

Climbing the Wall of Worry or Descending the Wall of Hope?

By Doug Wakefield with Ben Hill

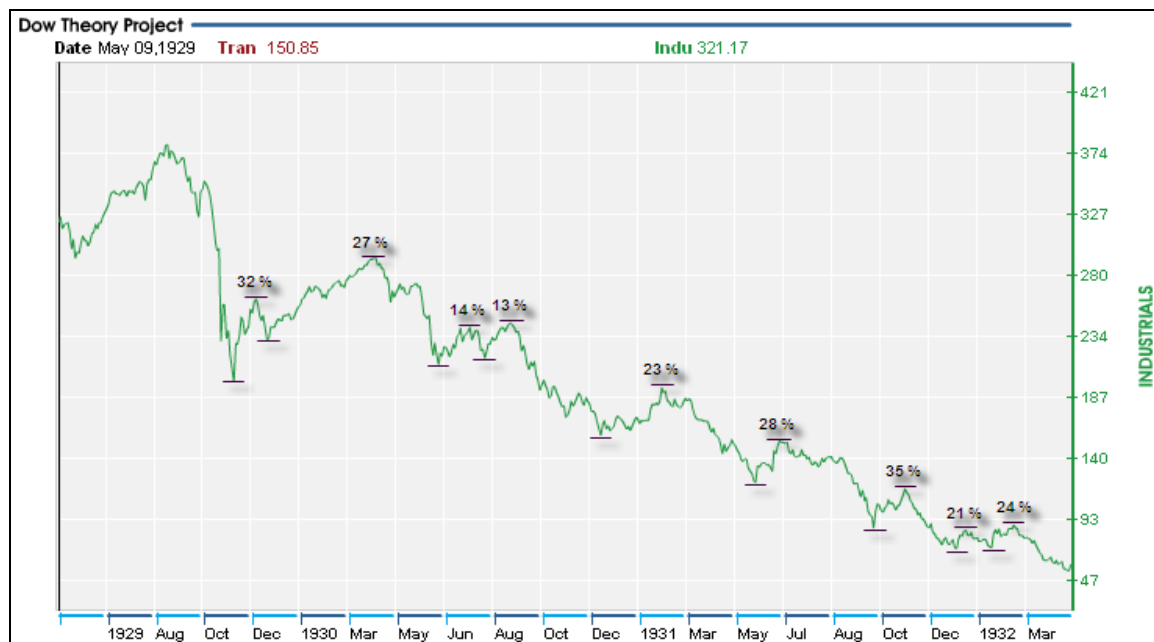
If you invested \$100,000 and participated in rallies of 32%, 27%, 14%, 13%, 23%, 28%, 35%, 21%, and 24% within a 3-year period, what would your initial \$100,000 be worth?

Before I answer that question, let me tell you a (true) story.

I remember the spring of 2001 like it was yesterday. Even though the markets had started down in January, we were assured that there was nothing to worry about because the Fed was about to come to the rescue with abundant liquidity through rate cuts. I was still uneasy because the few trading resources I subscribed to at the time were beginning to downgrade stocks that had received high ratings just one year earlier. But alas, one of the major fund companies came out with a piece titled, "Climbing the Wall of Worry," which presented (incomplete) historical evidence that supported the argument to sit tight and ride out the storm. Having been trained to buy-n-hold, leaning on research that supported that view, assured that the Fed would undergird the markets, and (honestly) wanting to believe in the new era, I dug in and endured the emotionally draining pounding of 2000 to 2002. Needless to say, I got my head handed to me. And, it bothered me – perhaps a little too much.

I've always loved research, and now I was sufficiently motivated. I suspected that I would have been better prepared if I had addressed all the inconsistencies and unanswered questions contained within the conventional schools of thought on investing. I was determined to find out. It wasn't until some time later that, by coming to understand the difference between rational thinking and rationalization, I gained some sense of absolution. Market rallies show us that investors, professional and retail, continue to cling to a bull market mindset, embracing the emotional high of each rally, somehow missing the overall downward trend of the markets, and discounting or disregarding the fundamental facts of the underlying economy.

But, before we do that, a quick look at our original question and the chart below tells us that nine strong rallies in a three-year period did not save investors and their advisors from devastating losses. In fact, during this three-year period, without making any distributions, our \$100,000 portfolio declined to a value of \$10,814.¹



Looking back, it's easy to think, "But, that was 1929 to 1932; everyone should've known where the market was headed." Prechter writes:

"Emotionally removed historians sometimes decry the lack of prescience among a population prior to a long-ago financial crisis. Yet unless one is there it is hard to imagine the social pressure to go along with the trend of the day."²

Add to this, the fact that, "Most people get virtually all of their ideas about financial markets from other people, through newspapers, television, tipsters and analysts, without checking a thing,"³ and we have a recipe for disaster.

