

MARTIN  
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# FIRESIDE CHAT

## Chat No. 3

November 13, 2008



“Good evening, friends.” With these words Franklin Roosevelt greeted his radio audience

during “fireside chats” beginning in March 1933, just days after he was inaugurated as the 32<sup>nd</sup> president. Fast-forward almost exactly 75 years to March 11, 2008, and this speaker recorded the first in what is becoming a series of his own fireside chats. Noting coincidence and not clairvoyance, I would point out that five days after the first chat the investment banking firm of Bear Stearns, which struggled but survived the 1930s, only to fall on its sword in 2008, will be remembered ignominiously as the proverbial “first domino.” In a telling tale of “pride goeth before ... a fall,” Bear Stearns was recognized in 2005–07 as the “most admired” securities firm in *Fortune’s* “America’s Most Admired Companies” survey. The annual survey is a prestigious ranking of employee talent, quality of management and business innovation. It’s never wise to read your own press clippings—and even worse to believe them. May we be wise enough to understand the humbling consequences of hubris

vicariously, should we ever drift toward pridefulness.

This is the third fireside chat. It was conceived early in the morning on November 5, only hours after Barack Obama was elected the first African-American president of the United States. Embodying the call for change, not unlike FDR in 1932 or Reagan in 1980, his mandate was a 6% margin of victory in the popular vote compared with 18% for FDR and 10% for Reagan. As the exit polls made clear, economic troubles were the primary catalyst for the call to “change the guard,” just as they were in 1932 and 1980. Roosevelt ushered in a liberal era and Reagan a conservative one. Reagan laid the foundation for almost 30 years of conservative ideology that was systematically and insidiously compromised by the age-old principle that success breeds excess. “Reaganomics” ultimately fell into disrepute, most conspicuously by the corruption of money. Whether a new Obama-led era of social and economic liberalism—if in fact that is how it will be remembered—ends with the corruption of power will be for our

grandchildren to judge. Just perhaps, like Roosevelt, who faced a financial and economic crisis that left a quarter of the nation's workers unemployed, he may possess that great intangible political leadership quality—the ability to inspire hope to a nation that despairs. As for those who fret over Obama's limited experience, having observed the goings-on for quite some time, I think it's all too apparent that none of the decision makers in high places can lay claim to much gravitas of their own. The Godzilla of financial crises, likely to be followed by an equally frightening economic contraction, is more than a match for any army equipped with peashooters. In this situation, to quote Albert Einstein, it just might be that "Imagination is more important than knowledge."

The second chat was delivered on June 5, precisely five months ago. It offered the following words of hope: "If Congress can keep its legislative pen out of the ink well, and if the Fed can regain its lost composure, this will be the gloomiest of the fireside chats." At the same time the chat reverberated with caveats: "Obfuscation from those who are in denial and leveraged financial structures that defy description have made getting to the truth of the matter exceedingly difficult." It concluded with an unequivocal warning: "This is one of those times that if you're going to err, you are strongly encouraged to do so on the side of excessive caution. There is a time for

heroes, but that time has not yet arrived. A steely, focused temperament, along with the patience of Job, will likely see you through. All ordeals come to an end, and this too shall pass. Those who make it through with their propensity to seize opportunity intact will be the very ones who lay the cornerstones of a new era of economic opportunity in the most resilient nation in the world."

The five months that followed represented the most tumultuous period in financial history since the 1930s, culminating with the market's eerily reminiscent October verdict. From peak to trough the Dow Jones industrial average surrendered more than 25% of its value. On October 10 trading volume exceeded 8 billion shares, and the percentage change from the day's high to its low was the greatest ever in the market history. To put a reliable long-term barometer of speculative sentiment in perspective, while the Dow Jones industrial average increased tenfold over the last 30 years, average trading volume has increased 100-fold.

Prior to the October 10 nadir, the crisis was accelerating in late summer. Far from inclusive, the following are several of the noteworthy events that occurred in the month of September alone.

- On September 7 the U.S. Government seized control of Fannie

Mae and Freddie Mac by placing the two companies into federal conservatorship.

- On September 14 Merrill Lynch became the less-than-enthusiastic bride in a shotgun wedding with Bank of America.
- On September 15 Lehman Brothers filed for bankruptcy.
- On September 16 the government announced an \$85 billion emergency loan to rescue giant insurer, American International Group (AIG). The price tag has since soared to \$150 billion.
- On September 19 the Bush administration, with Secretary of the Treasury Paulson and Fed Chairman Bernanke leading the charge, proposed to Congress a \$700 billion bailout plan as an antidote for the crisis. In the weeks since, the plan that never really was has mutated into the Rube Goldberg contraption that, without privatization, I feared it would become.
- On September 21 Goldman Sachs and Morgan Stanley were authorized to become bank holding companies in order to increase oversight and allow them access to the Fed's discount window.

Various and sundry other stopgap measures were imposed concurrently: insuring money

market funds to pre-empt a run once the "buck" net asset value was broken, increasing the FDIC-insured limit to \$250,000 when commercial bankers revolted over the actions to backstop the money market funds, etc.

