The Surprises of 2008

For twenty-three years, I have prepared a list of ten investment-related surprises and presented them to colleagues and clients on the first business day of January. I started doing this, because I believed that incremental thinking was the curse of Wall Street and it would be good to step back and look out a year ahead and reflect on what important unexpected events might influence the course of the financial markets. In the beginning, I viewed the surprises as a mind-stretching endeavor and did not think about keeping score, but that, of course, was naïve.

My definition of a surprise is an investment possibility that most portfolio managers would assign only a one in three probability of happening, but where I believe the likelihood of the event taking place is better than 50%. Usually, about half the surprises work out in some way. I have had years where seven out of ten took place, but I have never exceeded that. Last year was above average. I believed the Standard and Poor's 500 would trade above 1600. It got to 1576 but then ran out of breath and breadth. Volatility increased substantially, as I thought, with the VIX comfortably moving beyond my target of 20. The Chinese did allow the yuan to appreciate. It didn't quite make the 10% I expected, but it did rise about 7%.

I thought crude oil might exceed $80 a barrel. It almost got to $100, quite a move from $61 at the beginning of the year. I was bullish on agricultural commodities. I expected corn to go to $5.00 a bushel, but it only got to $4.40. Wheat, however, went to $8.85 where I expected $7.00. Soybeans went to $12.23; my estimate was $9.00. Cotton went to 68 cents; I was looking for 80. I thought S&P 500 earnings would rise 10% beating analysts' expectations; they did in the first half, but fell apart afterwards. I didn't think the Fed would lower rates in the first half and they didn't, but 10-year treasury rates fell when I expected them to increase during the year. Credit spreads did widen and defaults increased as I anticipated.

I thought the price of gold would rise to $800, and it did from $632, but silver only got to $15 when I expected $18. The dollar was weak when I expected it to be relatively stable. I thought the Japanese market would rise after a particularly weak 2006, but I was wrong and that market was down for the year. Most emerging markets did not rest as I expected, but my top pick was Brazil which was up 44% in local currency and 73% in dollars. Finally, I thought Barack Obama would emerge as the leading Democratic candidate during the year and that looks pretty good at this point. My Republican pick was Rudolph Giuliani who wasn't even a declared candidate in January of last year. He came on strong for a while, but seems to be lagging a confusing Republican field now.

Now let's take a look at the Ten Surprises for 2008:

1. In spite of Federal Reserve easing, and other policy measures, the United States economy suffers its first recession since 2001 as housing starts stay soft and banks are reluctant to lend to anyone where a whiff of risk is apparent. Federal funds drop below 3%. The unemployment rate moves definitively above 5% and consumer spending is lackluster.

2. Standard and Poor's 500 earnings decline year-over-year and the index drops another 10%. Energy and materials stocks hold up relatively well in what is viewed as a correction rather than a bear market. Market conditions start to improve during the summer.

3. The dollar strengthens in the first half reaching $1.35 against the euro and weakens in the second exceeding $1.50. The European Central Bank begins an accommodative monetary policy. Foreign investors flock in to buy cheap assets in the U.S. early in the year but the dollar declines later as several countries holding large reserves diversify into other assets.

4. Inflation rises above 5% on the Consumer Price Index as higher commodity prices and oil finally begin to have an impact in spite of modest wage increases. The 10-year U.S. Treasury yield rises to 5%. Stagflation becomes a frequent presidential campaign and Op-Ed discussion topic.

5. The price of oil goes down early in the year and up later, sinking to $80 a barrel in the first half as western economies slow and inventories are drawn down, and rising to $115 in the second. Established wells continue to decline in production while China, India and the Middle East increase their consumption.

6. Agricultural commodities remain strong. Corn rises to $6.00 a bushel and cotton to $.85 a pound. Gold reaches $1000 an ounce as disillusionment with paper currencies spreads across Asia.

7. The recession in the United States slows the Chinese economy modestly, but its stock market declines sharply. Investors recognize that paying biotechnology stock multiples for highly cyclical companies doesn't make sense. The Chinese revalue the renminbi by another 10% to control inflation and as a gesture to foreign governments participating in the Olympic Games who complain that Chinese terms of trade are unfair. Several long distance runners refuse to compete in certain Olympic events because of continuing air pollution problems.

8. The new Russian President Dmitry Medvedev, under the tutelage of Vladimir Putin, becomes more assertive in world affairs. He insists that Russian oil and gas be paid for in rubles and demands a Russian seat at major world conferences. Russia and Brazil stock markets lead the BRICs. The Gulf Cooperation Council markets begin to attract interest among emerging market investors.

9. Infrastructure improvement becomes an important election theme for both parties and construction and engineering stocks rally in anticipation of huge programs beginning after the new President's inauguration. Water becomes a critical problem world-wide and desalination stocks soar.

10. Barack Obama becomes the 44th President in a landslide victory over Mitt Romney. With conditions in Iraq improving, the weak economy becomes the determining issue in voters' minds. They want to make sure that gridlock ends and Congress gets something done for a change. The Democrats end up with 60 Senate seats and a clear majority in the House of Representatives.

Most years I have had some "also rans" which didn't make the first Ten Surprises because I believed they weren't quite as good as the ones I was using or I didn't believe they had a better than 50% chance of taking place. Here they are:

1. After suffering a series of write-offs and operating earnings disappointments, financial stocks finally begin to form a base in the early fall and are rallying strongly by year-end. Housing stocks remain in the doldrums, however.

2. In a sharp reversal, both North Korea and Iran prove agreeable to scaling down their nuclear development efforts in exchange for the removal of sanctions and the promise of aid. Pakistan destabilizes the entire region because of its Al Qaeda training grounds, nuclear weaponry and government turmoil.

3. The Japanese market finally makes a positive move. After two particularly disappointing years, the combination of low interest rates and attractive multiples begins to appeal to local and overseas investors. Japanese consumers also begin to spend a greater portion of their income with a resultant favorable impact on corporate profits.

4. Private equity firms demonstrate the dangers of being early in trying to save a troubled company. Investments in MBIA and Chrysler prove to be the beginning of a difficult period for that industry.

I take full responsibility for the surprises, but over a two month period I spoke with a number of people about them and these conversations were very helpful. I am grateful to my Third Thursday discussion group of former Wall Street research directors; Jim Hoge, the editor of Foreign Affairs; George Soros; Joe DiMenna; Scott Slayton at Morgan Stanley and many others who provided their insights. All of the skilled professionals at Pequot gave me thoughts and encouragement, but particular thanks goes to Mike Corasaniti who helped me through the final stages of preparing the surprises and gave me many valuable suggestions.

The surprises this year have a negative tone. I worry that the problems in housing and credit are more significant and longer lasting than the usual market-adjusting events. I also believe the policy responses so far have been ineffective. I am concerned that the presidential candidates are too busy raising money and trying to appeal to everyone to demonstrate the leadership characteristics and programmatic initiatives that will be required should they end up in the Oval Office. Finally, I fear that the geopolitical environment is becoming more threatening and our complacency leaves us especially vulnerable. We will see whether I am overreacting.