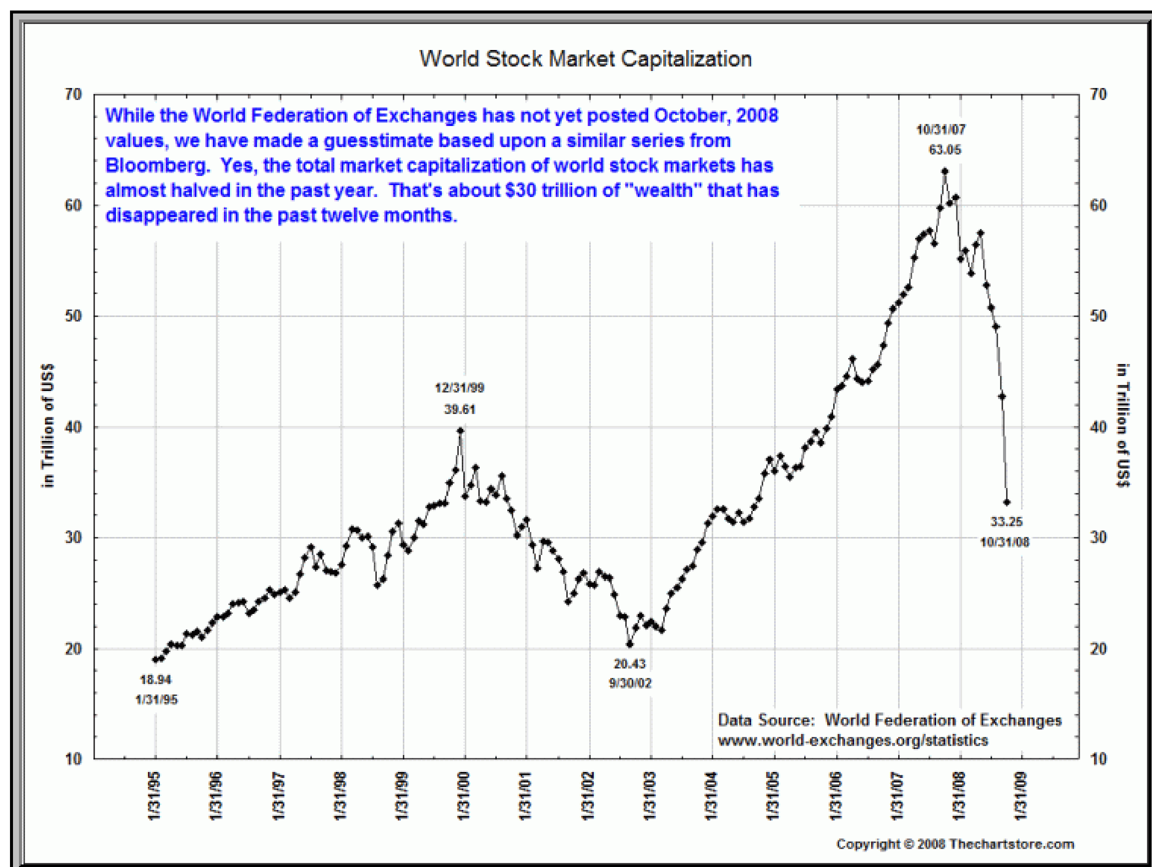
High Volatility: A Feature of the New Investment Environment!

Marc Faber

The wealth destruction that occurred over the last twelve months around the world is complete and unprecedented. Stocks around the world are down by 50%, property prices have collapsed and commodities are in some cases down by 50% or more. As can be seen from Figure 1, World Stock Market Capitalization is down by approximately 50%, which equals to losses for equity holders of around $30 trillion. Add to this the losses from non-government bond portfolios, CDOs, MBSs and assets such as ships (the Baltic Dry Index is down by more than 90%) the losses that investors and businessmen have taken are simply colossal.

Figure 1: World Stock Market Capitalization Cut in Half!



Source: Ron Griess, www.thechartstore.com

In the case of commodities, losses have been staggering especially for industrial commodities whose demand is driven by industrial production

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and capital spending. Nickel is down from a May 2007 peak at $53,452 per ton to around $10,000 (see Figure 2). As an aside, please note that Nickel peaked out already in May 2007 whereas the CRB peaked out in July 2008 (see last month's report). The point is that individual commodities can have widely diverging performances the same way in the stock market different sectors and stocks do not reach peaks and troughs at the same time.

