

What is one to do?

The drumbeat of negative economic and financial news seems to be incessant. Unemployment is rising, manufacturing activity is sliding, consumer confidence is eroding etc., etc., etc... The optimism that reigned supreme just 18 months ago has been shattered. Cash was trash back then. What happened?

We had nourished a culture of irresponsibility. It was a culture that encouraged us to borrow without almost a thought of how we were going to repay our debts. We could buy homes with little or no money down. We could use our credit cards to spend freely and not really worry about what we could really afford. On a grander scale, we could buy whole companies with little money down. Banks could lend almost limitless amounts of money because they could sell off their loans in a variety of financially engineered packaged products. In fact, finance took on the characteristics of the packaged food industry. It processed often questionable ingredients and put them in appealing cereal boxes. Who had the time to read the ingredients on side of the box, much less understand them?

In reaction to the crisis the Fed has reduced interest rates to nearly zero and the Bank of England has brought rates down to its lowest levels in its more than three hundred year history. The U.S. is embarking on a final stimulus package that may result in a budget deficit that will likely get close to 10% of GDP and probably approach two trillion dollars. Policy makers have made it clear that they will do whatever is necessary in order to avoid a depression. They will probably be successful and at some point, perhaps later this year or early next, the economy will start to stabilize and gradually improve. Success will mean that we have cast aside the fear of deflation and have started on the path to gradual inflation.

Consumers and corporations are in the process of deleveraging but the government is taking on massive amounts of gearing. We are busy printing money and have dismissed worries of debasing the currency. We shall welcome the first signs of inflation and in order to be sure that we have defeated deflation we shall continue the fight until we are sure of deflation's total defeat. Inflation will also be cheerfully greeted because it is a way of repaying our debts on the cheap. Inflation will come. It is only a question of time and level.

It is difficult to make portfolio allocation decisions in today's volatile markets. What asset classes are out there that are offering high enough potential returns to induce badly bruised investors to part with their severely depleted cash? None of us can predict short term price movements. We do know, however, that we are getting tremendous value in today's credit markets. Corporate credit is already discounting a depression scenario. An investor would still preserve capital even if default rates were in excess of 20% a year over the next three years.

The credit markets have started to open up. January will likely see a record amount of new corporate issuance of nearly 50 billion dollars. B/BB credits have continued to recover in January and have registered positive performance of more than 6% while most equity markets are down more than 6%.

We are buying attractive credits at yields above 10%. We are buying good assets at distressed prices. The risk/reward proposition is very compelling.