The Absolute Return Letter
December 2008

Do Dead Cats Bounce?

Emperors without clothes

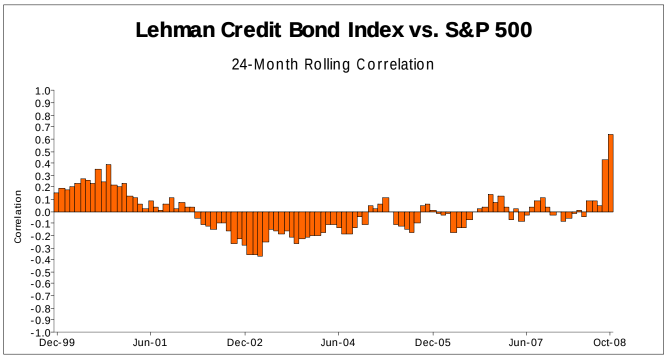
Most of us thought we could walk on water. 25 years of almost uninterrupted bull market had its profound effect on both investor sentiment and alertness but, as we have been ruthlessly reminded in recent months, never confuse genius with bull market. Hordes of investors, who claimed to be brilliant investors, have been brutally exposed as emperors without clothes. To paraphrase Warren Buffett – it is when the tide goes out that we will see who is swimming naked.

Now, a 50% correction in stock markets around the world should arouse some excitement in most investors. Stock prices suddenly look attractive. Or do they? Not surprisingly, this is the question most frequently put to us by investors these days. My belief is that, despite a somewhat more benign environment over the past couple of weeks, markets are by no means 'back to normal' (whatever that means these days), and it is this 'normalisation' which needs to take place before we can finally declare victory over the bear market. In the following, I will look at the conditions which must fall into place for a more sustainable equity rally to unfold. Let's jump straight in.

Correlations must come down

In times of crisis, correlations between equities and other asset classes, and between equities in different parts of the world, rise dramatically. Likewise, when correlations gradually return to normal, it is one of the surest signs that things are returning to normal.

Chart 1: Corporate bonds held by primary dealers ($ billion)



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The correlation between Japanese and US equities, which have averaged about 0.55 over the past ten years have, according to our calculations, spiked to 0.91 over the past 6 months and a similar trend can be found when comparing the returns of a number of other asset classes. In chart 1 above, I have illustrated the correlation between the

S&P 500 and the Lehman Credit Bond index. Over the past decade, the correlation between the two has been relatively low (about 0.15); however, in the last few months the correlation has exploded.

When panic strikes, investors sell indiscriminately. This drives correlations towards one. It is therefore a good sign when investors become more selective in their buying and selling patterns. On this last point we note that some selectivity has crept back into markets since the turning point around November 20.

Interbank mkt. must normalise

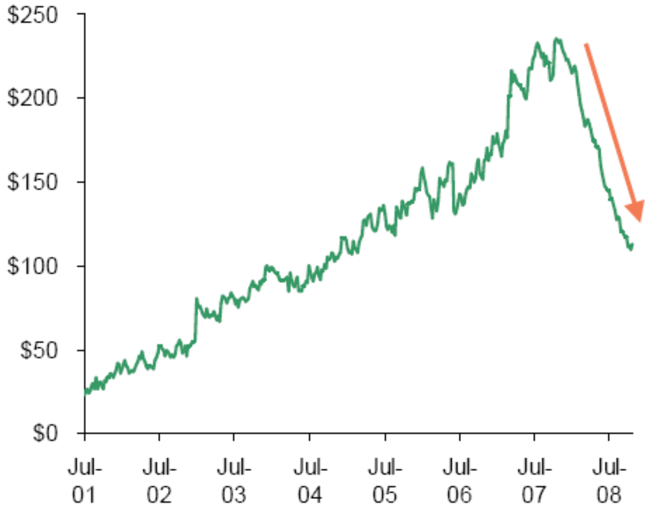
After the bloodbath of the past few months, banks all over the world are seriously wounded, many fatally so, and the appetite for risk is not exactly booming amongst borrowers either. Even worse, the inter-bank market continues to be ice cold as banks only reluctantly do business with counterparties they happily dealt with just months ago. The sickly state of the interbank market is doing considerable damage to business sentiment and hence to the underlying economy. This again affects equity markets negatively. A normalisation of the inter-bank market is therefore an absolute necessity for global equity markets to return to a more buoyant mood.