Figure 2: Nickel, 2004 - 2008

Source: Bloomberg

Figure 3 puts the losses from the US stock market's peak in perspective. As can be seen, the Dow Jones is down over the last twelve months by 40%, a loss that even exceeds the 12-months loss following the 1929 peak (see Figure 3). I freely admit that I originally thought that that the liquidity injections and fiscal measures by the US Fed and Treasury would lead to a water torture bear market such as we had in 1973/73 when stock market declines were followed by sharp recovery moves to give again way to renewed weakness. But I suppose that one of the key differences between the 1973/74 bear market and recession, and the present time is the huge leverage we built up in the system since 1980 (in 1973, derivatives hardly existed and securitization was largely absent). So when credit growth began to slow down in 2007 and when asset markets sold off, it triggered a huge deleveraging process, which then brought about further price falls and caused further deleveraging. In addition to the severity and speed at which asset markets collapsed globally, volatility also increased to record highs (see Figure 4).

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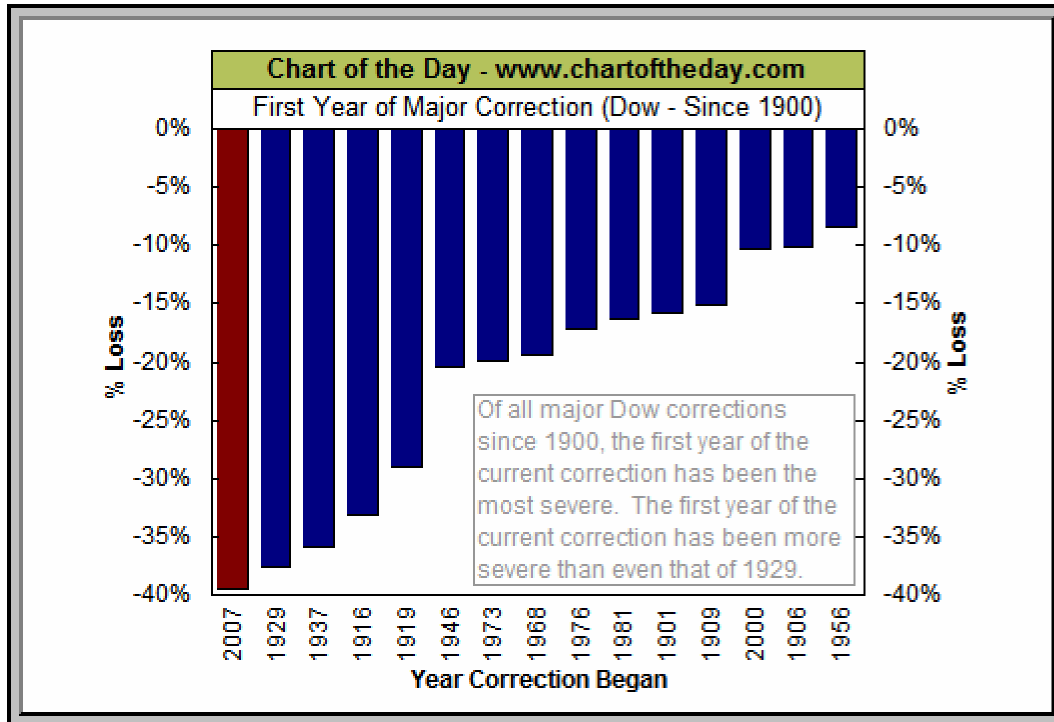
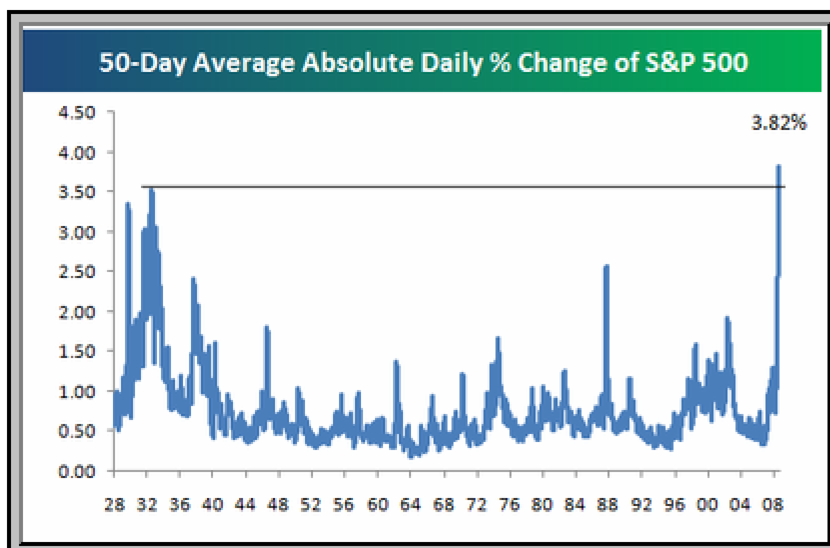
Figure 3: 2007/2008 Bear Market – Largest 12-months Decline Ever!



Source: www.thechartoftheday.com

Figure 4: Highest Stock Market Volatility Ever!



