Part I

THE CREDIT MARKET MELTDOWN

Chapter 1

How Has the World Changed?

History, as they say, repeats itself, and nowhere is this truer, perhaps, than in the economy. We find comfort in the predictability as the economy cycles through the four stages of expansion, peak, contraction, and trough. We tell ourselves that yes, indeed, the more things change the more they stay the same.

The world, however, has changed. This sentiment is evidenced in the level of federal government intervention to bailout, stabilize, and otherwise jumpstart the financial sector—a plan presented at $700 billion, which could balloon even higher. We see it in the government takeover of mortgage giants Freddie Mac and Fannie Mae and in the $100 billion-plus rescue and takeover of insurance company AIG. Being "too big to fail" is a battle cry that has the Treasury Department and the Federal Reserve running for their checkbooks.

"The world has changed," declared a spokesperson for Morgan Stanley, which after 75 years of being an investment firm decided to go back to being a bank—a step also taken by Goldman Sachs (and many others who want access to government money and cheap capital). In the process, they face more regulation, presumably less risk, and probably lower profits in return for consumer saving deposits as a source of funds—as well as access to the Federal Reserve discount window.[1]

The federal government's $700 billion bailout of Wall Street to buy discounted and troubled assets, many of them subprime loans, was supposed to put in a floor to keep the financial sector from spiraling lower, boost investor confidence in financial firms and the stock market in general, and help stabilize the housing market where home values have been declining at a dizzying rate—that is, when properties are sold. In the 11th hour, Treasury Secretary Henry Paulson, citing that conditions had changed, decided to focus on supporting the banking system. He pumped money into financial institutions in hopes of getting credit flowing again. If it works, then sometime in the future the great bailout of 2008 will be one those notable times, like the savings and loan crisis of the 1990s. We'll study it as a classic textbook case of crisis and intervention, and debate the merits of the expansion of the government's actions. If the bailout does not work (and as you'll read in Chapter 4, as a free market advocate I take issue with the extensiveness of the federal government's intervention), then the landscape may look even more different.

In the midst of the crisis, during the summer and fall of 2008, things looked very scary. The situation was referred to as the biggest crisis since the Great Depression. It was bad, and it felt even worse as stocks suffered 5+ percent daily moves regularly, and fears escalated that the next bank to go under would be the one with your paycheck in it. Money market funds were in danger of "breaking the buck" and cash on deposit was feared to be "money gone." The proverbial domino effect was about to fall into place as the system jammed.

Although it was bad, I don't believe we were about to have financial Armageddon. The events of 2008 stemmed from a breakdown in the financial system, not the economy. The economy was already weak and this was a hit where it really hurt. But the economy was still standing. Gross domestic product (GDP) grew by more than 3 percent in the second quarter of 2008 (although this could be revised downward). The preliminary report for third quarter showed a contracting economy with GDP down 0.3 percent. As of October 2008, 94 percent of the workforce was employed. Yes, we were in a contraction, but the economy was far from screeching to a halt. Even if the third quarter is revised lower, as it most likely will be, and the fourth quarter looks dismal because of the largest drop in consumer spending in two decades, the fundamental problem is the financial system—not an economy that was broken. In other words, we're having a garden variety recession on top of a financial crisis.

The financial system had to brake hard, but that was not bringing the economy to its knees. This was far different from the weak economy of 1929 to1932, which in turn, caused a breakdown in the financial system. In 2008, we had the opposite: a breakdown in the financial system that was dragging down an already contracting or slowing economy. This is a vital distinction to understand when surveying the current landscape.

As became apparent by late 2008, there have been fundamental—and most likely permanent—changes to the economy and, by extension, to society. The way we buy a house, make and finance large purchases, invest for the future, and even how and where we work have all been irreversibly altered due to the financial crisis. Buying a house, which in the not-so-distant past could be sparked by a conversation with a mortgage broker and after spotting a for-sale sign somewhere, will become a cautious undertaking. Shopping with a credit card will no longer be second nature; cash will make a comeback. People will probably not hop jobs as frequently because they're thinking twice about employment security.

Central to the theme of this book, investing has forever changed. The financial crisis and the toll taken on Wall Street have proven that buy-and-hold does not work—not with two 50 percent declines in the same decade. Retirees simply do not have enough time to make up for losses with buy-and-hold. Even those who are younger will be scrambling to repair the damage to their 401(k) plans—which makes people long for (and perhaps seek out) jobs with pension plans.

From what I observe, the aftermath of the financial crisis has resulted in a paradigm shift that is more profound than the change in behavior after September 11th. Moreover, as of this writing, the impact and magnitude of these changes are unfolding.

Although there have been fundamental changes in consumer and investor behavior, market forces will continue to hold some sway. We will still see the same cycles. Yes, the credit crisis is unique; but we can still draw lessons from the not-too-distant past to see that we've been in deep contractions before, just as we've gone through expansions. And we'll be there again.

Although my personal experience mostly covers the 1980s, 1990s, and today (which may sound like the promo for an all-hit radio station), for the sake of this discussion I will also include the 1970s, during which my work experience was limited to paper routes and being a vendor and an usher, but still enough to form a prospective. Let's take a look at some of the highlights of each of these decades in broad terms.