To make matters worse, the dire conditions make it less likely that continued rate cuts orchestrated by increasingly frantic policy makers will have the warranted effect. As many central bankers are about to find out, lending activity is not only a function of the absolute level of interest rates but of factors much less quantifiable as well. In todays risk averse environment, these factors suggest anaemic lending activity for quite a while yet, despite a sudden willingness amongst central banks to almost give money away.

Credit markets must unfreeze

For over a year now, it has been well known that banks and investment banks got caught on the wrong foot when global credit markets started to implode in the summer of 2007. After years of relentless price appreciation, the banks' risk managers had obviously forgotten that prices sometimes go down as well as up, so inventories of both corporate bonds and leveraged finance products were sky high when hell broke loose in credit markets last year.

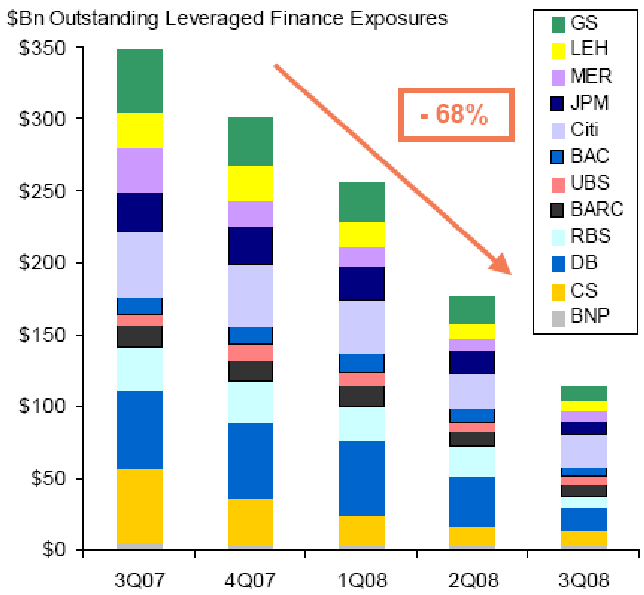
Chart 2: Corporate bonds held by primary dealers ($ billion)



Note: Corporate bonds with more than one year to maturity
Source: Morgan Stanley, New York Fed

As you can see from charts 2 and 3 (which we have borrowed with thanks from Morgan Stanley), banks have made considerable progress since 3Q07 in terms of reducing their exposure to credit instruments. We suspect – and only time will tell whether we are right – that the vast majority of liquidations coming out of banks and investment banks are now behind us.

Chart 3: Outstanding leveraged finance exposures ($ billion)

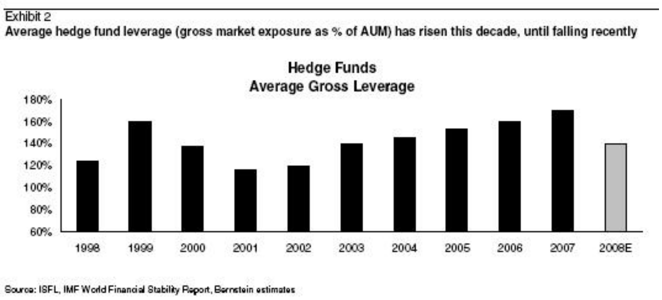


Source: Morgan Stanley

Redemptions need to slow

The other half of the story is the de-leveraging taking place in the hedge fund industry as a result of continued redemption pressure. We wrote extensively about this issue last month[1]; so I do not intend to repeat myself. However, since last month's Absolute Return Letter went to press, Bernstein Research has produced a detailed study on the phenomenon[2]. A survey conducted amongst their hedge fund clients shows that less than 20% believe that the current redemption wave will end this quarter. On the other hand, over 40% believe that redemptions pressures will continue beyond the first quarter of next year.