Source: Bespoke's Timely Market Research

In other words, as can be seen from Figure 4, over the last 50 trading days the S&P 500 has averaged daily up or down moves of nearly 4%! This

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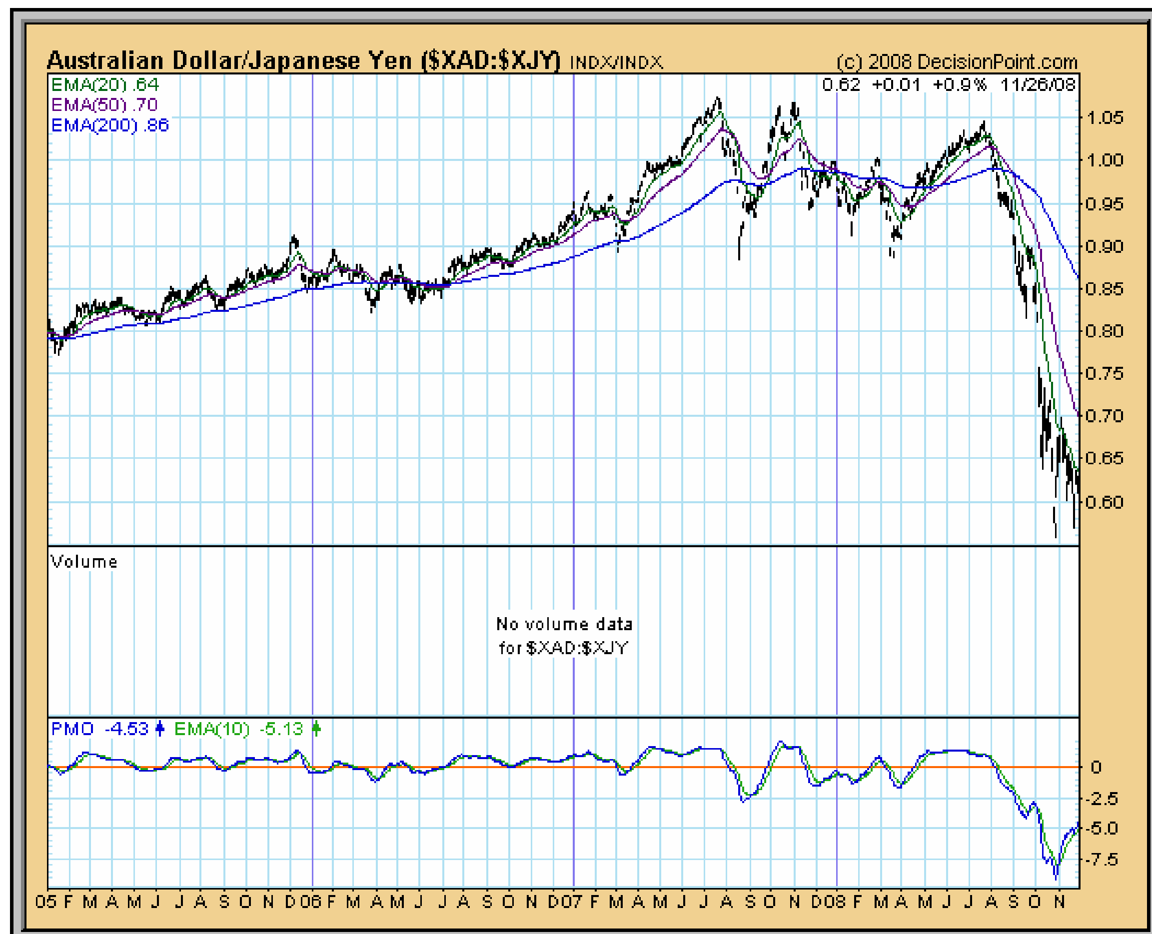
has clearly been the most volatile period in the history of the US stock market. Moreover, volatility has not only been extremely high in equities but also for commodities (see Figure 2) and for currencies and bonds. From a July 2008 high against the Yen, the Australian dollar has tumbled by close to 45% within less than 4 months (see Figure 5).

Figure 5: Australian Dollar Follows Commodities Implosion



Source: www.decisionpoint.com

In the bond market volatility also soared to record levels. Investors learned that corporate bond prices do not only depend on inflation and interest rates but also on the financial soundness of the issuing corporation (see Figure 6). In other words, the lower the quality of a corporate bond, the higher its equity character and its correlation to the underlying equity.

