Market Insight Series

Market Bulletin

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Investing Through a Storm of Uncertainty

Dr. David Kelly, CFA
Managing Director
Chief Market Strategist
JPMorgan Funds

The past two months have been filled with a series of dramatic and unprecedented events in financial markets and an ever-escalating government response in the U.S. and around the world. Credit has dried up in many areas with ominous implications for the economic outlook, while stocks have fallen very sharply, inflicting heavy losses on investors. These events have left many feeling dazed and demoralized. While this may be inevitable, investment success requires the ability to assess the economy and markets with a logical eye. In particular, it is important to recognize:

- The uncertainty of the short-term outlook
- The causes of the current crisis
- The dramatic government response to them
- Two paths for the economy in the short run
- The likely path for the economy in the long run
- Valuation opportunities and risks opened up by the crisis
- The advantages of a disciplined, diversified portfolio in a very uncertain time

Volatility as a Measure of Uncertainty

The past two months have been a time of truly extraordinary volatility in financial markets. Over the past 15 years, the average daily movement in the S&P 500 index, up or down, has been 0.75%. However, in September, the average daily movement was 2.5%, three times as large. Given the size of the U.S. stock market this implies that on the average day in September, between 9:30AM and 4:00PM, the market's assessment of the long-term value of U.S. companies changed by roughly $300 billion. This reflects genuine and dramatic uncertainty about the outlook for the economy and financial markets.

The Causes of the Current Crisis

While it is nearly impossible to fully outline all the causes of the current crisis, it is important to understand how we came to this pass, at least in rough terms. The root of the problem, as most people realize, was the housing bubble of the mid-2000s and the huge decline in housing activity since then. America has, of course, been through many housing bubbles over the years, none of which resulted in a crisis of this magnitude. What made this different was a number of factors that amplified the impact of the bubble on financial markets. Among them:

- The fact that so much of this bubble was financed by subprime mortgages that were destined to default in an economic or housing downturn.

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- The complex way the mortgages were packaged and repackaged, which meant that when they went bad they would be very hard to value.
- The leverage that hedge funds and investment banks employed in acquiring these assets, which led to forced selling and financial failures when they went bad, and,
- The complexity of the relationships among financial institutions, including the use of credit default swaps, which meant that the failure of one firm had very widespread repercussions on others.

The Government Response to the Crisis

This is now a global financial crisis and is eliciting similar responses by policymakers around the world. The important trends, however, are highlighted by the actions in Washington.

- **Expansionary Monetary Policy:** The Fed has cut short-term interest rates to 1.5%, well below the core inflation rate indicating a very easy monetary policy and has introduced a dizzying array of new credit facilities, guarantees, and injections of money into financial markets.
- **Greater Regulation:** The SEC has become more active in regulating short-selling. While some temporary restrictions have now expired, others may take their place. In 2009, we will likely see much greater regulation of the players on Wall Street and the financial tools they employ in an attempt to dampen volatility in financial markets.
- **Expansionary Fiscal Policy:** Most notably, the Federal government, after some hiccups, is intervening in a big way. The $700 billion plan to buy up toxic mortgage assets should, in time, help stabilize financial company balance sheets. And, because the plan involves buying up cheap assets in a distressed market it should not, on its own cost the full $700 billion. However, a new President and Congress may well inject further stimulus into the economy next year so 2009 is very likely to be a year of strong fiscal expansion.

Two Paths for the Economy and Markets in the Short Run

Given the current uncertainty, it is worth mapping out two alternative financial scenarios from here:

In the more positive scenario, actions by authorities around the world prove to be successful, credit unfreezes and companies are gradually able to borrow and hire. Unemployment still rises for a while and the economy experiences a pretty weak holiday season. However, early in 2009, the economy recovers as low interest rates, lower oil prices and potentially, a second dose of stimulus checks from a new administration set up a cyclical rebound. New regulations for short-selling and derivatives achieve the desired result of reducing volatility, and investors, seeing better prospects, gradually funnel money away from Treasuries and short-term securities, and towards stocks and high-yield bonds.

The second and bleaker path sees a longer and deeper recession as banks stubbornly refuse to lend and further shocks batter the global financial system. In this scenario, unemployment rises sharply and the economy languishes in recession for much of the next year, with the stock market reflecting, at least for a while, the national gloom. However, eventually, pent-up demand for cyclical goods and unrelenting efforts in Washington should be effective at generating a cyclical rebound.

The Likely Path for the Economy in the Long Run

It should be noted that while the two possible paths for the economy diverge in the short run, in the long run they should converge again. Government policy, both in the United States and around the world, is devoted to stoking up demand. Moreover, population growth, productivity growth and the innate over-spending, over-working and over-achieving behavior of Americans, should tend to return the economy to a growth path over time. Even with two possible outcomes over the short term, in the long term scenario, the economy should return to a position of low unemployment, low inflation, strong profit margins and somewhat higher interest rates.

Opportunities and Risks for the Long-Run

When the economy eventually returns to a path of normal economic growth, given current valuations, stock prices may be considerably higher and credit spreads may be considerably lower than they are today. Long-term investors (i.e., those who don't intend to cash in any of their investments in the next five years) can take advantage of this by overweighting U.S. stocks, municipal bonds, and high-yield bonds and underweighting cash and Treasuries in their portfolios today.

The Need for Discipline

For those who have a somewhat shorter time frame or those who don't want to experience this level of volatility, it is still important to maintain discipline. In the past, a diversified portfolio including stocks, bonds, international investments and alternative investments has provided a much smoother path of returns than a more concentrated portfolio. That balance is more important than ever today as the economy and markets navigate a particularly uncertain financial environment.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

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