

The Loper Report

June 2008

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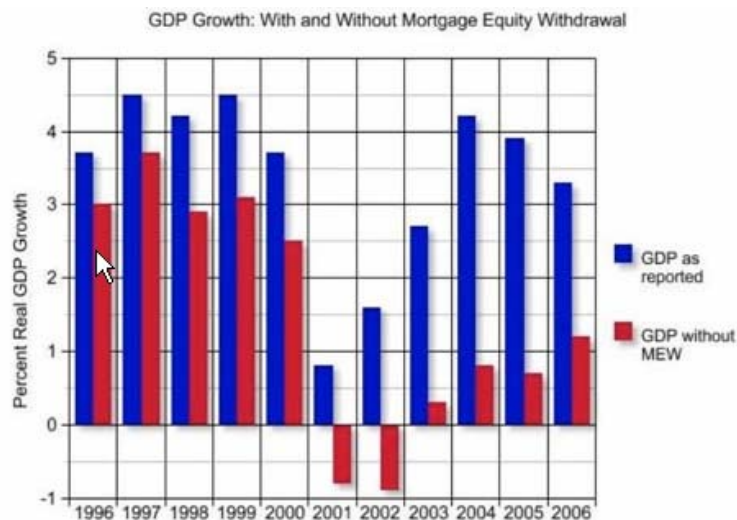
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This issue of the Loper Report will highlight the incredibly important role the United States housing market played in supporting the worldwide economy and stock markets over the past decade. We will explain how the stock markets were not fooled by this charade as evidenced by their so-called, "Lost Decade." We will present a compelling graph showing how the stock market analysts we all read and view on television have yet to recognize and report on the important shifts that are taking place in the world. We believe strongly that understanding the information contained in this Loper Report is critical to profitably navigating the difficult economic waters ahead.

The Decline in Home Prices Does Matter

Many people, including us, suspected that the housing boom was indeed a bubble. There is no longer any doubt that it was, and for the following reason: for house prices to have fallen as much as they have, and to do so with no sharp increase in interest rates, clearly shows that a pure bubble was in force. In retrospect, it was a significant speculative bubble fueled by excess credit creation and lax lending standards. What could not go on - did not go on.

What would have happened over the last few years if the housing bubble hadn't occurred? John Mauldin, in his weekly *Thoughts From the Frontline* letter, directs us to the answer: "Notice on the following chart that **without mortgage equity withdrawals the US economy would have been in outright recession for two full years in 2001 - 2002**, and would have been quite sluggish for the next two years. That is what you would expect from the bursting of a major stock market bubble in 2000 and an economic shock that was the 9/11 attacks on New York."



We did not experience a recession or anything near a recession because the Federal Reserve Board and others took aggressive steps to buffer the markets and the economy. One important step they took was dramatically lowering interest rates and adopting a lackadaisical approach to lending standards. The result was that the value of US housing rose rapidly and, in doing so, Americans felt richer and comfortable borrowing against the ever-rising value of their homes. We borrowed and spent our way out of that recession, but are now left with the repercussions.

Today, house values are falling and will likely do so for another year at the least. This means no more pulling equity out of homes for spending. **People either can't (or won't) borrow as much from their houses which lowers overall economic activity.** It is also evidence that we are at the beginning of a reversion to the mean on growth in national wealth (because homes represent such a large portion of a family's assets). From 1981 to 2006, the wealth of US households grew at a rate of 7.2% per year, far above the long-term average of 5.5%. For 2007, US household wealth actually contracted by \$500 billion. Below-trend wealth growth, coupled with people spending more on energy for gasoline and heating, means even less money is available for buying goods and services.