In the last 3 months, we have all witnessed some rather questionable investment advice. Yet, because of creeping normalcy and landscape amnesia, concepts we discussed in our July 2006 newsletter, we do not always recognize unsound (or sound) advice. So, let's look at a scenario together and see if the advice given by a nationally syndicated columnist measures up.

A 70 year-old gentleman is looking for a way to access more money to loosen up his budget so he can travel. He questions the "expert" on the use of a reverse mortgage as a way to access the desired money. The gentleman has \$200,000 in financial assets and receives \$26,000 a year from Social Security, retirement, and interest.

The expert suggests that rather than a reverse mortgage, the gentleman consider taking out a home equity loan for \$25,000. This would allow for \$5,000 a year in extra spending, allowing him to travel, and though (at 7 percent) the loan would accrue an additional \$5,250 in interest payments, if he assumes his house will go up in value 2 percent a year, he could pay off the principal and his interest when he sells his home in 5 years.

Now, what's wrong with this line of reasoning? We see two main issues. One is a substantial change, over the last few generations, in the way our society views debt. The other is our human tendency to extrapolate "conservative" long-term returns, rather than realizing that markets (and economies, and a great many other things) move in cycles and searching for data that would signal a transition.

Today, it seems that debt is always the solution. Politicians, central banks, and businesses have certainly set the example, but the problem is more likely our own human nature. The problem with the advice given, and the gentleman receiving it, is that neither party wants to accept limitations. And, in our current cultural mindset, that makes sense. Swept along by the current debt mania, the expert doesn't realize the irrationality of his advice, and the gentleman, it seems, has not properly assessed his risk to achieve a less-than-necessary goal.

Additionally, regarding future returns, homes, like any other asset, offer no guarantees. Like stocks they can become historically overvalued and then decline quite sharply in value. Consider the following comments regarding the housing market and how this data could warn this 70 year-old gentleman's that what looks like a walk in the park might turn out to be wandering into quicksand.

In a 2002 report titled, "When Bubbles Burst," the International Monetary Fund (IMF) reminds us:

"Housing price busts occurred on average about once every 20 years, lasted 4 years, and involved price declines of about 30 percent."⁴

In November of 2005, Dean Baker and David Rosnick, from the Center for Economic and Policy Research, wrote "Will a Bursting Bubble Trouble Bernanke: The Evidence for a Housing Bubble." In it, they observe:

"In the last eight years, house sale prices have risen by 55 percent, after adjusting for inflation. There is no precedent for this sort of run-up in home prices. In the past, home sale prices have on average just kept pace with inflation. The value of family owned housing is \$18.5 trillion, with more than \$6.5 trillion of this wealth attributable to [the] extraordinary run-up in housing prices of the last eight years. This run-up in home prices has had a huge impact on the economy and people's personal finances. The housing sector has been the major engine of growth following the 2001 recession, as construction has risen by almost 40 percent since the recession and a surge in home equity borrowing sustained strong consumption growth."⁵

Dr. Quincy Krosby of the Hartford Market Commentary notes a \$75 billion decline in home equity extraction that will be that many fewer dollars that consumers will be spending in 2006.

"The Fed's own studies indicate that between a third and a quarter of the cash extracted from home loans is used for personal spending. Freddie Mac, the second largest mortgage purchaser in the U.S. estimates that in 2005, \$244 billion was cashed out of home equity. In 2006, according to Freddie Mac, cash-out refinancing could drop to \$169 billion."⁶

From a historical standpoint, in speaking of Florida real estate speculation, Dr. John Kenneth Galbraith states:

"The first manifestation of the euphoric mood of the 1920s was seen not on Wall Street but in Florida – the great Florida real estate boom of the middle of that decade. Each wave of purchases then stimulated the next. As speculation got fully under way, prices could be expected to double in a matter of weeks. Who need worry about a debt that would so quickly be extinguished?

In 1926 came the inevitable collapse. The supply of new buyers needed to sustain the upward thrust dried up; there was a futile rush to get out. In 1925, bank clearings in Miami were \$1,066,528,000; in 1928, they were down to \$143,364,000."⁷

If consumer spending comprises more than two-thirds of our GDP, and this run-up in house prices has sustained consumption, what will happen to our economy and markets when the housing bubble bursts? Will we finally achieve the ever-elusive "soft landing?"

Clearly, today there are many indications that the markets are softening again. From May 10th to June 13th, we saw a broad sell off across the markets. The Dow was off 10 percent, and the Transports were off 11 percent, while most overseas markets fared much worse. In the last several weeks markets have recovered, but are still below their April – May highs.

