



Popular Delusions

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“It’s not how rich you are that matters, it’s how much you can borrow.”
Alan Bond, Australian entrepreneur, yachtsman and convicted felon

**“Much has been written about panics and manias, but one thing is certain,
that at particular times a great deal of stupid people have a great deal of stupid money.”**
Walter Bagehot, British author, philosopher and editor of The Economist

No student of stock market history should be without a copy of Charles Mackay’s *Extraordinary Popular Delusions and the Madness of Crowds*. Written in 1841, it remains one of the most comprehensive studies of panics, manias and moral epidemics that have gripped mankind over the centuries. Legendary financier Bernard Baruch claimed the book saved him millions in the stock market crash of 1929.

Less than a quarter of the book is devoted to financial panics, however. The majority of the book examines non-financial manias such as alchemy, witchcraft, magnetism and religious wars. Regardless of type, one common thread unites these popular delusions: how easily the public is led astray and how imitative and gregarious people are. As Mackay notes, “Men think in herds, go mad in herds, while they only recover their senses slowly, and one by one.” The book is a testament to the wisdom of contrary thinking and the ease at which conventional wisdom can morph into human folly.

Events of the past decade would have undoubtedly attracted Mackay’s attention were he alive today. The popular delusions of the last 10 years were the widely held beliefs that anyone who wanted a home should be allowed to buy one and that home prices would forever rise. The public responded by purchasing homes they couldn’t afford, borrowing too much money relative to income, and abandoning savings in favor of consumption. Financial institutions (aka Wall Street) catered to this folly by lowering credit standards and creating ever more complex financial instruments (credit default swaps and AAA-rated sub-prime mortgage securities) to keep money flowing into the real estate markets.

Government also played a role. It kept interest rates relatively low, passed laws mandating that mortgage lenders extend credit to those least likely to pay it back, and turned a blind eye to the excesses of Fannie Mae and Freddie Mac, two government sponsored enterprises (GSEs) which were, and still are, the nation's biggest guarantors and buyers of mortgages on moderately priced homes.

We all know now how the housing mania of the 2000s ended. It ended in a crash and crisis, the way all financial manias tend to end. And while the public is no longer deluded by a belief in steadily rising home prices, other popular delusions have arisen in its place.

The “It’s all Wall Street’s Fault” Delusion

One such delusion is the widespread view that the financial crisis and recession of 2008-2009 was only the fault of Wall Street. As the President said in a recent interview on CBS's *60 Minutes*, “I did not run for office to be helping out a bunch of fat cat bankers on Wall Street . . . you guys caused the problem and we’ve got 10% unemployment.”

Blame-the-bankers, of course, has great populist appeal. They are a relatively small group and relatively highly paid. Financial services (banks, brokers, insurance and real estate) make up less than six percent of total US employment and Wall Street per se less than one percent.

Fix greedy Wall Street and you fix the economy, so the reasoning goes. Thus from Washington we hear lots of talk about increasing bank regulation, taxing securities transactions, goading banks to increase lending, limiting executive bonuses, and bringing back the Glass Steagall Act, which separated commercial banks from investment banks back in the 1930s and remained in effect until the late 1990s.

The inconvenient truth, however, is that Main Street and Pennsylvania Avenue also played a role in creating the financial debacle of 2008-2009. Manias don't exist without broad public support and the public's strong demand for home mortgages fueled the boom in sub-prime lending and exotic financial instruments. When attempts were made to rein in the excesses of Fannie Mae and Freddie Mac, the Congress in bipartisan fashion routinely failed to act. During one 2003 hearing on GSE regulation, a Congresswoman captured the feelings of many legislators: “I have sat through nearly a dozen hearings when, frankly, we were trying to fix something that wasn't broke. Housing is the economic engine of our economy and in no community does this engine need to work more than mine.” Don't ever expect government to step in and be the voice of prudence when the good times are rollin'.

Undoubtedly Wall Street will face tougher and well deserved regulation as a result of its key role in the recent crisis. But it is a mistake to ignore the role of government and expect any material improvement in the nation's housing picture. Wall Street has retrenched and restructured over the past 15 months. The weakest players—Lehman, Bear Stearns, Countrywide and Washington Mutual—are gone or have been absorbed by

stronger organizations. Most of the large banks have repaid their TARP funds at a profit to the government. The risk of major loss to the government is now centered on GMAC, AIG and the GSEs, not the banks.

