MARKET UPSIDE DOWN

HOW TO INVEST PROFITABLY IN A SHRINKING ECONOMY

VINH Q. TRAN

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Introduction

In investing, pessimism is your friend, euphoria is the enemy.

—Warren Buffet
CNBC, Interview, July 3, 2009

In autumn 2008, the U.S. stock market crashed to the lows seen only at the depth of the tech stock bubble burst during 2000–2002, then it plunged even further a few months later.

The Dow Jones Industrial Average had just made historic highs the previous year. Euphoria still hung in the air. No one expected to see record lows again—not another bear market, not so soon. Yet, within 12 months, precipitated by house price declines and subprime mortgage defaults, the Dow Jones Industrial Average saw half of its value evaporate. Almost in a flash, investors saw their gains from U.S. stocks in the past decade disappear—all the fruits of their patient long-term investing.

As a result, the United States experienced a systemic crisis that rapidly spread from its bankrupt or near-insolvent financial institutions to all sectors of its economy and every corner of the world.

To prevent its economy from sliding into a cycle of depression and deflation like Japan in the 1990s, the American government and its counterparts abroad undertook aggressive interest rate cuts and initiated massive bailout programs aimed at averting the global banking system from collapse.

Like Japan in the 1990s, the Federal Reserve cut its Fed funds rate to near zero, and the Treasury injected huge amounts of capital to bolster the banks in the hope that they would resume lending to ease the liquidity crunch. But the banks, teetering on the precipice of bankruptcy, held on to the government funds instead of lending the money, fearful of losses from making bad loans in a recessionary economy.

And stocks kept plunging. By the time President Barack Obama launched his $787 billion stimulus program on the heels of his election to the presidency, accompanied by high approval ratings and soaring speeches, stocks had crashed through the lows of October crisis levels and had surpassed the 2000 bear market bottom.

Although not immediately greeted by the stock market with loud cheers, those rescue measures nevertheless stemmed the tide of economic setbacks and stabilized stock prices. Reinforced with stimulus programs like "cash for clunkers," a host of economic statistics stopped deteriorating by mid-2009, and the stock market was flushed with a renewed sense of confidence in the beginning of a new bull market—as some well-known Wall Street strategists have asserted. Robert J. Shiller, the Yale University professor and originator of the S&P/Case-Shiller house price index, however, was puzzled:

> The global signs of a recovery in economic confidence seem puzzling.
>
> It is a large and diverse world, after all, so why should confidence have rebounded so quickly in so many places? Government stimulus and bailout packages have generally not been big enough to have such a profound effect. What happened?...For a fuller explanation, look beyond the traditional economic links and think of the world economy as driven by social epidemics, contagion of ideas, and huge feedback loops that gradually change world views....
>
> All of this suggests that a social epidemic is supporting renewed confidence. This confidence can keep growing by contagion, as a kind of self-fulfilling prophecy, and we may see the markets and the economy recover further. But in an economy that is still unstable, the stories could also morph into different forms, the price feedback could turn downward, and the dynamic could turn ugly again—just as it has in the past.[1]

Thus, it is not impossible to imagine that the rally from the March 2009 lows could turn into a lengthy extension, like the bounces in the aftermath of previous crashes. The Federal Reserve can keep money cheap for far longer than expected; it has the Bank of Japan's near-zero interest rate policy as a model. And the federal government can offer up one after another of the cash-for-clunkers programs it copied from a program two-and-a-half-times as big that was started in Germany. It is the sovereign power of printing money and deficit spending. Although current equity valuation is hardly a bargain, stocks are often bought for no other reason than because prices are expected to go higher. "An upward movement in stock prices generates its own upward feedback," as Robert Shiller put it.[2] We saw this phenomenon in Japan during the several years before the 1989 peak and numerous times again during Japan's 20 years of slumber. We saw it prior to the tech bubble burst in 2000. The multiyear market advance before the collapse in 2008 was built on an upside-down pyramid scheme of easy credit and inflated house prices. Before the collapse of Lehman Brothers Holdings and its abandonment by the Treasury and the Federal Reserve in September 2008, the stock market was almost oblivious to the subprime debacle and the pending banking collapse.

But when the recognition came, everyone in the crowd tried to exit by the narrow door.