Chart 4: Average hedge fund leverage (gross exposure as % of AuM)



Source: Bernstein Research

[1] *See "When the Chickens Come Home to Roost", The Absolute Return Letter, November 2008.*

[2] *See "Equity Portfolio Strategy: The Hedge Fund Deleveraging and Redemption Debate", Bernstein Research, November 21, 2008.*

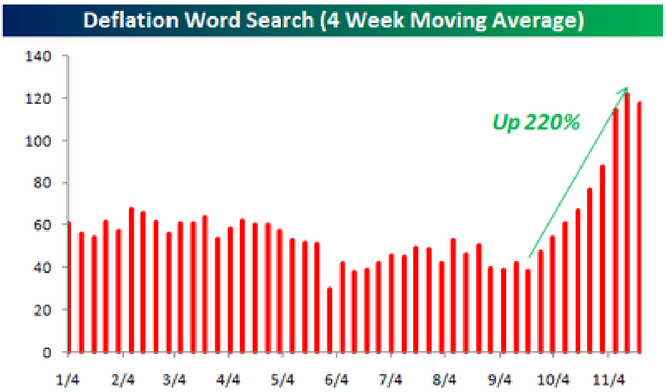
Before you despair, though, bear in mind that redemptions do most damage when leverage is high and cash levels low. On both of those fronts, there is good news. According to the same Bernstein survey, cash as a percent of total assets under management in the hedge fund industry has risen to 31% from a two year average of 7% and the average gross leverage is now about 140%, down from 175% a year ago (chart 4). The conclusion is inevitable – there is more pain to come but October probably marked the low point in terms of damage done to the markets.

Deflation must be avoided

It is becoming increasingly obvious that central bankers have been fighting the wrong war in recent months. Rather belatedly, they have woken up to the fact that it is not inflation but rather deflation which poses the biggest risk to a global economic recovery which is looking much more distant than it did just a few months ago. Deflation is bad news for two reasons. It kills any incentive to spend money (why buy something today which is going to be cheaper tomorrow?) and the combination of high debt and deflation is a devastating cocktail.

The problem facing policy makers is that the money multiplier (the ratio of broad money to the monetary base) has collapsed at a time when interest rates are already very low. This is particularly a problem in the US economy which is now at serious risk of falling into a so-called liquidity trap. This happens when policy rates are very low and you can no longer stimulate the economy with monetary policy tools. If this were to happen, all bets are off in terms of the depth and the length of the current recession.

Chart 5: The mention of 'Deflation' in US media



Source: Bespoke Investment Group

P/E ratios must come down

Stock market valuations around the world are not as attractive as you would expect after a fall of almost 50%. This is obviously due to the fact that earnings have also collapsed. The naked truth is that we are still some way off the levels that have been reached in prior secular bear markets.

All the way back in June 2004, I wrote about secular bull and bear markets[3]. A secular bull market is a market characterised by rising Price/Earning values. A secular bear market is therefore characterised by falling P/E ratios. There have been seven complete bull and bear cycles in the last two hundred years and, in each bear market, the P/E ratio has reached single digits before entering a new bull phase.

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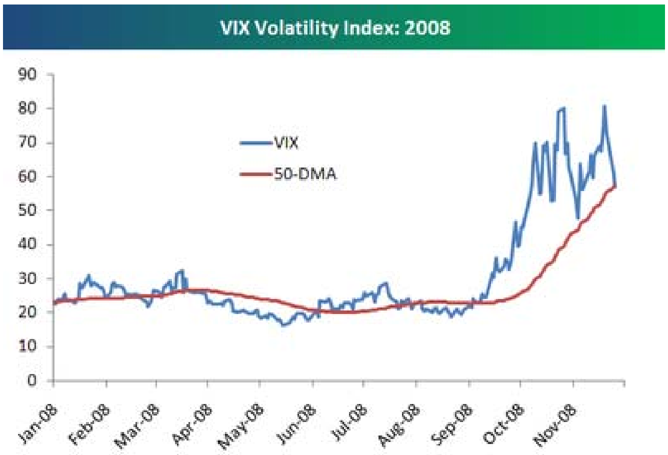
[3] *See "Four Reasons to be Cautious", The Absolute Return Letter, June 2004*

The average secular bear market has run for just over 13 years. We are now 8 ½ years into the current one. I believe that it is *highly unlikely* that we won't reach single digit P/E ratios before this bear market has run its course. This doesn't mean that you cannot have powerful rallies embedded within a secular bear market. The 2003-07 was one such rally. And we could be due another one after the hefty falls of the past few months. But the conclusion remains the same. You will see single digit P/E ratios before this bear market is over.