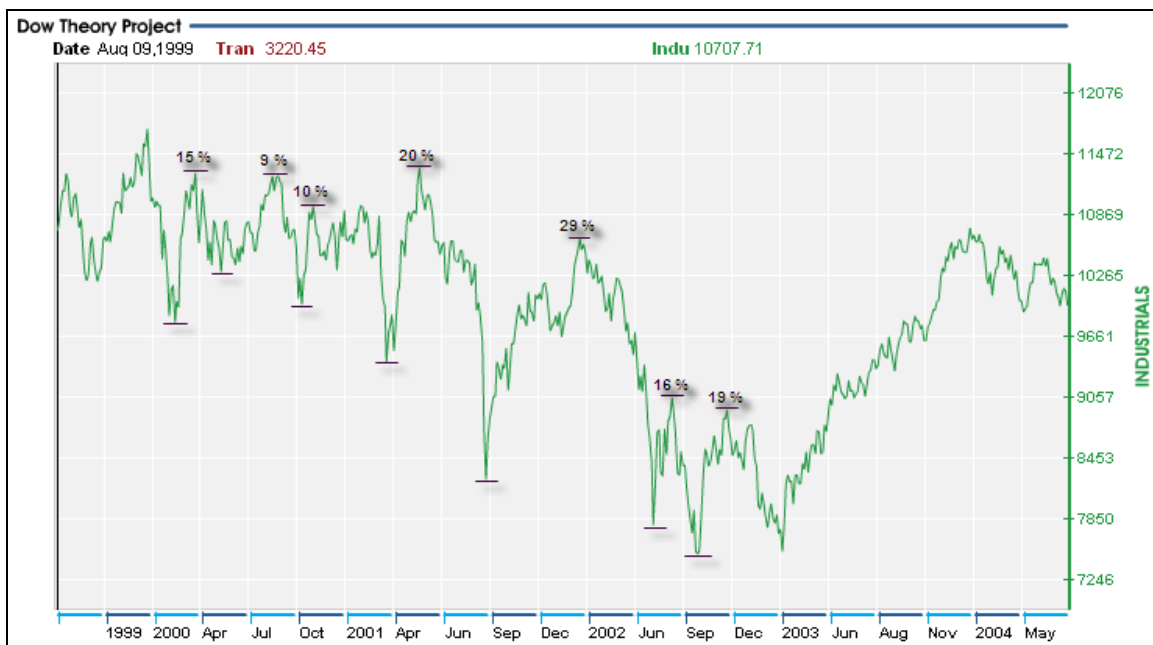
In 2005 *The Journal of Behavioral Finance* contained a piece by Associate Professor of Finance John R. Nofsinger of Washington State University. In it, Nofsinger made the following observations.

"Declining social mood precedes disagreement. Disagreement manifests itself in the market through volatility. The stock market itself is a direct measure or gauge of social mood. Since the tone and character of business activity follows, rather than leads, social mood, stock market trends help forecast future financial and economic activity. During periods of low (or declining) social mood, the increased general conflict within society is also reflected in stock market volatility."⁸

And, therein lies the rub. Increased volatility is evidence of the declining social mood that precedes, and arguably causes, market declines.

Investors who do little research will find many reasons to rationalize their investment decisions. However, other investors, who are willing to look at information like the data from the IMF or the Center for Economic and Policy Research, will likely conclude that they shouldn't expect a market rally, that is dependent on real estate appreciation and consumer spending from ever-expanding consumer debts, to continue.

In many ways, we've been here before, and it wasn't even that long ago. As 2000 to 2002 unfolded, investor's clung to the stocks-for-the-long-term, buy-and-hold mantra. Lacking knowledge of other options, there was little else they could do. Ignoring the cognitive dissonance, we dismissed all of our nagging concerns and followed the crowd. Yet, as the chart below reflects, this period was not a time when we were climbing the wall of worry, but rather (borrowing a phrase from Jim Dines) a time when we were "descending the wall of hope."



Yes, it is true that the markets did rebound into May of this year. But, that is the past. What does the future hold? The weeks and months ahead will clearly show us the true longer-term direction of the various markets. Though millions of investors and advisors who have no exit strategy will enjoy strong rallies, much like those of 1929 to 1932 and 2000 to 2002, ultimately the declining value of their assets could prove quite devastating.

Sources:

1. Though the data for this chart is a matter of public record, the idea came from a 2005 Rydex presentation.
2. The Wave Principle of Human Social Behavior and the New Science of Socionomics (1999), Robert R. Prechter, Jr., page 157
3. Ibid, page 153
4. When Bubbles Burst (2002), IMF Report, Thomas Helbling and Marco Terrones, page 74 <http://www.bestmindsinc.com/documents/WhenBubblesBurst.chapter2IMFReport.2003.pdf>
5. "Will A Bursting Bubble Trouble Bernanke: The Evidence of a Housing Bubble" (November 2005), Dean Baker and David Rosnick, Center for Economic and Policy

Research, page 3

<http://www.bestmindsinc.com/documents/CEPR.HousingBubble.112005.pdf>

6. The Hartford Market Commentary (July 24, 2006), Dr. Quincy Krosby, Chief Investment Strategist, The Hartford, page 3
7. A Short History of Financial Euphoria (1994), Dr. John Kenneth Galbraith, pages 73 – 75
8. *The Journal of Behavioral Finance* (Volume 6, Number 3, 2005), "Social Mood and Financial Economics, John R. Nofsinger, pages 144, 150 & 151