Government, on the other hand, seems to be digging itself (and the taxpayers) deeper into the nation's housing crisis. Today the feds underwrite, directly or indirectly, about 90% of new residential mortgages, twice the pre-crisis level. The two GSEs now own or guarantee about half of the nation's \$11 trillion in home mortgages. And on the night before Christmas, *when all through the house not a creature was stirring, not even the media*, the Congress agreed to cover "unlimited" losses at Fannie Mae and Freddie Mac through 2012. Credit demands from the government are growing rapidly just as credit demands from consumers and businesses begin to contract. Slowly but surely, the private sector is getting into better financial shape than the government.

The "US Doesn't Manufacture Anything Anymore" Delusion

Another important delusion regards the health of the US manufacturing sector. The steady decline in manufacturing employment over the years has given rise to the myth that US manufacturing is in a state of secular decline. In the early 1980s over 20% of our work force was employed in manufacturing compared to less than 10% today. What's more, the US has run chronic trade deficits over the years, reinforcing the view that the rest of the world doesn't want the stuff we manufacture.

While it is true that US manufacturing has been under severe pressure from emerging market economies, it is also true that the US remains the world's largest manufacturer. What's more, US manufacturing output as a share of our total economy has remained a remarkably stable 13 to 14% over the years, even as employment has declined. Today the US accounts for about 19% of global manufacturing output compared with 13% for China and 10% for third place Japan. Continued rapid growth in emerging market China should enable it to overtake us in five to ten years, but among the developed world economies (Western Europe, Canada and Japan), we should remain the #1 manufacturer for the foreseeable future.

The trade deficit creates the impression that most US goods are not competitive on world markets. This is not the case. Exports, in fact, represent a growing share of the US economy, running 12% of total output today compared with just less than 6% in the early 1960s when we didn't seem to worry as much about foreign competition. A hefty 70% of our exports are manufactured goods, particularly those industries where we are a world leader. These leadership categories include aerospace and defense, computer software, computer hardware, scientific instruments, movies and entertainment, pharmaceuticals and medical devices, and energy exploration and production equipment. We frequently find some of our best investment ideas in these groups.

In the recently released third quarter 2009 GDP report, US exports were the strongest major component of our economy, growing at an 18% annual rate compared with a 2.2% rate for the overall economy. We believe manufacturing and exports will continue to be

two of the strongest parts of the US economy in the years ahead. For the country to meet its burgeoning debt service obligations, we must become more production and savings oriented and less consumption and borrowing oriented. Helping spur this transition will be 1) strong productivity gains by US factories, 2) the steep decline in the foreign exchange value of the dollar over the past decade and 3) the fact that over half of US goods exports are now to emerging market economies which grow two to three times faster than the developed world. In this environment, the production-oriented sectors of the market—technology, industrials, energy and materials—should benefit.

Economic and Investment Outlook

Many of the events of the past two years have been described as "unprecedented", but the sequence of these events has followed an old familiar pattern, not dissimilar to the Tulip Mania of 17th century Holland, described by Mackay in his book, or the numerous financial crises of more recent times. An investment mania eventually ends in a panic. Massive investment losses occur. The economy contracts. Eventually order is restored, usually with the help of the government. The stock market recovers, followed a few quarters later by economic activity.

In 2010, we see a US economy in the early stages of recovery. The recovery will be modest by historic standards because the economy's huge debt burden will limit private sector credit expansion and the uncertainties inherent in health care reform and tax policy will limit job growth. We expect real GDP growth of 2.5–3.0% this year, not the 5.0-7.0% growth characteristic of past rebounds from sharp recessions.

Despite a tepid economic recovery, stocks should do reasonably well this year, with price gains of 7-10%. Corporate balance sheets are in much better shape than consumer and government balance sheets. Moreover, Corporate America responded quickly to the recent financial crisis by cutting employment and inventories. A lean cost structure has created opportunities for favorable earnings surprises, particularly for those firms exposed to the dynamic growth of emerging market economies.

The outlook for bonds is more problematic. While we expect inflation to remain below 2% in 2010 due to continued slack in factory utilization and the labor markets, the demand for credit should strengthen with a recovering economy and continued deficit financing by the federal government. We see long-term interest rates drifting higher over the next 12 months with the Federal Reserve beginning to hike short-term rates around mid-year. ♣♣♣

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