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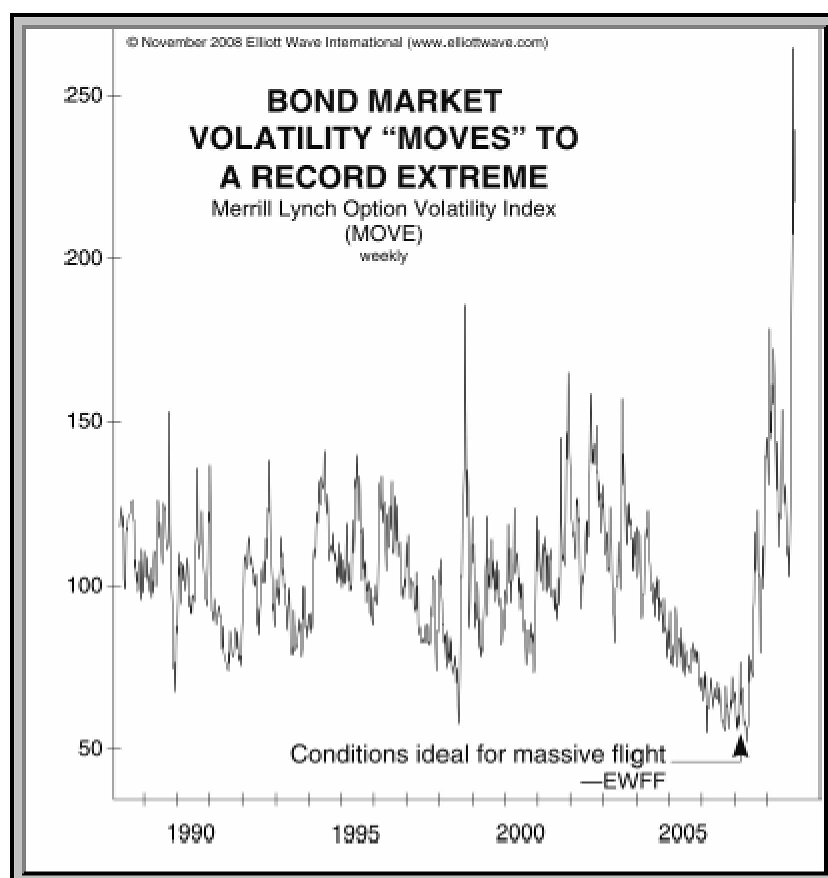
Figure 6: Bond Market Volatility, 1988 - 2008



Source: Robert Prechter, www.elliottwave.com

I am discussing the unprecedented volatility in asset markets for several reasons. Philip Isherwood of Dresdner Kleinwort published a while ago a study in which he showed that when volatility is above average, equity returns tend to be weak whereas low volatility leads to higher returns. He notes: "Unsurprisingly, high volatility is pro- Defensive, not pro-Cyclicals"! Isherwood then goes on to explain that, "…generally, markets prefer volatility to be low and the reason is understandable (not just for planning and sanity reasons) — for European equities have risen on average by 0.3% a week since March 1987 when volatility has been below average, but have fallen by 0.02% when volatility is above average.…Within the market, it is no surprise to find a stability-versus cyclicality angle to high-versus-low volatility — shifts in volatility after all reflect changes to the macro outlook.…" When volatility is below average the winners are headed up by the technology companies, telecoms, mining, oil equipment and life insurance and industrial and cyclical stocks. According to Isherwood, "within the market, low volatility is pro-Cyclical. Conversely when volatility is above average,

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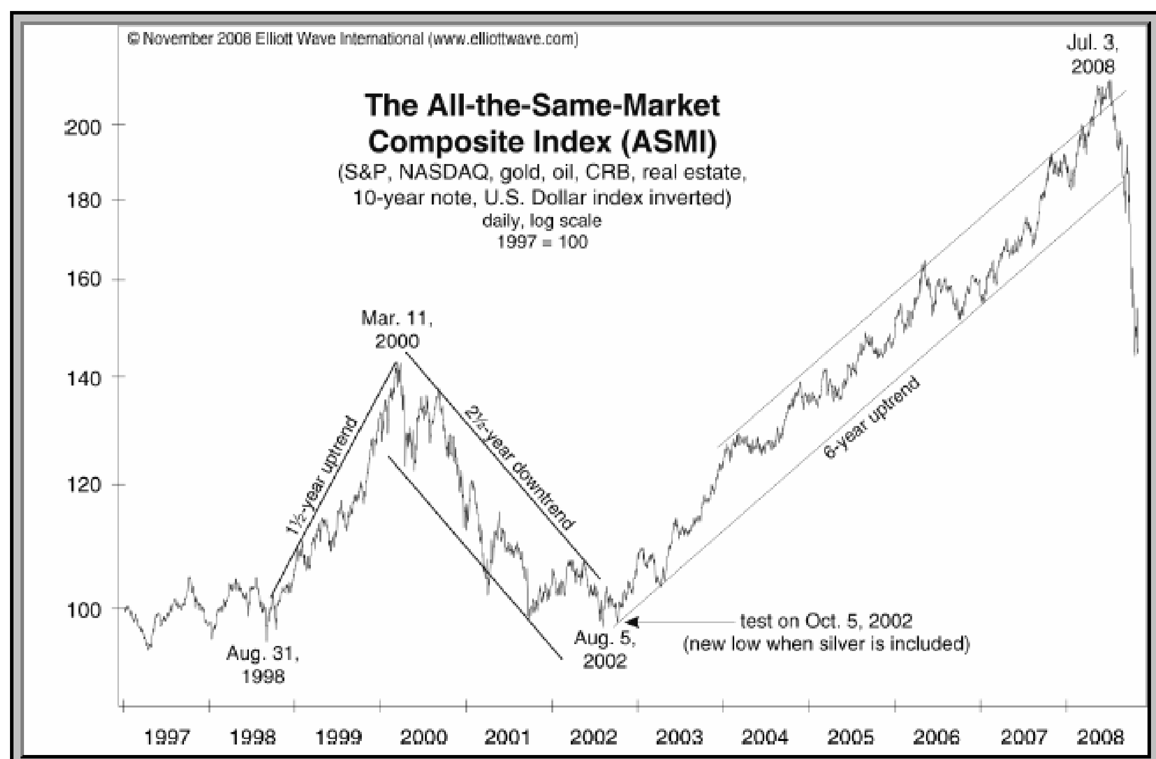
Tobacco and Beverages perform best, followed ….by Multi-Utilities and Mining.” Other sectors that perform well when volatility is above average include food retailers, pharmaceuticals, and electricity. I am mentioning this for the following reason: As can be seen from Figure 7, between 2002 and 2008 all asset markets increased in value (see Figure 7). The only asset class that fell in value was the US dollar.