- The 1970s: High energy prices, Arab Oil Embargo, double-digit interest rates, Paul Volcker in charge of the Fed
- The 1980s: Stock market "crash" of 1987, interest rates, Alan Greenspan in charge of the Fed, savings & loan crisis, junk bonds, merger & acquisition activity
- The 1990s: Long bull market, Asian credit crisis, Long Term Capital Management, Dot-com revolution, low interest rates, Greenspan at the Fed
- The 2000s: Technology bubble bursts bear market correction, low interest rates, Greenspan era comes to a close, credit crisis, inflation makes a comeback, credit crisis causes a liquidity drain

Looking at these highlights decade-by-decade, we can see that each period is distinct. And certainly no other period of history has been exactly like another decade. I would argue, however, that the distinctions involved are actually quite subtle; the way that no two snowflakes are alike. Although the patterns of crystals may be different, snowflakes are still more like each other than, say, a snowflake and a raindrop. So, too, with periods of history when viewed through an economic lens: There are differences among specific time frames, but often it is only a matter of degree.

So has the world changed? Yes. Has the economy changed? Yes. But the capitalist democracy that our economy enjoys, with recurring cycles of expansion, peak, contraction, and trough, has not changed—even as every financial crisis and downturn portends to be the last one.

With a deeper understanding of the cyclical nature of the economy, and the expansions that create bull markets and the contractions that result in bear markets, we can look to the future for investment opportunities. While an understanding of the past is important, what will benefit you the most as an investor is to know how to apply the lessons gleaned from history. This means looking for the bull market opportunities that emerge as the next expansion occurs in one area, and avoiding the bear markets that occur as another area contracts.

The Next Bull and Bear

For those of you who have to know how the story ends, I will tell you what this book is working up to: the next bull market expansion and also the upcoming bubble burst and contraction. The expansion will be in equities, driven by an increase in corporate profits. The next bubble that bursts will be in Treasury securities. Now, that doesn't mean that you should immediately put down this book and run over to the computer screen or the telephone to buy stocks and sell bonds right now. As you'll read in Part III, there are also specific indicators or triggers that we need to look for in order to confirm that the bull has emerged in a particular market or that the bear has come out of his cave in another.

The bigger point to make here is that even in the midst of a bear market contraction in one area, an opportunity is setting up in another. As of this writing, the aftermath of the credit crisis and the bursting of the housing bubble continue to weigh on the economy and the stock market. While consumers in general and homeowners in particular are wringing their hands over lower housing prices and tighter availability of mortgages and other financing, it's not the end of the world. Rather, as we'll discuss in upcoming chapters, an overexpansion in housing and liquidity created a bubble scenario, which overexpanded and then burst. The bigger the mess, the longer it takes to clean up and return to equilibrium.

But the remedy for a problem in one sector becomes the tonic to boost activity and opportunity in another. The key is to look for the remedy and follow it where it flows. And that, in a nutshell, is the bull inside the bear.

A Valuable History Lesson

The reason we know to look for a new bull market expansion to capitalize upon, or to avoid the next bear market contraction, is that history does, indeed, repeat itself. We can take what we saw (and hopefully learned from) in the past and apply it to the future. Although we can count on the cycles reoccurring, I thought it might be interesting to look deeper into why. Not just from an economic policy standpoint, but also from a social and behavioral view as well.

Changes to interest rates and money supply will have identifiable textbook outcomes. However, when changes in workforce demographics meet changes in wages and money supply growth, the outcome is less predictable. For example, women entering the workforce in the 1970s and 1980s, as never before, changed the labor pool forever. In upcoming chapters, we will explore more deeply this fundamental workforce change and how it impacted the economy, inflation, wages, and so forth.

Technology changes like the personal computer, introduced in droves during the 1980s, was a technological revolution that also impacted everything, including the way we work and conduct business. Even Bill Gates' mother could not understand the impact or the need for a PC on every desk and the impact on the economy. What we have seen in time is that the worker productivity increase from having a PC on every desk created a boom that no one could have predicted based on economic data analysis alone. Once it became clear that businesses of all shapes and sizes could not survive without a computer and the software that powered it, the race was on to maximize its potential. A lull occurred in productivity as the skill set needed to program and in some cases even just to run a simple program was in short supply. Programmers and IT positions commanded higher wages and more sophisticated training.

By the 1990s, the workforce had become more competent with computers, and productivity gains continued. Jobs initially intended for higher skilled workers with computer competency were being done by assistants and first-year new hires to whom computer knowledge was second nature. This shift had profound changes on the workforce as lower-skilled workers, in some cases, had knowledge that higher-paid employees did not. Business could increases their productivity by hiring efficient, sometimes younger, and less expensive employees. While the economy enjoyed employment gains, older, higher paid workers found it more challenging to find satisfactory employment. This shift was the beginning of even greater changes. These workers were more entrepreneurial and less rooted. Moving and quitting a job for another one was factored into where and how they worked. This also gave rise to the younger homeowner.

Workforce changes caused a rethinking of economic data. In fact, after the recession of the early 1990s, Federal Reserve Chairman Alan Greenspan noted a sudden increase in orders for computers, chips, and components, along with the increase in hiring of the computer savvy sect by small and mid-sized businesses. These developments were noted well before the economic data turned, declaring the end of the recession. The technology revolution was now the foundation of business development and growth, and hence led the way for the next expansion. While every other gray-haired economist was looking for production and manufacturing data to turn, the cutting-edge leading indicator was new orders for computer parts and job growth fostered by the small businesses—which account for more than half the private-sector jobs in the United States.