Since then the pandemic has spread apace, eerily appearing like the Hydra of Lerna from Greek mythology, the multi-headed serpent that sprouted two new heads for each one that Mercury lopped off ... Fear not, the beast was eventually bested but by cleverness, not brute force.

Besides pride, optimism also goeth before a fall. In earlier missives the speaker recounted upbeat pronouncements from the Fed, the Treasury, and the Oval Office only days or weeks before events rendered them frightfully wrongheaded. Likewise, the CEOs of financial institutions, almost without exception, confidently affirmed their financial stability, often only hours before their firms succumbed to the harsh realities. In sympathy with those whose motives and actions were clearly selfless, and who found themselves in a classic Catch-22 conundrum, their choices may have been limited to the evil of two lessers.

Speaking in Florida in March 2008 on free trade, President Bush couldn't ignore the elephant in the room. "This is a challenging time for our economy," he said. "You know that. I know that. A lot of Americans

understand that.” But he couldn’t leave it at that. “In the long term, we’re going to be just fine,” Bush said. “People will still be able to work.” If one gets carried away with bromides, as the President apparently did, the message quickly disintegrates to the disingenuous.

As the nation was heading into the Great Depression, President Herbert Hoover kept up the happy talk. “He was the most optimistic guy in the world,” says Davis Houck, author of *Rhetoric as Currency: Hoover, Roosevelt and the Great Depression*. “His optimism is what did him in, because the economy kept getting worse and worse and worse.”

FDR, not inclined toward supercilious “happy talk,” demonstrated the constructive use of a president’s words during tough times. By calling his closing of banks a “holiday,” he cleverly and effectively changed the perception. Sometimes imagination does trump knowledge.

As we turn to the conclusion of this fireside chat—by seeking to address the harsh realities in a dispassionate way—we’ll leave the use of “rhetoric as currency” to others, of whom there will surely be many in the months to come. Hyperbole is a dangerous distraction from the singular focus on the emerging facts. We must not allow ourselves to be tempted by will-o’-the-wisp “happy talk” diversions.

“Could it be that the long-feared capitulation of the consumer has arrived?” wrote Nobel laureate Paul Krugman in an op-ed piece in the *New York Times* on October 31. Even before consumer confidence fell off the charts in mid-September following the bankruptcy of Lehman Brothers, the plunge in the Dow below 10,000, and the sharp cutback in the availability of consumer credit, third-quarter GDP data—for July through September—was ominous: Real consumer spending fell at a rate of 3.1% in the quarter, with spending on durable goods like cars and TVs falling at an annual rate of 14%.

To put the consumer retrenchment in context, the forever-upward trajectory in “Joe the plumber’s” spending has always been assumed, just like the perpetual upward sloping trend in home prices—that is, until one day home prices stopped rising, and the mechanical backward-looking models that displaced enlightened thought were exposed and the financial world went into seizure. Similarly, ever-resilient consumers spent their way right through the 2001 recession. The last time there was a hiccup was in a single quarter in 1991. There hasn’t been a decline of this magnitude since 1980, when the economy was buffeted by the twin gales of a severe recession and double-digit inflation.

If this is in fact a harbinger of a very big change in consumer behavior it couldn’t

have come at a worse time. Aided and abetted by rising prices of stocks and later homes, Americans, who used to set aside 10% of their income in savings prior to the mid-'80s, decided to let their investments do their savings for them. The idea is not inherently illogical. However, the simple extrapolation of ever-rising asset prices is. Prices don't exist in a vacuum: There's a sometimes tenuous relationship between the value of houses and the rental income they could earn. Likewise, stock prices are ultimately tied to corporate profits, and consumer spending cannot forever outstrip disposable income. Complicating the up cycle is that optimism often begets more optimism. Throwing caution to the wind, consumers splurged on debt at the same time they ceased squirreling away a portion of their income. Consumer debt is now 98% of GDP, twice the level of 25 years ago.

Thus we have run headlong into the "paradox of thrift." Chastened, consumers may return to what was an individual virtue only to unintentionally contribute to a public vice. Just as Congress and the Federal Reserve are pulling every proverbial rabbit out of their respective hats to entice us to spend, consumers seem determined to go on strike in the name of self-preservation. As the negative feedback loop gains momentum, it becomes increasingly difficult to reverse. It doesn't take a great stretch of the imagination to believe that cutting the Fed funds rate from 1% to zero, as the

Japanese did in the 1990s, might not be enough to induce consumers to return to their spendthrift ways. Counterproductively, market interest rates for homebuyers and businesses are moving upward, indifferent to the Fed's policy pleas.

Even if successful, the ongoing efforts to bail out the financial system may not goad an overextended and recalcitrant consumer to spend for the common good. Christmas, of course, is coming, when—more than almost any year in memory—it will be make-or-break time for myriad U.S. retailers. See below.

Thus, Ben Bernanke's worst nightmare could become a reality, though what follows is not intended to masquerade as a forecast. Only a few months ago, American policymakers were worried about incipient inflation as soaring oil and food prices were coursing through the world economy. In July, average prices were 5.6% higher than a year earlier—the fastest pace of inflation since 1991. After all, prices keep rising until...