Figure 7: Prechter’s All-the-Same-Market Composite Index, 1997 - 2008



Robert Prechter, www.elliottwave.com

The 2002 to 2007 period was also a time of first diminishing and then ultra low volatility (see Figure 4 and Figure 6). Not surprisingly the most cyclical sectors of the global economy performed best: emerging economies, cyclical stocks like iron ore, steel and shipping companies. Since the US economy is a less cyclical economy than the Asian economies, which have large industrial production and heavy capital spending, the US underperformed foreign assets (partly also because of the US dollar weakness). Then something changed at the end of 2007. US equities topped out at 1576 on the S&P 500 index. This was followed by a bottoming out of the US dollar in the first quarter of this year and a

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peak in commodity prices in July 2008 and a total collapse of all asset markets since then (see Figure 8).

Figure 8: US Dollar Index, 2002 - 2008

Source: www.decisionpoint.com

What I am driving at is to show the connectivity between various markets. 2002 – 2007: diminishing volatility, rising asset markets with emerging economies' stock markets and commodities out-performing the US amidst a weak US dollar and amidst growing US trade and current account deficits, which increased global liquidity. Then, 2008: rising volatility, falling asset markets, with emerging economies, commodities and cyclical stocks such as steel, iron ore and shipping companies underperforming the US stock market amidst US dollar strength and a shrinking US trade and current account deficit, which tightened global liquidity.

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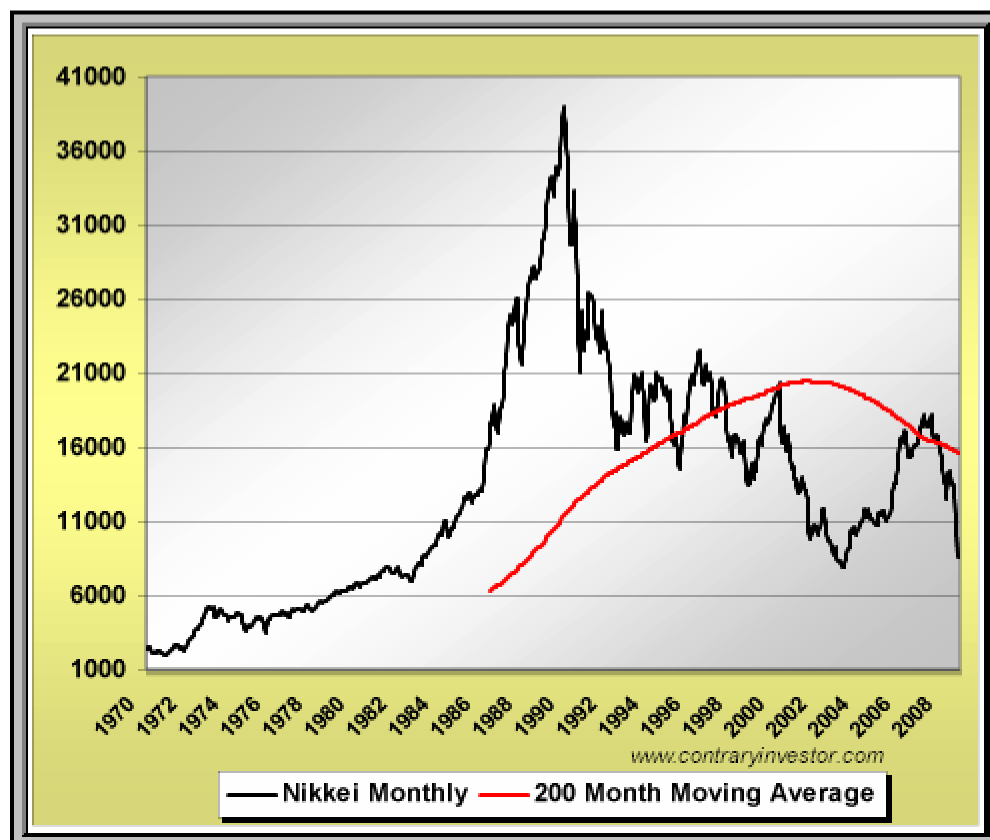
I have repeatedly characterized the current economic conditions as comparable to a war being fought between central banks around the world and the private sector and that this war is likely to be very protracted and will lead to high volatility in all asset classes. We have seen that governments are desperate to support asset markets with "extraordinary" and unprecedented monetary and fiscal measures (in the US the budget deficit is likely to exceed 10% of GDP in 2009). Moreover, it is evident that the worse the economic situation becomes the more governments (not only in the US) will throw money at the system (inflate) in order to boost equity and home prices – in short the Japanese model post 1990 (see Figure 9).