The economy has changed over the years from agriculture to manufacturing to service to financial to information. Each change has brought about new dynamics to analyzing the change in cycles. At the end of the 1990s and the beginning of the next millennium, the development of the Internet changed the way we work and communicate, and also changed the way we live—or should I say where we live. Now, thanks to high-speed Internet and Federal Express, you can work from almost anywhere and at any time. This helped fuel massive development that spawned the ex-burbs and suburban sprawl. Mega-malls and McMansions spread across the land. Twenty-four hours a day you can find a Starbucks, Kinko/FedEx, and Walgreens open and ready for you to work, shop, and play anytime, all the time. It's not just a "city that never sleeps," as Sinatra told us, but apparently the suburbs never take a snooze either.

Business' answer to the migration out of the city was not to build a significant high-rise in any major city other than Chicago and New York for nearly a decade as developments and office parks proliferated on farmland, swampland, and rural open lots. This led to the rise of the soccer mom and the two-car-and-one-SUV family. While commuting for work declined, shuttling the kids to activities increased, as did overall short-mile trips because the new suburbs had few places to which one could walk.

Society changes for good or bad, and my views on these changes are just one man's opinions and, of course, subject to change—just because. But let's take a look at what consumers value and where they put their time, attention, and dollars.

At the turn of the twentieth century, economist and sociologist Thorstein Veblen gave us the leisure class and conspicuous consumption, with consumers more interested in the status-value than the utility of their purchases. The turn of the twenty-first century brought consuming conspicuously to another level, with bigger-is-better for houses, cars, SUVs, and television screens. It makes me wonder what will come next, with the rise of energy consciousness and green (as opposed to greed) being good. Will the next status symbol be the electric car or the bicycle? Will people compare the size of their backyard compost piles or recycling bins? And don't forget we've been here before, in the 1970s when we tried to "save the planet" and "Earth Day" celebrations declared the end of the hydrocarbon-burning engine (obviously, a bit premature). Whatever societal and demographic changes emerge, rest assured they will have an impact on the economy.

New societal developments—combined with fluctuations in inflation, employment, wages, and growth—play a significant role in why cycles change faster or harder, or why a contraction is shallower or shorter than if one viewed the data alone. While it's important to take into account shifts in demographics and spending patterns, and their influence on the economy, it's important not to let one's own opinion color the reality of what is really happening in the economy. For me, the stalwart economic indicator of employment pervades my analysis. Yet I cannot ignore immigration, outsourcing, discrimination, and so forth to make an informed decision on the economy. Opinions on these topics aside, the reality is what we will discuss.

For example, beginning in 2007 and through early 2008, inflation became a concern. Then late in 2008, deflation grabbed our attention as a host of assets, especially commodities, dropped by a third or a half as they were sold to raise cash. In the wake of deflation, we will need an inflationary environment to help restore the value of these assets. Inflation will make a comeback (a task the Fed is particularly good at) and it will most likely be greater than we've seen in the past.

Earlier in 2008, inflation was suddenly staring us in the face with gasoline prices over $4 a gallon and gold approaching $1,000 an ounce. This seemed to be a tremendous difference from the 1990s when inflation appeared to be a nonissue, and much more similar to the late 1970s when inflation was the hot button topic. The Fed may have appeared to put inflation concerns on the back burner for a decade or two in the 1980s and 1990s; however, from a purely economic standpoint, the fact is inflation is *always* an issue. (Even after the deflationary period of late 2008, inflation will become an issue again.) To illustrate, one of the primary functions of the Federal Reserve is to establish U.S. monetary policy to keep inflation under control. It may be that economic conditions at a particular point in time are not inflationary, but that doesn't mean inflation is any less important. And it's not like the Federal Reserve can take extra long holidays because there's no inflation and the Fed governors have nothing to do. Inflation is still on the radar screen; it's just not moving any closer to the target.

Economic events that grab headlines and send gyrations through the markets do color a specific decade a certain way, whether it's high inflation in the 1970s or the dot-com boom of the 1990s. For the decade of the 2000s, the credit crisis is a distinct feature of this time frame. When we take a step back and examine the credit debacle as a bubble that burst, however, we see there are far more similarities between what happened in the 2000s and other events of the recent past. The boom and bust of the credit market is not all that different, for example, from the dot-com explosion and crash and the sharp decline in the stock market that ensued.

As Figures 1.1 through 1.3 show, there have always been bubbles—the hyper-economic expansion of overextension, unrealistic valuations, and irrational exuberance. While markets and time frames involved differ, what remains the same is the economic propensity for creating bubbles.

