Do Not Lose Hope

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Headline writers are running out of synonyms for shock in describing the fate of financial markets. When fear trumps fact everyone is a loser. The savage downdraft we are experiencing is a made-in-America crisis born of hubris and horrendously bad governance. It takes no prisoners at home or abroad, the negative verdict dead on the mark. As the scale of the challenges become clearer, governments enjoying the respect and confidence of their citizens are likely to weather the stresses more easily than those where politicians and bureaucrats are viewed with disdain. Economies based on human resources, creativity, and efficiency, with interlocking investments in industry, agriculture, and education will lead the way to recovery. Pinning the US louse up on the perennial hobgoblins of corporate greed and CEO compensation is off target. Mounting evidence places the onus on runaway central bank policies, botched regulations, and political interference. Having pumped too much money into their economy over the past half decade, the authorities are trying to address the problem by doing more of the same, along with yet another burdensome blanket of bureaucracy. Those who have no understanding of what has happened are charged with the responsibility of solving the problem, only to undermine the capital markets and make tomorrow's pain worse. To wit the continuing decline in equity prices.

The upheaval being experienced is more than financial. It is a historic geopolitical shift in which the balance of power is being altered irrevocably. The United States' era of global dominance is over. Its dire condition is as result of embracing the dangerously simplistic ideology of deregulation. Dependent on large inflows of foreign capital to finance mounting deficits and generous tax cuts, and fund military commitments, it will be those who spurned the free-market model of capitalism that will shape its future. Though it will continue to be the world's largest economy for decades to come, several newborn super powers have the money in store to buy up what remains intact in the wreckage of its financial system. Having created the conditions that produced history's biggest bubble, its politicians appear unable to grasp the magnitude of the dangers the country now faces. Mired in their rancorous culture wars, and squabbling amongst themselves, they seem oblivious to the fact its pre-eminence is fast ebbing. A new world is coming into being almost unnoticed, where the US is only one of several stalwarts.

Policymakers know the current uncertainty can never be entirely eliminated, the consequence of refusing to shoulder full responsibility for their actions. There is also the chance government bailouts could encourage further imprudence. The Federal Reserve

Board is front and centre in efforts to contain the damage, applying direct help for credit woes via increasingly creative lending facilities and the broad power of interest rate cuts for the ailing economy. People are depressed, dour, and pessimistic. They display the absence of intent in owning securities, are a vacuum of optimism, a black hole of negativism. GDP growth has topped out. A consumer-led recession has dire consequences. The housing collapse commenced early last year as the sub-prime slime began to ooze through residential real estate. Excess inventories continue to do their grim work. Lenders are tightening the purse strings just as wage-earners face job cuts, higher food and energy costs. Any discretionary expense is fair game, even for top income earners who have heretofore been considered immune to business cycles.

There are many entry points to the story marking the complete washout of Wall Street, a cleaning so thorough it represents a shift in the essential form of Western capitalism. Nothing less than epochal. Members of the New York Stock Exchange, who saw themselves as masters of the universe, displaying a fearful arrogance that knew no bounds, were riverboat gamblers who risked their reputations and that of their firm's, the client's pocket book, and the viability of the financial sector. Why the forces of regulation, reform, and corporate governance failed to take action remains an unanswered question. Dark clouds are gathering. North America may be headed into an entirely new cycle, one that will witness a period of volatility – not unlike the 1930s say some. While corporate acquirers see select opportunities, they remain cautious, alert to the risk of not being able to raise the necessary bank financing. In a true bear market there is no place to hide, a voracious media intensifying the hysteria. Share prices have reached a point where the raising of additional equity would badly dilute existing investors. Mistrust limits the size of equity and debt issues, only self-funding enterprises able to grow. Economic gurus advancing complicated and expensive taxpayer-financed rescue plans is not good stewardship, a mixed blessing at best. Unloading commodity and equity holdings to meet margin calls, coupled with record mutual fund redemptions, hedge fund liquidations, capitulation, and tax-loss selling has resulted in a dramatic decrease the value of most securities, providing opportunities for astute investors to improve the positioning of portfolios. Discipline in the investment process, and allowance for dispassionate assessment of risk and reward, is paramount.

