LightHouse
Investment Services

"Over a period of time there are going to be good and bad years; there is nothing to be gained by getting enthused or depressed about the sequence in which they occur."

Warren Buffett – Letter to Investment Partners 1960

Whilst we are clearly entering a period of slowing economic growth, it is useful to look at the history of economic cycles to put this in context. The economy goes through a recession on average once every seven years and we are currently in the eleventh bear market since the Second World War. However the market is currently pricing equities at levels that suggest we are entering a period that will be even more dire than the Great Depression. But unlike the Great Depression, central banks and national governments have shown that they are prepared to do whatever it takes to restore liquidity to, and confidence in, the markets as well as intervening to cushion the extreme effects of corporate failure. If the economic slowdown is less severe than that then equities are currently cheap.

A lot of the selling that has occurred over the year has been forced (and therefore irrational). The level of margin calls has been unprecedented. "Mum and dad" investors have repeatedly been faced with the choice of topping up their margin accounts with cash or having their shares sold. As these are leveraged portfolios, if debt has to be reduced by $10,000 about $50,000 of shares will need to be sold. The same dynamic has been at work in the wholesale markets. Institutional investors in hedge funds have redeemed their investments forcing the hedge funds to liquidate their positions in unfavourable markets.

The earnings multiples on which securities are currently trading are at historical lows, even taking into account an expected decline in earnings over the next year. Some very solid businesses without debt are available at single digit multiples of depressed after-tax earnings

Bear markets typically last for 9 to 18 months and fall around 30% to 40% from top to bottom. The All Ordinaries Index fell 53.4% from top to bottom over 13 months to 21 November 2008. If this bear market resembles others (and fundamentally there is nothing to suggest that it doesn't) we are quite likely very close to the point at which it turns. (In the 1973/74 bear market, which has many similarities to the current one, the market fell 54.1% over 21 months.) It may also be worth bearing in mind that the market has recovered by an average of 46% (and at least 21%) in the first year after every bear market since 1932.

We also need to remember that equities markets anticipate, rather than respond to, conditions in the real world. So we should expect to see markets recover even as conditions in the "real economy" weaken, just as we saw those markets slump ahead of a slowing of economic growth over 2008. When this shift in market sentiment occurs it is likely to be swift.

December 2008