My premise, therefore, is that, no, the world hasn't really changed. Some of the indicators may have changed and the causes of the cycle changes are different, but the recurring cycles are still with us, time after time. The same issues continue to affect us, but some to a greater degree than others. In some phases, inflation is more of a factor than others. Or, a particular sector or investment opportunity may become

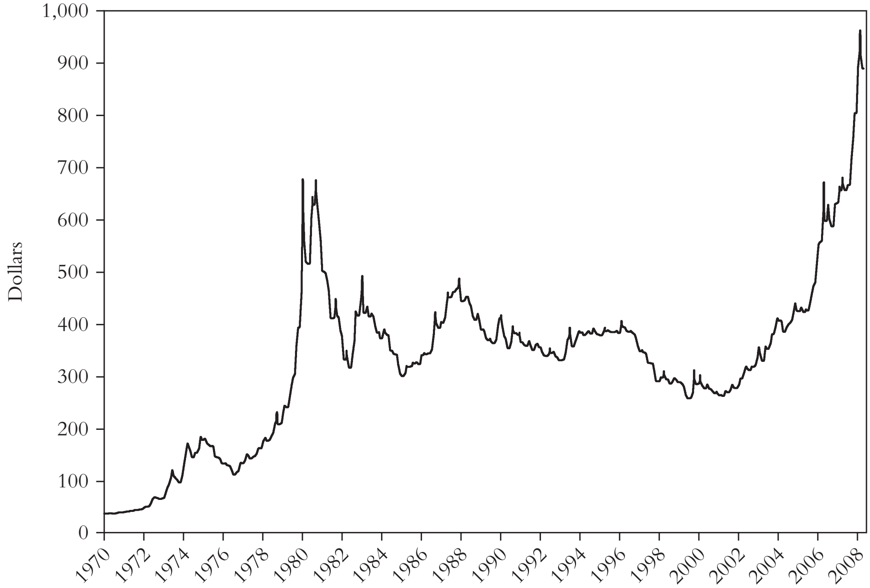

Figure 1.1 A Bubble in Gold in the 1970s Followed by a Long Lull—and Another Spike in 2007 and 2008
SOURCE: http://www.kitco.com.

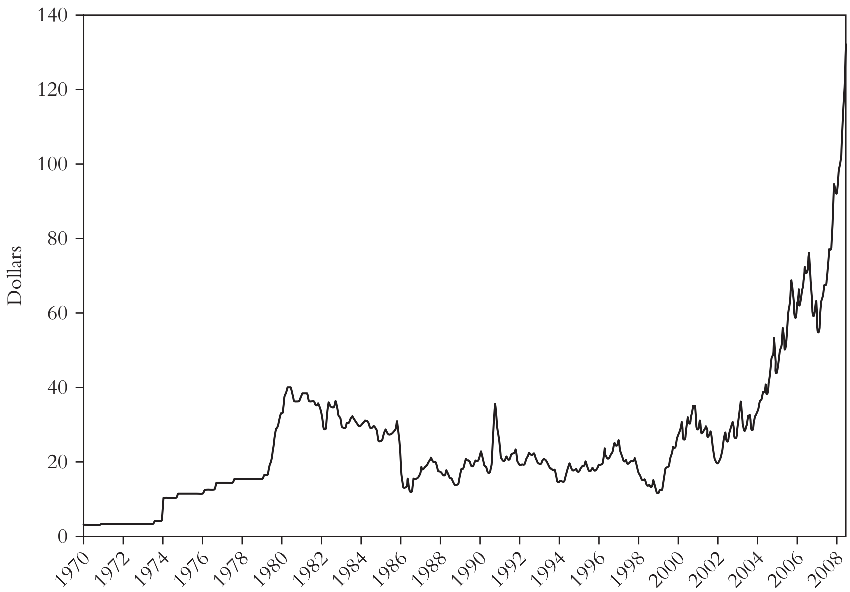

Figure 1.2 The Previous Price Peaks in Oil Pale by Comparison with the "Mount Everest" of Prices in early 2008
SOURCE: Federal Reserve Bank of St. Louis: FRED.

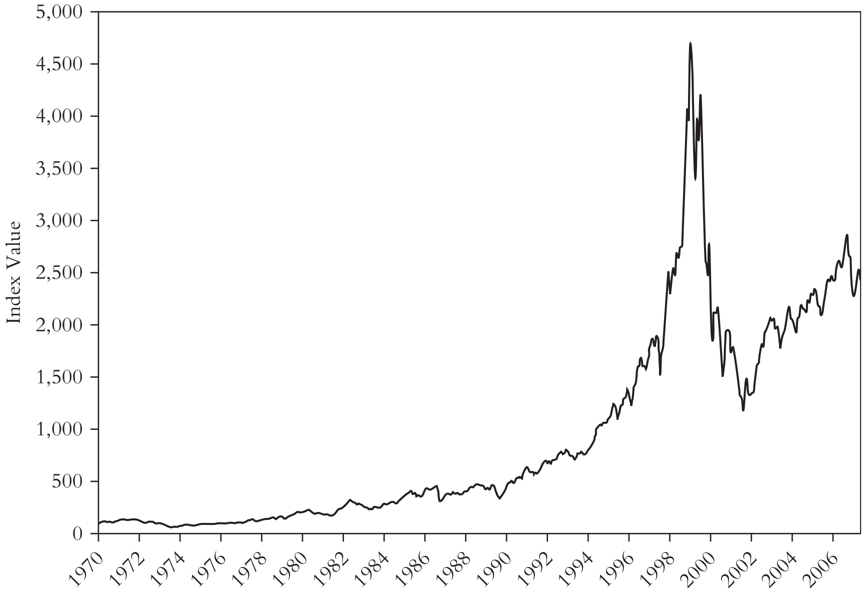

Figure 1.3 NASDAQ Peaked in Late 1999–Early 2000, Fueled by the Tech Stock Bubble
SOURCE: The Nasdaq Stock Market, Inc. (NASDAQ): NASDAQ.com.

overheated. Regardless of the factors that are grabbing the attention in the foreground, the most important things are happening behind the scenes. Here, in the background, the economy continues to cycle through its phases, each identifiable and distinct.