Bad choices, greed, and never learning from past mistakes brought an end to the bull market. With the bottom nowhere in sight, investors face even more losses, and a humbler future under the watchful eye of regulators whose responsibility it is to oversee the financial system, not to stab the corpse. Capitalism is often about the difference between the short and long run. Current accounting standards have been destabilizing. The mark-to-market nonsense should be replaced by a more realistic economic value calculation, particularly given as it is virtually impossible to put a price on frozen assets. Though late in the game, hedge fund accounting must become more transparent. Prohibiting the practice of short selling financial company stocks, supposedly to protect the integrity of the capital markets and rekindle investor confidence, has served to do the exact opposite. Outlawing naked shorts and reinstating the uptick rule would be beneficial to longer-term investors.

When the state gets involved in economic matters it usually leads to suppression of entrepreneurism, starvation of investment, lack of innovation, technological retardation, and more powerful unions able to dictate terms as they chose, choking off factors that give rise to success in business. Straightening matters out is easier said than done. Consumers entrapped by stagnant wages, depleted savings, and falling house prices are being squeezed. Allowing for the conversion of CMHC-insured mortgages into marketable securities will increase the readily available money supply, and temper interest rates charged homeowners without exposing taxpayers to greater risk. When the liquidity logjam becomes unclogged, the mortgage debacle brought under control, the flight into US Treasuries subsides and investor confidence is restored, the Canadian dollar should regain its footing.

Most humans innately worry about the wrong things. Investors should be indifferent to the daily – even annual – gyrations of the stock market. Panic attacks make matters worse – the first time a tragedy, the second a farce. One of the side effects is bond defaults. They come in waves, not a continuous stream. They usually occur when ivory-tower tenants get worried and lines of credit are cut off, heaping more bad news on those whose faith in the future is already impaired. Another issue is the US dollar. When the unit of account around which the world economy revolves is unstable, the potential for investment mistakes is magnified. The answer does not lie in taxpayer bailouts, but a creditable desire to steady and strengthen the measuring rod. Until such happens, financial markets will remain in limbo. As it stands, the fundamentals are scary, the scope of the credit crunch yet to be determined. Seeing as the investing world's brightest stars seem to be just as confused as the rest of us, "stay the course" may not be the best advice. A reassessment of portfolio strategy to take advantage of new opportunities is recommended. Those prepared to commit cash reserves before the Chicago Board Options Exchange Volatility Index – commonly referred to as the VIX – pulls back from record to more reasonable levels, and a few sleepless nights are not a bother, should consider buying the high-quality stocks and trust units to have suffered the greatest percentage pullback relative to their peers, as they are the more likely to bounce back and do so sooner than others. All should take steps to assure research analysts and investors they will survive and prosper anew.

There are key distinctions between risk and uncertainty. Risk can be gauged based on evidence, uncertainty the unknown of unknowns. When scared tips to fear, it becomes self-fulfilling. The greatest danger comes from altruists who think they comprehend what is causing the cathartic sell-off and can legislate and regulate inoculation against repetition. This is misguided. The advantage of global markets is they provide choice. The disadvantage of pandemic politics is the containment thereof. The key to investing is to estimate the value, handicap the risk, keep a margin of safety, and let compounding do the real work. Always remember that bull markets are born of pessimism, grow on skepticism, mature on optimism, and die on euphoria. The only strategy to have beaten the odds in recent times has been to load up on cash and short equities, and avoid leverage. The reverse will eventually prove to be the better choice. Despite the prophets of gloom dispensing negative messages based on dark scenarios of their own creation and heavy doses of useless hindsight, the world is not headed for a remake of the Great Depression. Human ingenuity will see to that. If you bail out now you will regret having done so within a year or two. Do not lose hope. The world is not about to meet its maker. Never has, never will. It just feels that way some days!