Figure 9: Nikkei Index, 1970 - 2008



Source: www.contraryinvestor.com

That these monetary and fiscal measures will at some point succeed to boost asset prices should be clear as the longer they do not work the more the "dose" will be increased. **Basically, these measures amount to a gigantic asset swap. Toxic assets are being transferred from the**

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private sector (mostly from banks and Wall Street) to the US government (taxpayers). Based on a thorough analysis, Bloomberg estimates that the U.S. government is prepared to lend more than $7.4 trillion on behalf of American taxpayers, or half the value of everything produced in the nation last year, to rescue the financial system since the credit markets seized up 15 months ago.

According to Bloomberg, "the unprecedented pledge of funds includes $2.8 trillion already tapped by financial institutions in the biggest response to an economic emergency since the New Deal of the 1930s… The commitment dwarfs the only plan approved by lawmakers, the Treasury Department's $700 billion Troubled Asset Relief Program. Federal Reserve lending last week was 1,900 times the weekly average for the three years before the crisis". Given the gigantic future financing needs of the US government it is, therefore, not surprising that the cost of ensuring US Treasury bonds against default has **quadrupled** over the last six months, as my friend Eric Kraus pointed out (see Figure 10).

Figure 10: CDS spreads on 10-year US Government Debt, 2008

Source: Bloomberg

I may add that in the UK, where the financial condition of the government is even more precarious than in the US, the CDS spread on 10-year British government debt has increased ten times to 100 basis points in 2008!

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Incidentally, Eric Kraus rightly asks from whom one should buy US or UK default protection. From AIG, Citigroup, UBS or an Icelandic bank??? But the point is this: If governments around the world throw money at the system, a relieve rally is the most likely scenario although, as in the case of Japan post 1990, it may only be temporary and not lead to an improvement in economic conditions (Japan has hardly grown since 1990 and the stock market made recently a 26-years low – see Figure 9). A relieve rally from deeply oversold conditions would in my opinion lift assets that were battered the most: emerging markets, commodities and in particular gold mining companies (see Figure 11).

Figure 11: Gold Bug Index: 30% rebound Potential

Source: www.decisionpoint.com

Above, I discussed the performance of different sectors in an environment of low volatility (favors cyclical sectors) and high volatility (favors non-cyclicals such as tobacco, beverage, food, pharmaceuticals). At the same time we saw that low volatility yields higher returns than high volatility.