The Four Stages of a Recurring Cycle

The U.S. economy experiences four stages of a recurring cycle, otherwise known as the business cycle: expansion, peak, contraction, and trough. One can determine the current stage of the economic cycle by examining and analyzing economic data, such as GDP, inflation, and unemployment. From an investment perspective, one can make decisions based on the current economic cycle to take advantage, for example, of an expanding economy, or to adopt a more defensive posture during times of contraction.

Here are typical qualities of each of the four phases of the economic cycle.

- Expansion: Characterized by ascending employment growth, positive GDP growth, and strong money flows into equities. Often, an expanding economy is also signified by rising productivity and output, as well as rising consumer confidence and spending.
- Peak: Typically this phase is consistent with "irrational exuberance" in the markets, rampant prosperity, and, in some cases, overbought equity prices. While productivity and output remain strong during this cycle, they show signs of weakness and inconsistency. Consumer confidence also tends to reach a high at these levels.
- Contraction: After the peak comes the contraction. Noticeable weakness in economic data begins to surface, such as: decreasing employment, rising unemployment, leveling-off of productivity, and overall output decreases. Money flows that come out of equities favor fixed income investments and money markets.
- Trough: The trough stage of the economy occurs when economic data, such as output and employment, are at their lowest points. Consumer confidence and spending also hit new lows. Productivity tends to fall as output bottoms and morale decreases. Money flows into equities are at their lowest point, while money market investments are in favor.

Two distinct snapshots in time provide an insightful look at the four stages at work, as the economy cycles from expansion to peak, and then contraction to trough, and back again. Figure 1.4 shows Gross Domestic Product (GDP) during the 1950s. As the chart clearly displays, the economy slowed through 1951 and, after a brief reprieve in mid-1952, declined sharply through 1953 into early 1954, when GDP registered negative.

From a low point (trough) in 1954, the economy gathered steam to expand, with GDP on nearly a straight-line ride to 1955 to form a picture-perfect peak, and then began the next contraction to the trough in 1958, followed by an expansion to end the decade.

Flash forward five decades for the GDP expansions and contractions from the late 1990s and through the 2000 decade to date. As Figure 1.5 shows, the expansions and contractions are clearly discernible as GDP growth increases and diminishes. The world from this view has not changed from the time when Barbie and Hula Hoops

Figure 1.4 GDP Chart Showing Percent Change, Year Over Year, in the 1950s
Source: Bureau of Economic Analysis.

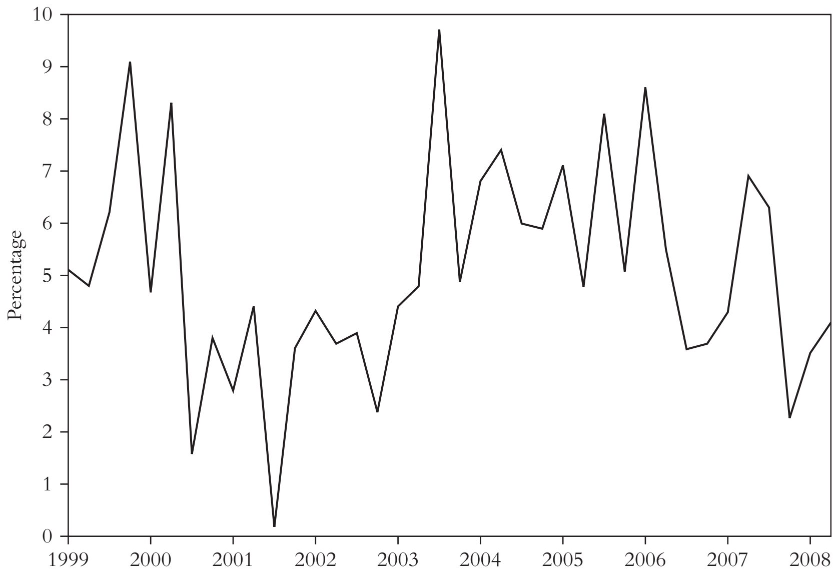

Figure 1.5 GDP Chart, Showing Percent Change, Year Over Year, from 1999 into 2008
Source: Bureau of Economic Analysis.

were new products, to the age of iPods that surf the Internet. What is discernibly different, however, is the length of time between the stages. In the 1950s, we saw two contractions between three peaks. From the late 1990s to the late 2000s were two peaks and two contractions, including one slow meltdown from 2004 to 2008.

Always a Bull Inside the Bear

Given the cyclicality of the economy, we know that even when it looks as if we're entering a bottomless pit and things won't *ever* get better, they will. A contraction will eventually exhaust itself, depleted inventories will call for increased production, employment will rise, and the economy will begin expanding again. And just when we think things are *so* good that it will last this way forever—that the economy can just keep expanding like a balloon made of some space-age elastomer—the expansion will get out of hand. We'll hit the peak and then begin to contract, or else some sector or industry (think dot-com, the credit market) will overexpand and a bubble will inflate. Then the economy will snap back into contraction to get itself back on track.

