which typically leads to lower interest rates. Which force will prevail? The answers to many of these questions are dependent on policymakers' decisions, not on natural market forces. That subjectivity adds considerable guesswork to current fixed income analysis. At today's historically low yields, there is more loss potential should rates rise than profit potential should rates remain stable or even decline further. As a result, we are not maintaining a permanent bond position, but we continue to look for strategic bond opportunities when interest rates rise intermittently.

On the equity side, while we are adding individual stocks which meet all of our value-based selection criteria when we can find them, we are not stretching those criteria just to add more names. Things continue to play out in the long weak cycle that we correctly forecast a dozen years ago. Notwithstanding being significantly risk-averse during the two strong rallies of the past decade, our clients who have been with us over the full cycle have far outperformed most portfolios. And the long weak cycle very likely has some years yet to run. Ours will remain a task of defending portfolio values in major market declines, adding risk-free income as we have over the past few quarters, and seeking opportunities for strategic equity ownership where we can identify companies at attractive prices.

While the long weak cycle is still well short of average length, conditions are reaching potential disaster realization points. Will they be successfully deferred again or not? We urge all readers to avoid risks that could lead to losing irreplaceable assets should the debt crisis come to a head soon.

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