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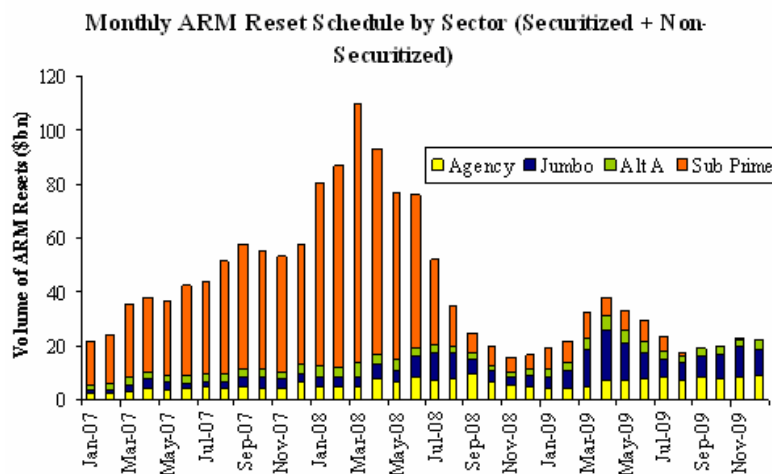
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The Potential for More Mortgage-Related Problems

We devoted the entire September 2007 DouglasBradley *MoneyWise* to the implications for housing and the economy caused by the reset of thousands of Adjustable Rate Mortgages (ARMs). In the last few years, borrowers took out historic numbers of ARM loans with initial “teaser” interest rates that allowed them to borrow more than they might otherwise using a traditional fixed-rate mortgage. ARMs are loans where the interest rate, and therefore the monthly payment, reset after a period of time – usually upward.

The following chart from Bank of America illustrates that we are only now in the heavy period of ARM resets – where lower “teaser” rates are reset to reflect actual market rates. To understand the implications of this schedule, it is important to recognize the foreclosure timeline. As economist Dr. John Hussman (www.hussmanfunds.com) explains, “Once a reset occurs, it takes up to 30 days for the first payment to be missed and another 90 days for the homeowner to be served with a ‘Notice of Default.’ It then takes a further 90-day period with the homeowner in default for a “Notice of Trustee Sale” to be delivered, soon after which the property is sold in a foreclosure. In short, there is generally a span of about 6 months from reset to foreclosure, which means that one has to lag the data to get the profile of anticipated mortgage loan losses.

“Fortunately, only a portion of the mortgages that reset will actually go into default, but we can estimate where we are in the subprime mortgage crises by calculating the cumulative amount of mortgages that will have reset at each point in time, and lagging it by 6 months (roughly the span between reset and foreclosure).”



The point is: ***we appear to be early in the mortgage crisis*** with only about a quarter of the cumulative resets having occurred. Hussman continues, “Unfortunately, the next three quarters are when the bulk of the problems will occur as the cumulative amount of resets will surge. With that surge, loan losses and foreclosures will also predictably spike higher.” This is consistent with what Federal Reserve Board Chairman Ben Bernanke told Congress. He said that a housing swoon “will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.”

The repercussions for the US economy stemming from the real estate slowdown are significant. This is because housing, like automobile manufacturing, touches so many aspects of our domestic economy. Just as the average American felt wealthier when their house values increased by double digit percentages each year, they are now feeling poorer as the prices of real estate adjust downward. Homeowners have no more home equity to withdraw and are no longer looking for ways to spend.

Ignoring Your Portfolio Can Cost You

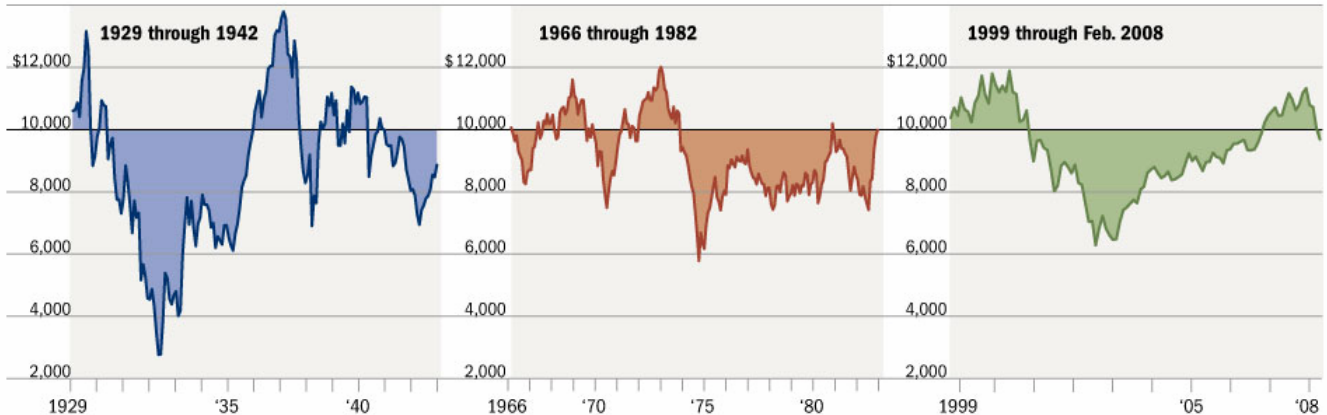
Thanks to the double digit returns investors got from the stocks of large US corporations from 1982 thru 2000, it became popular to overweight one’s portfolio in these same stocks (i.e. investors were simply chasing the returns).