Like waves on the ocean, rolling in and washing out, it's the cycles that keep things, in the long run, on an even keel. So too with the economy, which even when the market is contracting and the bear is reigning supreme, you know it's only a matter of time when the bull will emerge. But that's not all. In *every* economic phase—expansion, peak, contraction, and trough—there is always an opportunity to be tapped. Perhaps it's a sector that's hot when everything else is ice cold. Maybe gold is moving higher in an inflationary environment. Maybe corn prices are skyrocketing because of weather-related delays in planting that will hurt the harvest. Or stocks are up when bonds are down, or vice versa.

As I said before, there is always a bull inside the bear. No matter what the rhyme, reason, or climate, there is always an investment opportunity to be found. As will be discussed later in this book, whatever sectors and industries are expanding at any given time, there are investment vehicles to take advantage of these opportunities. The exchange-traded fund (ETF) allows investors to take advantage of price moves in a particular index, sector, or industry, from the broad-based Standard

& Poor's 500 (ETF symbol SPY) to something much more narrow like solar-energy (with the clever symbol of TAN). So rather than stockpiling gold bars in your basement because you think precious metal prices are going up, you can buy a gold ETF (GLD). Like agribusiness? Then MOO—that's the symbol. As you'll read later on, I believe the development of the ETF is the most significant investment revolution since the put.

The Role of the Fed

As we study the world for what has changed and what stays the same, we must keep an eye on the Federal Reserve, which over the past four decades has been led by three distinctive chairmen, who differ in personality, temperament, leadership style, and the economic climates they face. The Fed has utilized a variety of tools to heat up or cool down the economy, depending upon what was necessary.

What remains steadfastly the same is the role of the Fed. The Federal Reserve has a stated mandate to promote price stability, full employment, and noninflationary growth. It has, in my opinion, limited tools to address these goals. Of course the Fed can raise or lower rates, and add liquidity into the system through open market operations or, more recently, through the term auction facility (TAF) program, swaps, and so forth.

One of my favorite Fed weapons is to increase or decrease the reserve requirements of member banks. All this can do in reality, however, is instill confidence in the system, because market dynamics are truly The Force behind the cost of money. For example, in early 2008 when the Fed wanted—no, actually needed—to lower rates in a hurry in response to the credit crisis, short-term rates actually went *up* as the Fed lowered the Fed funds rate and the discount rate (see Figure 1.6).

As the role of the Fed morphs with the evolution of the economy, there will be debate over just how much power the Fed should have. For example, did the Fed exert too much control with respect to orchestrating the rescue of Bear Stearns, taking over Freddie Mac and Fannie Mae, providing an initial $85 billion in financing to AIG, and then the $700 billion bailout of Wall Street? Is it the Fed's mandate to oversee financial institutions that are not member banks? Should the Fed

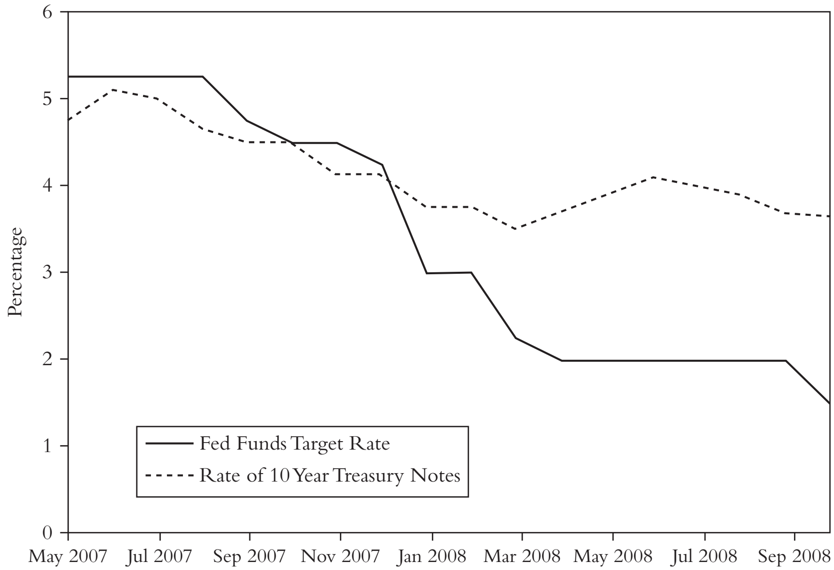

Figure 1.6 Fed Rate Cuts in 2008 Were Ineffective at Lowering Long-Term Interest Rates

SOURCE: U.S. Board of Governors of the Federal Reserve System; Federal Reserve Board of Governors.

allow nonmembers to borrow at the discount window? Add to the list any number of questions of how the landscape of the markets, business, and the role of the Fed has changed forever.

New tools and policies, and new faces in the role of chairman—all of it will make a mark on the power, control, and influence of the Federal Reserve. That has changed over time, and will most likely continue to in the years and decades ahead. What remains the same, however, is the role of the Fed when it comes to price stability, full employment, and noninflationary growth. That mission does not change. How the Fed manages to accomplish that, however, will be altered over time.

In the past, I believed that too much emphasis was put on watching the Fed as it had limited powers to influence the economy. Raising or lowering the fed funds rate, changes in the discount window, and changes in reserve requirements for member banks were the tools in the Fed workshop. As the economy matured and other instruments met the needs for the marketplace (commercial paper, capital markets, etc.), the Fed's influence over rates remained in question, at least to me. After all, it was not as if the Fed could buy my house, grant me a mortgage, or find me a job. Rather, it could in some small way stimulate the economy, which would have the trickle-down effect. I remember an article I wrote entitled "Ignore the Man behind the Curtain," in which I called the Fed a fiscal post office whose function was to make sure liquidity flowed and that my checks cleared.