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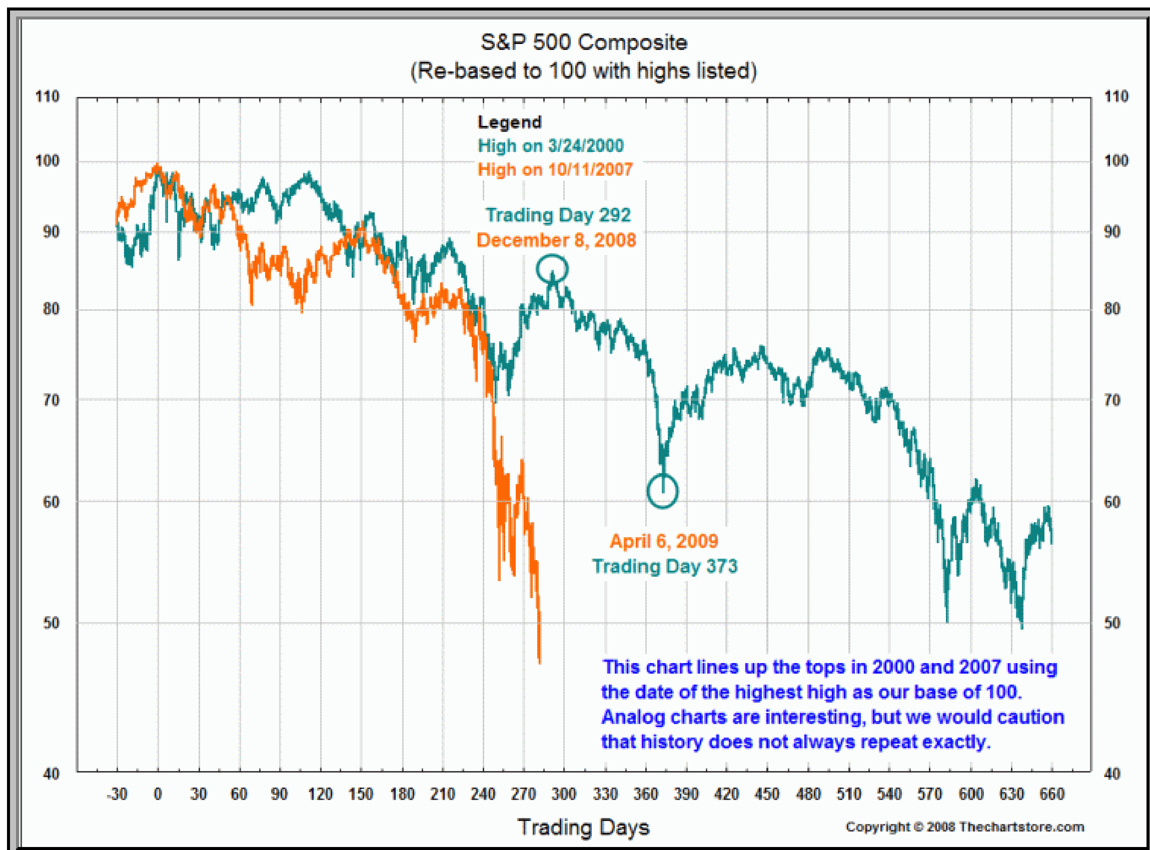
Now, let us combine these findings with the totally different investment conditions we had between 2002 and 2007, and with the ones we had in 2008 as well as with the oversold stock market condition amidst a rapidly deteriorating global economy, which is inevitably going to depress corporate profits for a long time to come. First, the oversold condition of the stock market: At their recent lows, US equities were as oversold as in November 1929 (before they rallied by almost 50% into the summer of 1930), as in October 1987 and as in the fall of 2002 (see Figure 12). So, purely statistically it would seem that the path of least resistance would be a rebound (same applies to commodities).

Figure 12: S&P 500 Performance from High: 2000 – 2003 and 2007 - 2008



Source: Ron Griess, www.thechartstore.com

In fact, the US stock market is far more oversold than at its low in 2002/2003 because it has declined in percentage terms by as much as then but in a much shorter period of time (see Figure 12). **So, let us assume a rebound is underway. In other words, the liquidity injections by the US Treasury and the Fed are for now successful. If the pattern of**

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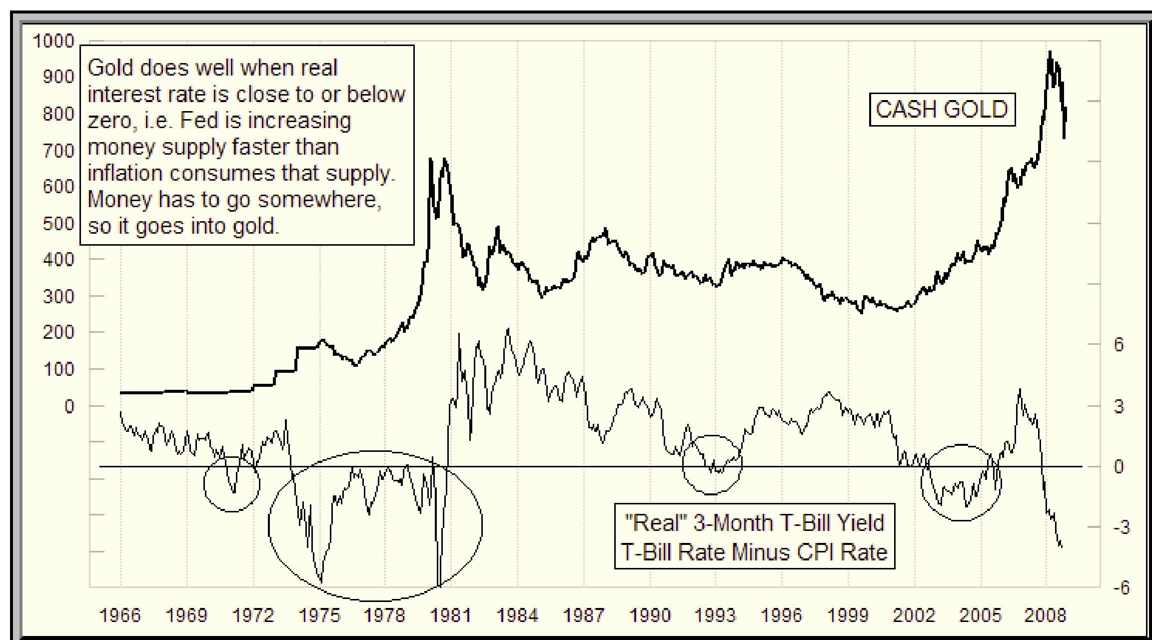
2002 – 2007 repeats itself it would imply declining volatility (but not to the lows seen in 2006/2007), a weakening dollar and an outperformance of cyclical sectors of the global economy (emerging stock markets and commodities and material stocks). But then we also need to consider the imploding global economy, which will lead to renewed weakness after the relief rally runs its course. **As in the case of Japan post 1990 (see Figure 9) asset markets will then weaken again and increase volatility, which will necessitate investors to move back into non-cyclical sectors, to liquidate positions or to enter short positions.** In the next few years I expect asset markets to favor aggressive traders and not long term investors. I therefore still think that for the average investor precious metals such as silver and gold will be the preferred investment (see Figure 13).