It's a trend that is still in effect. But the reality is that investors who put their money in the S&P 500 over the last 10 years have essentially generated **no** returns. This is a period that the *New York Times* labeled a "Lost Decade" in a recent article (see graphic below).

Lost Decades

The stock market is currently trading right where it was nine years ago. In fact, adding in dividends and taking inflation into account, stock market investors have lost money since 1999.

The extended U.S.-stock underperformance puts the current stock market in very bad company: the 1930s, with its terrible unemployment, and the 1970s, with its double-digit inflation. In both of those periods, stocks would rally strongly only to fade. It took well over a decade in each case - until World War II in the first case and until 1982 in the second - before stocks moved lastingly upward. Compare monthly changes in the Standard & Poor's 500-stock index over three market downturns and see the return on a \$10,000 investment.



Source: Morningstar Note: The S&P 500 index, which started in 1957, has been extrapolated back in time.

For the next several years, we expect the broad US stock markets to continue to be a wild roller-coaster ride. The Dow Jones Industrial Average and the S&P 500 index will likely trade in a range – much like they did from 1966 to 1982. The indices will alternatively go up and down (and in the process will set all-time highs and multiyear lows), but will also stagnate. After many years, however, we will likely see that the market went nowhere – albeit in an interesting way. And, importantly, at some point during the ride index investors (those who simply buy baskets of stocks) and buy-and-hold stock collectors will realize that their portfolios haven't shown much of a return.

Though we tend to think about market cycles in either-or terms, bull (rising) or bear (declining), in the long-run markets spend a lot more time in bull or range-bound (sideways) patterns. The distinction between bull and range-bound markets is extremely important for investors, as one needs to invest very differently in one versus the other. Are you able to distinguish the difference and respond accordingly? If you can't, we believe you should expect to be disappointed with your future investment returns.

I'll conclude with the following factoid, again from John Mauldin: **“Over the last 200 years, every full-blown, long-lasting (secular) bull market (and we just had a super-sized one from 1982 to 2000) was followed by a range-bound market that lasted about 15 years.** This has happened every time - with the exception of the Great Depression - over the last two centuries.”

What Happened to the Analysts?

