1982 or 2009: Pick your Poison

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Dear Fellow Investors:

1982

The stock market bottomed in August of 1982 just below 800 on the Dow Jones Industrial Average (DJIA) during the worst recession that had occurred since the 1950's. Unemployment exceeded 10%, smokestack industries were decimated (remember Billy Joel's "Allentown"), housing and forest products were in a depression (foreclosures up dramatically), auto sales almost sank both Chrysler and Ford, interest rates peak at 15% on Treasury bonds and the U.S. had lost its respect around the world. The stock market had peaked in late 1972 at 1000 on the DJIA and investors could look backward and see how fruitless investing in common stocks had been for the prior decade. Business Week had called it the "Death of Equities" on a late 1979 cover.

Wise economic commentators explained in 1981 and 1982 why we could not have any meaningful economic recovery. Unemployment kept going up for months after the stock market exploded to the upside. Housing affordability was at a 38-year low. Credit needed to buy houses, cars and expand business was at such high interest rates that it seemed like nobody would want to borrow the money. Many of the home buyers and businesses who did borrow the money failed to keep up with the interest expense, damaging bank balance sheets in the process. Huge federal budget deficits were going to be exacerbated by the Reagan tax cuts. The government's borrowing was crowding out private borrowers. Banks were competing with money market funds. The disintermediation of the banking industry forced them to pay competitive interest rates on a relatively new instrument called a Certificate of Deposit (CD). It appeared highly unlikely that a strong economy could get born in those miserable circumstances.

2009

The stock market bottomed in March of 2009 at around 6500 on the DJIA during the worst recession since 1982. Unemployment has reached 9.8%, most cyclical industries have been devastated. Auto sales dropped so low that Chrysler and General Motors went into Chapter 11 bankruptcy. Retail sales have been "reset" to markedly lower levels. The U.S. has lost its respect around the world. Homes have fallen in value more than at any time since the 1930's. Looking back ten years, investors have suffered losses and many commentators are referring to the first decade of the 21st century as the "Lost Decade" for stocks. Numerous asset allocation experts are advising people to reduce their portfolio weightings in stocks and increase ownership in bonds. We believe this advice is being acted on. Bond mutual fund sales have run more than 20 to 1 ahead of equity fund sales since the start of the year.

Huge budget deficits exacerbated by the U.S. Treasury's TARP program and the Federal Stimulus Bill have convinced economic experts and commentators that whatever economic recovery comes could be accompanied by much higher levels of inflation. Many economists believe that the huge debt overhang left from the prior cycle, which equals around 375% of GDP, will serve as a drag on the economy for years and mute the magnitude of an economic recovery. Banks have such large write offs from the bad loans made in 2002 to 2007 that they are pulling back from lending to even creditworthy borrowers or asking for traditional down payments and collateral levels. Compared to 2007's levels these requests look onerous. It appears unlikely that a strong economy can get born in these miserable circumstances.

Pick Your Poison

Therefore, which is worse? An economic recovery which requires people to borrow money at ridiculously high interest rates from crippled banks, when houses are the least affordable that they've ever been? Or an economy where houses are the most affordable and the mortgages have the lowest rates they've had for 50 years from crippled banks in a society that already has seemingly unsustainable overall debt levels? Pick your poison. Did I forget to mention that the first incredibly miserable circumstance was the beginning of one of the greatest bull markets in U.S. stocks in history (1982-1999)? Did I forget to mention that the economy grew immensely and relatively consistently for 25 years? At Smead Capital Management, we don't believe all the doomsayers out there who say, "It is different this time". We think that a weak economy going forward is a "Well Known Fact" and is already factored into current prices.

Best Wishes,

William Smead

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