

## **How the Current Market Is, And Is Not, like 2008**

The current market decline since last April is evoking memories of 2008-9, when stocks swooned by over a third to a half, depending on the index used. The relevant question is: to what extent is history repeating itself?

The first difference is the cause of the decline. In 2008, the focus was on the collapse of securities associated with the real estate market and the financial failure of the US firm of Lehman Brothers. This time, the attention is directed to Greece and the euro internationally and a paralysis and poisoning of the political process domestically. To better understand each factor and what they share, an analysis is in order.

The euro is a currency that exists as the result of a confederation of countries collectively agreeing to embrace it. Unlike a domestic currency such as the US dollar, the euro does not have the backing of a single institution. Rather, its legitimacy is the result of the support of the countries that use the euro as legal tender.

One of the countries that embraced the euro is Greece. It now appears that Greece gained use of the euro by presenting the other countries with financial data that was bogus. Greece has adopted retirement and welfare policies that its tax structure cannot support, even if tax evasion were not that country's national sport. Because of this, the debt of the Greek Government looks like it will lose value should the Government be forced to declare bankruptcy to preserve its existence.

If Greece still had its own currency, the default of Greek bonds would hurt no one else but Greece. Since the debt is denominated in euros, the debt of Greece is owned by other euro-denominated countries, chiefly Germany and France. In addition, financial institutions in both countries have written default contracts on Greek debt, in effect guaranteeing the face value of Greek bonds against default in a manner reminiscent of AIG's guaranteeing mortgage bonds. Because of these derivatives, the financial exposure of the German and French Governments could be many times the face value of the Greek debt.

Germany is hoping that Greece can avoid default until 2013, when most of the derivative contracts would expire worthless. To do this, a rescue fund needs to be put in place to back the Greek euro bonds with the credit facilities of other countries. This is not a politically popular thing to do, as voters in the countries being asked to support Greece wonder why they should underwrite the debt of a country whose social welfare programs gave their citizens benefits denied themselves. The fact that adopting the euro led to economic expansion within Europe that has chiefly benefitted everyone, but mostly Germany, seems to have been forgotten. The issue is whether the leaders of the European countries can persuade their voters that their best interest lies in not letting Greece go under financially. So far they have not done so.

In the US, a belated shift to job creation by the Obama Administration has been met with both skepticism and scorn by Republicans and Democrats alike. Republicans do not like funding the program by taxing the rich. Democrats do not like the program because in the eyes of many it needs to be larger to be effective.

Add to this conflict the ideologically pure but politically immature members of the House who voted down the temporary funding resolution of the Federal Government. If carried out, it will be the second time in two months that the portion of the Republican Party aligned with the Tea Party has threatened to shut down the Government over deficit spending. Living in the shadow of threatened shutdowns is no way for a government to effectively conduct business.

Like some of the countries of Europe, the Tea Party cannot see beyond its own self-interest. Any effort to address the greater good by compromise is considered irrelevant. The mindset of both members is: better to die nobly for a cause than live humbly for one. The problem is that the outcome of such thinking will hurt not just those who embrace their cause but everyone else.

Europe suffers from a structural defect in the organization of its currency, which is embraced by many but supported by few when it comes under pressure. America suffers from a defect in its politics, as the more extreme members of both political parties assume control and force more moderate voices out. The financial markets of both parts of the world depend on a stability that only political compromise, commonality and continuity can provide. Once these three factors are again held in esteem the crisis of the world will abate. The resources are available. The will needs recognition at the ballot box to proceed.

## **The Economy**

After the adverse impact of the August threat to shut down the Government on the economy, a new round of the same threat has again been visited on the appropriations process.

The new shutdown is in some ways a smokescreen to divert attention away from the jobs bill which the Administration is promoting. Spending \$447 billion for infrastructure repairs is a moot point if the Government is on standby status due to a lack of appropriations to operate.

One telling statistic: total debt to economic output (GDP) has declined from its peak of 379.5% in early 2009 to 350.4% this past quarter. Of the improvement, 86 percent came about from increased economic activity. Only 14 percent was caused by debt reduction. The idea that the country's debts will shrink due to smaller deficits alone is bogus. They will shrink due to rising economic activity, which the jobs bill is designed to provide.

## **Interest Rates**

In the absence of political support for stimulus spending from the Federal Government, the Federal Reserve has tried alone to promote economic growth. It has been an at times painful exercise to watch.

With short-term rates close to zero, and long-term rates for Government bonds around three percent, the Fed has designed a program to push short-term interest rates up and long-term rates down. The merits of this exercise are largely unknown.

The real problem is the lack of demand, as corporations sit on record amounts of cash and consumers continue to reduce their debts. To stoke demand, the Government needs to increase spending. This is anathema to those who feel, after a decade of deficits, that the Government needs to suddenly get its house in order.

Some are suggesting that this drive to reduce spending is part of a larger agenda to keep the economy off balance until the 2012 elections. If this is true, the conduct of those responsible borders on the criminal. To hold the economic fortunes of millions hostage for possible political gain is neither good politics nor good government.

## **Inflation**

The inflation rate has shown some signs of uptick, mainly due to somewhat higher prices for houses sold year over year. This is among the first signs that the housing market is finding a bottom and will stop being a drag on the economy.

The rate of productivity has declined, but this more reflects the politically-induced economic slowdown rather than wage pressures. As the economy cools, use of labor becomes more difficult to schedule. This problem will be especially true if the holiday selling season does not come back strong this year.

## **The Stock Market**

In view of the hits the economy has taken, it is surprising that the market is doing as well as it has. Just as in 2008-9, a financial crisis is causing a rush out of assets into safe havens like the dollar and cash. Even gold, supposedly an investment that benefits from world instability, is going down.

Crowd psychology is a difficult thing to call the turn of, but is a dramatic event when it happens. It will be like watching the world coming out of a collective bad dream. Whether this happens because of a resolution of the Greek crisis, the breaking of the political logjam in the US or some other combination of events, the effects on stock prices will be dramatic. Stocks are currently selling for the lowest valuations since 2008. If the market recovers in a fashion similar to 2009, the Dow Jones Averages should reach 16,000. That would make for more pleasant conversations than any enjoyed by investors today.

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