Well, has that all changed! I guess the Fed *can* buy my house, or at least my bad cash investments. Actually I think they could buy or at least swap my house for cash if I was an investment bank or another firm whose existence was essential to the daily functioning of life as we know it. The Fed has suddenly exercised or, along with the Treasury Department, has been given powers that can impact the economy more directly, at least in the short run. The jury is out on the success of these measures and the true damage to your life and mine if some of these "too big to fail" institutions really did fail. But the bottom line is the Fed now has more powers to influence short-term economic fundamentals. Let's see if it really can change the weather.

The World As We Know It

While the world has not changed, differences can be perceived as one cycle comes to an end and another begins. In early 2008 employment trends indicated an economic cycle change. Long before it showed up in GDP, we noticed the signs in employment first. No one could have predicted the severity of it. But truth be told, jobs were not being created at a pace that would support the economic growth and, therefore, stock prices as we saw then. As Figure 1.7 shows, GDP growth, from quarter to quarter, slowed considerably in Q4 2007 and Q1 2008.

For some, this meant more than just a contraction or slowdown. Warren Buffett proclaimed in March 2008 that the U.S. economy was already in a recession "by a common sense definition," even if it didn't meet the technical definition of two consecutive quarters of negative growth.[2]

While GDP indicated an economic contraction and the Oracle of Omaha was preaching recession, these were not the top concerns for

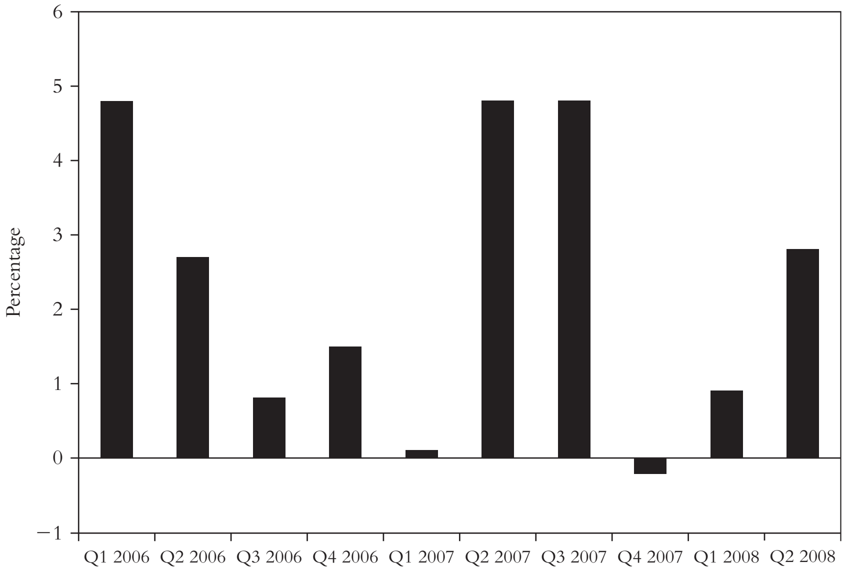

Figure 1.7 Quarter-to-Quarter Growth in Real GDP
SOURCE: Bureau of Economic Analysis.

most people. In fact, if you asked people what their biggest concern was in mid-2008, it was a good bet that they would have said energy prices.

When gasoline prices rose well above $4 a gallon—something that was not only unprecedented, but was once unthinkable—energy costs became front-and-center on consumers' minds. And while, as a consumer, I had my share of sticker-shock when I filled up the tank of my car, as an economist, I knew that energy prices were *not* the biggest factor driving inflation at that time.

Energy was still a smaller percentage of consumer spending than it was years ago. Yes, it was significant, and the media made a point of showcasing lower-middle-class Americans who were making the tough choice between filling up the tank and buying groceries. High pump prices and emotional impact aside, energy prices did not escalate all that much when you compare them to wages.

For example, in 1979, the average gasoline price was $0.943 per gallon, and the average hourly wage was $6.343, for a gas-to-earnings ratio of roughly 0.149. By 1981, gas prices had run up to an average of $1.41 per gallon, while average hourly wages also rose to about $7.438, for a gas-to-wages ratio of 0.190.

Table 1.1 Average Gasoline Prices, Average Wages, and Gas-to-Wage Ratio for 1980, 1990, 2000 to mid–2008

	Gas (US$)	Hourly Earnings (US$)	Gas/Hourly Earnings (%)
1980	1.27	6.85	18.5120
1990	1.28	10.20	12.5321
2000	1.64	14.01	11.7291
2001	1.56	14.54	10.7032
2002	1.56	14.97	10.4129
2003	1.70	15.37	11.0950
2004	1.94	15.69	12.3492
2005	2.49	16.12	15.4313
2006	2.74	16.75	16.3814
2007	2.99	17.42	17.1472
Mid-2008	3.84	17.85	21.1513

SOURCE: Oil Price Information Service (OPIS); U.S Bureau of Labor Statistics.

By early summer 2008 with gasoline rising to levels that made motorists actually think about walking (proving that the numbers at the pump are a more powerful motivator than other numbers such as weight, waist measurement, and cholesterol levels), one might have expected that the gas-to-wage ratio had skyrocketed. Right? Wrong. As Table 1.1 shows, the escalation in average wages has tempered the bite from the rise in gasoline.

