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Deal or No Deal?
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Deal or No Deal?

As our government works to unwind itself from the current paralysis surrounding the current bailout plan, it is critical that clear thinking and sound investment judgment prevail. We have written several communiqués in regard to the current situation, and though very few in the investment community thought Congress would fail to pass the bill given the high stakes, it is now our responsibility to discuss the consequences of both a "Deal or No Deal" scenario.

Deal

The smart money expects a deal will yet be struck, and the markets will swing violently as investor perception of the Congressional Bill's passage adjusts. If an acceptable and reasonable deal is approved, a level of doubt will be removed around the US economy and banks should be able to sell toxic assets, removing them from their balance sheets. Although the eventual cost to taxpayers is currently unknown, this should restore confidence in banks and enable the free flow of cash in a currently paralyzed credit environment.

The extreme volatility that is occurring, which is historic by any measure, should not be ignored. Any time we have reached these extreme levels of fear in the market (measured by something called the CBOE Volatility Index— or VIX); we have seen extreme "snap back" rallies. It is highly possible that the market could stage a meaningful rally based upon these rare volatility levels. For example, the last time we saw an extreme VIX reading was August 8, 2002, prior to a multi-year 87% increase in the markets. The time before that was when the markets opened after the September 11 attacks. Over the subsequent three and a half months, the markets rallied 21% (as measured by the S&P 500). Although there are no guarantees, past fear extremes have often led to recoveries in the markets, though not always long-term ones.

We believe an approved bailout plan will enable some level of resolution to the current credit crisis, however there are a few important things to remember. The current plan and new environment will place regulatory seat belts on the US economy, likely leading to slower growth and a less leveraged lending environment. The net affect will be an economy that may be more stable, and less risky, but it will not be able to sustain the type of year over year growth that we have grown accustomed to. Removing or reducing global debt will slow global growth; however the markets should adjust to a gradual and predictable tapping of the brakes.

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It is also important to note that the current market levels seem to have already priced in an economic slowdown. Through yesterday, the S&P 500 was down almost 30% from its peak, with many indexes down a lot more. The consequence of this Bill's passage may be a "relief rally" often seen after extreme market uncertainty. After this it will be back to fundamentals as much of this coming slowdown is already priced into the market.

No Deal

If Congress does not pass the bailout bill, or passes a highly amended "neutered package" there will be consequences to our credit markets. This scenario may save taxpayers money in the short term; however the long term economic implications could be severe.

A failure to pass the Bill could result in a domino effect of bank failures causing a seizure in the flow of credit. This would cause the cost of borrowing money to skyrocket not only for large financial institutions but everyone engaged in the utilization of credit (yes, all of us, US consumers too).

The US is a nation of net borrowers. No bailout plan, or an onerously amended package, would have the effect of slamming on the brakes on the US and global economies. Japan faced a similar situation in the late 1980s in which their banks carried huge real estate related bad debt; and the government chose to do nothing. They allowed their banks to not properly price their delinquent loans. This was the initial trigger that led to almost twenty years of flat economic conditions.

Credit is the oil of our capitalist machinery. If no formal deal is reached it is inconceivable that the US government would not take measures to establish a backstop with an alternative plan to prevent an implosion of our credit markets. Unlike Japan, the US approach has always been one of confronting challenge and adjusting to the new reality in a fairly prompt manner. In the meantime, the uncertainty would roil the markets.

What should you do?

Sitting tight when your investments are falling can feel dreadful; we all dislike the price of investing in times like this. But it is important to avoid emotional decision-making at all costs. Selling into weakness and turmoil is rarely a sound strategy and requires two perfect decisions; when to get out and when to get back in. Remember that locking in losses by selling assets for unneeded liquidity needs creates the challenge of when you should be re-entering the markets and potentially missing out on potential upswings. Extreme declines almost always lead to extreme advances.

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The market has already fallen because the stock market is a gauge of the future. The current relevant question is what happens a year or two from now? In our opinion, given the extremes we have been experiencing recently and the incredible pessimism in the system, the more likely scenario is a far better market outlook over the next few years. However, we should buckle our seat belts and be prepared for a bumpy ride.

All decisions about your investments should be made from a personal perspective relative to your overall master plan. These decisions should be made considering both your short and long-term investment objectives; and we are here to help you understand what the market action really means to you and whether any changes to your strategy should be considered.

As always, our team is here to work with you and help you through these difficult questions. Please know we are overseeing your portfolio and our investment team continues to monitor every individual manager and fund we have chosen on your behalf.

Thank you for your continued trust and confidence,

Kelly Trevethan CIMA®
CEO / Managing Director

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