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Bad Economy, Bad Markets

You need only look at two pieces of data to understand why the capital markets have struggled through the first half of this year; consumer confidence is at its lowest level since 1980; and only 17% of the American people are optimistic about the direction in which we are headed as a nation. This pessimism, driven by a number of factors, directly causes the economy to slow down and stocks to fall. The factors causing this pessimism include the following:

The price of oil and other commodities We have discussed the price of oil often over the past couple of years and it remains an issue. The high price of energy affects almost every segment of our economy in addition to making people feel poorer every time they fill up their car. Food prices and other basic materials are also rising rapidly. This type of inflation has always unnerved consumers and causes them to slow their spending in other areas. A worker making minimum wage spends almost 25% of their weekly earnings to buy one tank of gas for their car. Farmers earn more on their crops but spend huge amounts on fuel and chemicals. Nobody benefits from spiking commodity prices.

The housing market We are in the first sustained drop in housing prices since the 1930's and comes as a direct result of the huge gains seen in housing over the past five years. Since the bulk of most people's net worth is in their home, this also makes people feel poorer. In addition, many people have taken equity out of their homes over the past fifteen years because of low interest rates, exacerbating the problem. Nationally, three million people owe more money on their homes than they are worth. The bubble in home prices over the past five years looks a lot like the bubble in internet stocks in the late 1990's with the difference being that people did not borrow the money to buy tech stocks like they have to buy their homes.

The mortgage fiasco The fact that everyone didn't see this problem coming is amazing. Mortgage brokers were paid to make loans, which were then sold to investment pools, which were sold to investors. These brokers had no incentive to make good loans since they were not putting their own capital at risk. To book more loans, they went to the sub prime sector, making loans to people who had never been able to get mortgages before. These borrowers were the most susceptible to rising interest rates and falling home values, although many prime mortgages have also defaulted. Investors that thought they were buying high quality mortgage bonds are finding that historical default rates are meaningless in today's environment.

Identifying the problems is easier than knowing when things will improve. It sometimes seems that things will never improve and the stock market is in an endless downward

spiral. Fortunately, there is no historical basis for these fears. The American and world economies are very resilient and have always gone through cycles. It is worth noting that we have only suffered through two recessions over the past twenty five years. Maybe we have forgotten that these cycles are normal, not uncommon, and temporary.

Investing during economic times like these is certainly difficult. There is a tendency to want to throw the investment plan out the window and bury the money in coffee cans in the backyard. Space does not permit a full discussion on why this is a bad idea, but suffice it to say that we would always advise against that course of action. It is a true statement that it is more important to be in the market when it's going up than to be out of the market when it's going down. Over the twenty year period from 1988 through 2007, the S&P 500 index was up 11.8% per year on a compounded basis. If you missed the twenty best days over that twenty year period, your return dropped to 7.2% per year. Compounded over twenty years, that results in a huge difference in dollars.

The spikes we are seeing in commodity prices are no different than price spikes we see in other assets. Spikes like this are not sustainable and eventually always pull back to normal trends. We are seeing this pullback now in home prices. While predicting at what point oil will peak is difficult, if not impossible, it will happen. Likewise, home prices will stabilize and the excesses of the mortgage industry will subside. We will likely need to see these things improve before consumers feel optimistic again. Investing money, whether it's in stocks and bonds, or in a home or new car, requires optimism. This optimism normally returns quickly and when people least expect it.

Please call us if you would like to review your investment plan to ensure that you are on the right path with your investments.

Wabash Capital