Volatility is still too high

To suggest that high volatility and benign equity markets can go hand in hand is sheer nonsense. The 5% plus swing days that we have grown accustomed to in recent months must become a thing of the past before there is any realistic hope of a sustained recovery in stock prices. The VIX Index which measures volatility in the US stock markets currently hovers around 60 (chart 6). Although down somewhat from recent levels, it is still extreme and must fall to at least half current levels before we can declare victory over the bear.

Chart 6: US Stock Market Volatility



Source: Bespoke Investment Group

Policy makers must be seen to be doing the right things

The decision not to save Lehman Brothers will go down in history as one of the worst decisions ever made. Whatever reason US Treasury Secretary Hank Paulson had not to save Lehman Brothers, it was a serious miscalculation. As Anatole Kaletsky of GaveKal Research put it – "Hank Paulson has turned a drama into a crisis". Investor sentiment deteriorated dramatically in the days following Lehman's demise and it has been an uphill struggle ever since.

Japanese policy makers made a catalogue of errors back in the 1990s, many of them a result of blatant inactivity. This resulted in what is now known as the 'lost decade' for Japan, a situation which western policy makers are acutely aware of and desperately keen to avoid. In that context it was interesting to observe the market reaction to President-elect Obama's choice of new Treasury Secretary last Friday. The response was instant and it was positive.

In times of crisis it is critical that the policy response is swift and determined. Unfortunately, as a European, I do not have as much faith in our policy makers as I have in the American dittos when it comes to their ability and willingness to take swift action. A good example of this is the embarrassingly late u-turn on interest rate policy demonstrated by both the Bank of England and the European Central Bank when it was evident even to my 73 year old mother and her dog that the war we must fight is a war against deflation – not inflation.

The Bottom Line

So, after all, the rally of the last two weeks may not be a dead cat bounce. The cat may still be alive – only just. But the elements are not yet in place for a more sustained rally. Valuations do not suggest that we are at the bottom of a secular bear market. Furthermore, volatility is still too high. So are correlations. The inter-bank market is not yet back to normal. But, most importantly, equity markets are quite unlikely to lead credit markets out of this crisis. It is much more likely that credit markets will take the lead[4].

One final point – if you wish to take advantage of the opportunities currently presenting themselves, look at credit, not equities. Leveraged loans had an absolutely dreadful October, suffering from forced liquidations amongst hedge funds facing large redemptions and banks downsizing their balance sheets. At the beginning of the month, senior secured loans traded around 80-85. Four weeks later the average price had dropped to 60-65.

The worst ever default rate for senior secured loans is about 8% and the average historical recovery rate in bankruptcy situations is 74%. If you assume a 35% annual default rate (!) and a 50% recovery rate, at current prices, the IRR to maturity is 22-23%, using no leverage whatsoever. John Reid at Deutsche Bank has calculated that the implied P/E ratio on senior secured loans is now less than one third that of equities. Either this is the investment opportunity of the century, or equity markets have seriously underestimated the economic downturn in which case things will get a whole lot worse for equity investors.

Some investors have asked us whether corporate high yield bonds offer a similarly attractive opportunity as they have also sold off. My advice is to stick with senior secured loans. First lien only. The typical capital structure of a leveraged company is far more complex today than it was in the last recession, and there is a great deal more debt on the balance sheet than there used to be. Historical default rates and recovery rates for high yield bonds are therefore meaningless. I wouldn't be surprised if the average recovery rate on high yield bonds in this recession ends up being close to zero. First lien is the new high yield. Be content with the returns they offer. Don't be greedy. It doesn't pay in the long run as many investors have learned over the past few months.

Niels C. Jensen

[4] *Since this letter was written, the latest Investment Outlook from Bill Gross at Pimco has landed on my desk ("Dow 5000 Redux"). He reaches more or less the same conclusion as I do but uses a different approach. I would encourage you to read Bill's piece as well, as he makes some excellent observations which I haven't touched on.*

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The ARP Credit Opportunities Portfolio
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