Figure 13: Performance of Gold amidst Negative and Positive Real Interest Rates (1966 – 2008)



Source: Tom Mclellan, The McClellan Market Report, www.mcoscillator.com

In my life I experienced two major trading markets (1968 – 1982) and Japan post 1992 (see Figure 9). I can assure my readers that during these trading market conditions (no net gain for the indices and in the case of Japan new lows) hardly anyone except very smart (lucky) traders made any money.

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Above I tried to show the existing connectivity between global liquidity (coming from the US current account deficit), asset markets, and currency movements. To navigate successfully between all these volatile and often unpredictable market movements you need to be a genius. And whereas I am sure that my readers are all above average investors (80% of investors think they are above average investors), I am not and, therefore, in very volatile periods I try to avoid losses and look for a safe heaven such as physical gold (gold miners and silver could, however, outperform for a while).

When Mr. Bernanke became Fed chairman and when he talked about dropping dollar bills from helicopters onto the US and taking "extraordinary" monetary measures in order to support asset markets, people did not take him too seriously. But as it turns out, he has done exactly what he wrote about and what he repeatedly stated in speeches. He is the John Law of the 21st century - a money printer and market manipulator par excellence. **A friend of ours recently sent us the following comment from Dr. G. Gono, chairman of the Reserve Bank of Zimbabwe (no hoax):**

"As Monetary Authorities, we have been humbled and have taken heart in the realization that some leading Central Banks, including those in the USA and the UK, are now not just talking of, but also actually implementing flexible and pragmatic central bank support programmes where these are deemed necessary in their National interests.

...That is precisely the path that we began over 4 years ago in pursuit of our national interest and we have not wavered on that critical path despite the untold misunderstanding, vilification, and demonization we have endured from across the political divide.

...Here in Zimbabwe we had our near-bank failures a few years ago and we responded by providing the affected Banks with the Troubled Bank Fund (TBF) for which we were heavily criticized even by some multi-lateral institutions who today are silent when the Central Banks of UK and USA are going the same way and doing the same thing under very similar circumstances thereby continuing the unfortunate hypocrisy that what's good for goose is not good for the gander.

...As Monetary Authorities, we commend those of our peers, the world over, who have now seen the light on the need for the adoption of flexible and practical interventions and support to key sectors of the economy when faced with unusual circumstances."

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The problem with the "practical interventions and support to key sectors of the economy" is of course that the market mechanism is badly disturbed by such measures and that the interventions are, as in the case of Zimbabwe, in the long run highly inflationary. For instance, I doubt that considering the large and growing budget deficits and the costs associated with the various bailouts the US will ever again have positive real interest rates – at least not until the system breaks down and a new monetary order is introduced, which will be run by real central bankers (ideally even without them) and will not be managed by some academics who in their insanity have become money printers. As Walter Bagehot stated, "the whole history of civilization is strewn with creeds and institutions which were invaluable at first, and deadly afterwards."

In any event, an environment of negative real interest rates is gold friendly and will be highly inflationary in the long run.

I wish all my readers a Merry Christmas and a Happy New Year (no emails will be answered between December 23 and January 8).

Above I hinted at the possibility of the eventual introduction of a new monetary system a point, which my friends Paul Brodsky (pbrodsky@qbamco.com) and Lee Quaintance, principals of QB Asset Management discuss in the enclosed report entitled "A Not-So Modest Proposal."

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