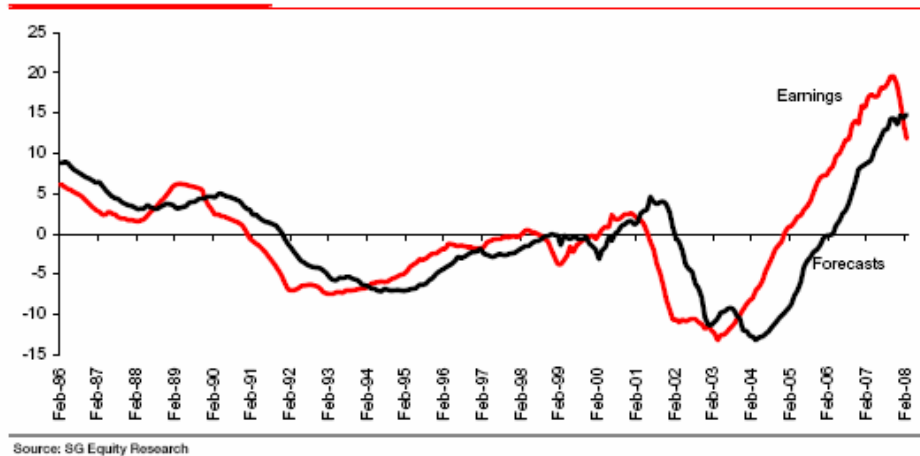
One of my favorite *Loper Report* pieces is one I wrote in 2003. In it I explained that early in 2001 twenty-two (22) "experts" on Louis Rukeyser's "Wall Street Week" program on PBS gave their estimates for the Dow Jones Industrial Average for the coming year. Their estimates ranged from 11,400 to 12,300, but the actual Dow close was 10,021. None of the 22 panelists predicted that the Dow would close under 11,000. Again in 2002, 22 analysts gave their estimates as to where the Dow would close the year. The estimates ranged from 10,750 to 12,100. The Dow closed 2002 at 8,341 - still not even in the ballpark. Moving to *Business Week*, for 2002, out of 54 experts *Business Week* polled, only four were within 5% of where the Dow ended the year.

Well, it is happening once more. The chart below, as James Montier of Societe Generale states, “makes it obvious what we already know - that analysts lag reality; **stock analysts only change their minds when there is irrefutable proof they were wrong, and then only change their minds very slowly.**”

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Analysts lag reality (S&P500 earnings, deviations from trend, \$ per share)



We can see that analysts have hardly adjusted their earnings Forecasts (black line) at all, yet the beginning of the downturn in Earnings is clearly visible from this chart (red line). So far, the downgrading of estimates has been limited to financial stocks (no surprise) and to a lesser extent stocks in companies focused on the consumer sector. Looking back in history, we can see two similar times where the red line (Earnings) crossed below the black line (Forecasts) during periods of above-trend earnings. The first time was late in 1989 and then again in late 2000/early 2001. This led to losses of 18.5% and 41.7%, respectively, on the S&P 500. Given that Wall Street analysts continue to build a major second half 2008 recovery into earnings projections, it is important to ask whether those earnings estimates are likely to be reliable.

In light of the above, is your portfolio designed to weather a potential financial storm triggered by a worsening mortgage and banking crisis that then spreads into the general economy? If you are not a client of DouglasBradley, the following are a few of the many steps we've taken that you and/or your advisor may also wish to consider.

- 1) Review your asset allocation and reduce exposure to mortgage and financial services/banking firms
- 2) For mutual funds, invest in true "stock picking" funds vs. an index or glorified index fund
- 3) For bonds, stick with short- and ultra-short bonds, preferably US-government issued (Treasuries or GNMA)
- 4) Do not chase performance returns and unknowingly become over weighted in foreign market stocks
- 5) Review your 401k to ensure your Elections and Allocations are accurate and in-line with your expectations

Successful investing!

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About DouglasBradley LLC: DouglasBradley LLC is an independent personal financial advisory firm specializing in helping clients deal with the complex decisions regarding their finances and investments. As a Fee-Only advisor, we are beyond the influence of service providers and their products. We represent our client's interests solely in all dealings and are free to recommend the best strategies in all cases. At DouglasBradley, we believe that your portfolio should grow as much as possible - but must also be protected from major losses. In other words, "you win by not losing." Research has shown that the portfolio that achieves consistent real growth will beat the portfolio subjected to the swings of the market. That is our goal.

If you find our analysis helpful, we also write an email-only monthly bulletin called *MoneyWise* that provides timelier information using short, succinct write-ups on topics that we find informative, practical, and interesting. *MoneyWise* highlights easy-to-understand economic insights, stock market observations, and useful tax advice – as well as relevant snippets on health care, retirement saving, insurance, etc. If you are not receiving *MoneyWise* each month, please send us an email at info@douglasbradley.com to be added to the distribution list. You will not be solicited, your email address will not be shared, and you can be removed at any time. As always, we encourage you to share the *Loper Report* and *MoneyWise* freely with family, friends, and acquaintances that you feel would benefit from them.

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