However, another crash of the equity market and the resulting depressive impacts on savers and the economy may not be easily reversed this time by lowering interests, quantitative easing, or public spending programs. Interest rates will have been too low to be reduced for effect, and the Fed balance sheet is already stressed out. The government should find that its budget deficits and record debt load make it difficult, if not impossible, to get a trillion dollars here, another there for bailout and stimulus spending. The banks that have recently reported profits on the back of subsidized capital provided by taxpayers while retaining toxic assets on their balance sheets may find their financial strength inadequate to absorb new write-offs and loan defaults. In the meantime, American households are hardly in a position to take another hit after losing trillions of dollars in equities and real estate, amid rising job losses and low savings rates.

The reality is that the United States and its citizens are deep in debt. The country is now in far worse shape than Japan was at the start of its two-decade decline; the latter's stock market is still mired near the bottom with no end in sight. How long can an economy grow and its stock market rise on unsustainable debt and reliance on foreigners' largess to fund its relentless spending? How many fabricated booms and busts can a country absorb before its paper money loses its international standing and its social fabric is torn apart?

When the next crisis comes, where will the United States and its citizens find the resources to combat and recover? The Federal Reserve may crank up the printing press at full speed, but the global markets have ways to express their displeasure through soaring interest rates, the dollar's collapse, and sell-offs of stock prices. By the time the next crisis rears its head, when the effects of "the massive shots in the arm" have worn off, the pain and patience of real people may have reached their limits. Confidence may be replaced by recognition and fear of even darker days ahead. Without confidence and optimism, the values of the stock certificates will simply evaporate.

Optimism and hope may be created by sound bites on television, but they are not sustainable for too long.

For savers and long-term investors, there must be better ways to save and invest than hoping for the stock market to go up.

* * *

This book is not about doomsday. Nor is it about predicting the future, because forecasting, especially that of stock prices, is a hazardous business, besieged with mistaken signs and distorted rearview mirrors, made foggier with the passage of time and emotion. But the more confusing the outlook, the clearer one thing is: The equity investing game is becoming less favorable, the odds are increasing, and winning is questionable and much less assured than it was in the 1980s and '90s. We discuss these issues in Chapters 1 through 6. In the first three chapters, we take a close look at the conditions leading to the government policies following the stock market and real estate collapses in the United States in 2008 and in Japan following their respective peaks in 1989 and 1991. In the next three chapters, we examine the factors framing the prospects of future stock prices and the risks of equities to savers and long-term investors.

This book is about opportunities for savers and long-term investors who diligently save and invest to prepare for their retirements and for those who are already retired. The book sets the stage for you to assess your goals and objectives in an upside-down stock market; to think about the critical facets of risks of stocks, and the potential devastating impacts of risks and stock losses on your financial well-being and futures; to explore investment opportunities that may be better positioned to provide liquidity and income; and to seek a safer approach than investing in only traditional stocks and betting on stock prices to keep rising. We explore and discuss these issues in Chapters 7 through 9, with a focus on the absolute return approach to save and build wealth for the long term.

My goal is not to draw a map of the future but to lay out the landscape of the prospects of the U.S. economy and the stock market to help you discern the contours of a vague outline, what the stock market must deal with in the long term and what savers and long-term investors should be aware of, and what you might be able to do to protect your life savings and your family's financial future. My purpose is rooted in the view that, unless the weather is fine, the journey to sea is not worth taking for savers and investors who rely on their investments for retirement income and support. There are other ways to save, perhaps at a tortoise's speed, but these ways are dependable and, in the long term, potentially more rewarding. In Chapters 10 and 11, we discuss these opportunities and strategies that can generate returns while their risks of losses are better managed and contained within the margins you can afford.

Hopefully, when another stock market crash comes, savers who follow this approach will not see the results of their years of hard work and deprived cravings devastated, and retirees will not have to look for work to put food on the table. At the most euphoric moments, when TV commentators and market sages predict higher and higher stock prices and years of bull market, investors should remember the unprecedented and growing mountain of debt and leverages that support the American economy and its stock market while the United States relies on foreign governments of questionable dependability for support of its public and consumer spending habits. And remember, too, how savings were damaged and financial futures undermined in the aftermath of the 2008 stock market crash!

To paraphrase an old saying, wariness is the mother of prevention.

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