What has happened to the real estate markets, as prices have crumbled under the weight of a glut of new and used homes, could possibly occur with other consumer goods and services. Retailers from Tiffany's to Wal-Mart have embraced a similar strategy for the upcoming holiday season—discount, discount, and discount some more. A trip through Wal-Mart recently was as surreal as

it was prophetic: Prices everywhere were displayed in bold and brazen integers, below signs that in the unmistakable simplicity of one word, “Unbeatable,” threw down the gauntlet to upper-scale competitors one and all. The word for Bernanke’s nightmare is the “D” word, as in deflation.

Price deflation was indigenous to the economic Depression of the 1930s.

Persistently falling prices also were at the heart of Japan’s so-called lost decade after the catastrophic collapse of its real estate bubble at the end of the 1980s—a phenomenon with eerie parallels to the U.S. predicament. The 50% plunge in gas prices at the pump to less than \$2.00, while clearly providing at least short-term relief to the auto-dependent consumer, is, from the macro economic perspective, not an unearned consumer rebate out of the blue but, rather, a symptom of the growing malaise. If you just lost your job, the savings at the pump pale by comparison.

The new demon, that consumer prices may go the way of home and stock prices, could signal the beginning of a malevolent long and slow slide in the spending of consumers and businesses worldwide. Bernanke’s fears are well-founded: It’s comparatively easy to choke off spending by raising the price and reducing the supply of credit. Stimulating demand with the same policy tools can be much more difficult, analogous to pushing on a string. Retrenchment, in which

consumers and businesses worldwide lose the wherewithal to buy, can send prices downward for many goods. Though still considered unlikely by most economists, that could prompt businesses to slow production and accelerate layoffs, taking more paychecks out of the economy and further weakening demand.

A late-breaking employment report on Nov. 7 only added fuel to the flames. All told, 240,000 payroll slots went up in smoke. And the unemployment rate jumped to 6.5%, from 6.1%, the highest level since March 1994. What with upward revisions in August and September, the ranks of the unemployed are growing at an accelerating rate, with year-to-date job losses weighing in at a not-inconsiderable 1.2 million.

The more inclusive category of joblessness that rarely gets reported by the press that gives one both the willies and a better feel for the way things really are out there on the job front, dubbed “U6” by the Bureau of Labor Statistics (much like the protocol for measuring the money supply), includes marginally attached workers, part-timers who can’t find a full-time job, and the officially unemployed. In October that measure reached 11.8%, the highest since 1994, when it was designed, compared with 7.9% a year ago. Equally alarming, the yearly job losses in private services of 0.4% match the worst of the 1982 recession and exceed the worst of the 1975 slump. Once upon a time, we

note with just a trace of nostalgia, the service sector wasn't very cyclical; now it is.

Have I thus sounded the death knell for investment in marketable equity securities? Let me respond to that rhetorical question by talking first about the "stickiness" of prices of different assets. Labor rates, recognizing the output of workers as an asset, are the stickiest, in large measure because employers and workers have preferred to reduce the workforce through layoffs rather than to accept a haircut in wages. Home prices are less sticky than wages, with the median price declining approximately 17% over last year after decades of comparative stability. While there are many explanations, two of the more obvious are that many homes are the mortgagee's primary residence and that buying and selling are a costly process. Common-stock prices, at the other extreme, appear to be lubricated with WD-40. Transaction costs and inconvenience are comparatively trivial. There are few if any retail day traders in housing. The Dow Jones industrial average plunged 10% in a matter of two days in early November. Compare that to the previously mentioned decline in home prices over the last 12 months.

Equally important, centralized markets, instantaneous information, and self-reinforcing feedback loops foment both types of contagion: the speculative, euphoric type *and* the fearful, get-me-out-at-

any-price strain. "Mr. Market" overshoots, sometimes to extremes, in his manic-depressive compulsions. For example, the Dow Jones industrial average reached a low of 41 in the summer of 1932, bounced back in the fall to 80, only to "retest the lows," in market parlance, retreating to 50 in the spring of 1933. Despite deflation and the ongoing Depression, which most economists argue stubbornly lingered until 1939, over the next four years ending in 1937 the Dow advanced fourfold to 195. Think about the following, as it may be instructive in coping with the current volatile market environment. Despite the mid-year doubling in the Dow during 1932, the calendar year was a disaster for stocks because of the freefall that preceded the advance. By contrast, 1933 (once the still-volatile market had failed to make a new low for almost a year) proved to be the most productive calendar year in market history, laying claim to a doubling in value of the Dow.

Make no mistake, extended recessions or worse almost guarantee enormous economic and sometimes deflationary headwinds for investors. Thanks to the sometimes extreme volatility in markets, on rare occasions the stock prices of great businesses fall to such low levels that the margin of safety at purchase—irrespective of the dismal state of the economy, falling prices of goods and services, or the attitude of extreme aversion espoused by nearly all pundits—is simply too compelling to forgo. Those who don't

fully understand the disconnect between  
stock prices and the economy will own too  
much stock in the boom times and too little  
in the busts.

Until we chat again,  
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