Thus, in this book, when discussing energy, we need to make the distinction that while crude oil and gasoline prices were high, they were not the biggest inflationary factor. (And with gas prices sinking to below $2 per gallon on the national average in late 2008, it appears that the inflationary impact of energy is the least of our problems.) When prices go high enough, demand is curtailed, and prices fall. These are the classic supply-and-demand forces at work.

By contrast, wages are the biggest—and most worrisome—cause of inflation. Wages are inelastic on the downside and don't fluctuate as easily as energy prices. It takes a full-on recession and an increase in unemployment to 6.5 percent to even curtail wage growth. By acknowledging that, we leave the door open for supply shock inflation and monetary inflation—the kind that damage the economy because of wage pressure or monetary policy.

Today's World and Money Supply

While the world has not changed fundamentally, there has been a significant change the impact of which will be felt for decades to come. We are now—and I know you are sick of this phrase—a global economy. That means more than the shoes on your feet imported from Italy, the coffee in your cup from beans grown in South America, and so forth. Money supply growth in the United States can cause bubbles elsewhere. Growth in China and India can offset weakness in Europe. Cheap labor in developing countries can offset inflation in the United States. Therefore, we need to be mindful of global imbalances such as wage growth, money supply growth, and currency pegs (read: manipulation) that even a decade ago would barely cause a blip on the U.S. economy.

As we'll explore later in the book, one of the significant attributes of our current times is the aggressive bubble that developed in credit and liquidity. This was created from a global increase in money supply and world output—the latter being the excuse of why we can leverage without worry and why a slowdown in the United States would be offset by growth somewhere else. Therefore investors need not worry, as a new sucker was born every minute to feed the insatiable thurst for liquidity. (See Figure 1.8.)

Conclusion: A Changing, Consistent World

So has the world changed? We have become a global economy and sophisticated tools exist to monitor and shape the world's economies. However, the recurring cycles of expansion, peak, contraction, and trough, have not changed—thankfully. We need all four for a healthy economy, the contraction just as much as the expansion, even though most people think of contraction as "negative" or "bad for the economy." (Not fun, perhaps, but definitely not bad.) Trying to avoid contractions would be like eliminating winter in favor of endless summer. That might sound good on paper, but would cause devastating results for the other three seasons (not to mention the ski resorts).

Even the severe fallout from the credit crisis has carried some good lessons that apparently needed to be learned the hard way: identifying

Figure 1.8 Money Supply (M2) Spiked in the Late 1990s and Early 2000s, but Inflation (as Measured by the Consumer Price Index, or CPI) Did Not Follow. Rather, CPI and Wages Have Been More in Lockstep
SOURCE: U.S. Bureau of Labor Statistics; Federal Reserve.

and managing risk; being prudent in lending and borrowing; and the need for new regulations (for starters I would advocate changes in mark-to-market accounting to avoid massive writedowns of depreciating assets). At the risk of adopting a Pollyanna view, we need the difficult times to get rid of the fat and the excesses, which will eventually allow us to emerge stronger and more efficient.

The recurring cycles of expansion, peak, contraction, and trough are most pronounced when viewing the economy as a whole. Employment trends and output trends measured by GDP and the employment report are most reflective of the overall economy. Historically (or within my reference points of the 1970s through the present), investment choices and allocation decisions vacillated between stocks, bonds, and real estate (housing). In fact, if we look at the price appreciation over the last 25 to 30 years you will most likely see a very similar total return from all of these assets.

However, the paths to the returns were very different. Equities enjoyed what some call the longest bull run on record as the U.S. economy enjoyed an extended period of low inflation and declining rates along with tax code changes and savings incentives that promoted stock investments. Housing lagged equity investments for a decade or so until demand accelerated as criteria for home ownership and first-time buyers became more flexible as the risk of default was mitigated by securitization of loans. Home ownership was not reflective of long-term plans; therefore temporary ownership was suddenly acceptable, which created more demand. During the last 10 years or so housing outpaced equities as the NASDAQ bubble popped and housing became the seemingly more practical investment, thanks to lower mortgage rates and an even greater population of potential buyers who supported higher housing prices.

The overperformance in equities of the 1990s was followed by a decline and then a long period of flat to nonexistent appreciation. Although it was to be expected, it's hard to believe it actually happened as many thought we were in the midst of a new paradigm of the ever-expanding market. Now that the housing market has significantly outperformed for the past decade and the contraction is well under way it's clear that the fate suffered by the equity markets is being shared by the housing markets: a hard drop to eliminate the froth followed by a long period of flat pricing with little or no appreciation. Although there are many good reasons to own a home for the long haul, investment and quick appreciation will not be among them.

As I stated earlier in the chapter, the next opportunity will emerge as stocks finally take the lead as the investment of choice and return for the next expansion. With a higher interest rate environment about to begin and housing still suffering from oversaturation, overleverage, and overvaluation, equities will be investors' first choice.

Additionally, as greater diversity of financial assets through ETFs and other exchange-traded securities mature further, investors will have a greater selection of securities to use—resulting in a more efficient and targeted approach that will have benefits beyond a broad equity investment. Investors can invest in specific areas of the economy that are expanding without having to have exposure to areas that are contracting. This will be a very exciting next 10 years.