Interim Market Correspondence
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The Mother of All Overreactions

The big news in the markets was the markets themselves: on Monday, the S&P 500 fell 79.92 points, losing 6.66% of its value. The Dow was down 5.55% and the Nasdaq technology index dropped 6.90%. Globally, the EAFE index, which tracks the overall market moves in the developed nations, fell 3.37%.

Until the last ten days, the U.S. markets were in positive territory for the year. It seems clear that the awful posturing and bickering spectacle in Washington, coupled with the ratings downgrade of longer-term (over 1-year) U.S. debt over the weekend, badly frightened many investors.

Should it have? An interesting recent column in New Economic Perspectives points out that the Standard & Poors rating agency has not been exactly a bastion of great judgment over the past few years. During the 2008 market meltdown and housing bubble, the agency rated toxic subprime junk securitized loans as AAA paper. Subsequent investigations found incestuous and (the web site's wording) "criminally incompetent" relations with the Wall Street issuers.

Moreover, unlike Greece, Portugal or Ireland, the U.S. Treasury has control over its own currency, which makes default ridiculously easy to avoid. To illustrate how simple, since government debt with maturity of less than 12 months is still AAA rated, the government could stop issuing long-term bonds and sell only three-month bonds. The rates on these are generally controlled by overnight rates for bank reserves, a figure that is largely under control of the Federal Reserve Board.

Or the Federal Reserve Board could buy U.S. bonds at whatever rate it chooses. As a last resort, the Treasury department could simply print more money. More likely, however, the Treasury will continue as it is, because there is no shortage of investors who want to invest their money in the safest, most liquid fixed income market in the world--and accept astonishingly low interest for the privilege of safety.

Meanwhile, a web site ominously titled "Credit Writedowns," which closely tracks credit downgrades, says essentially the same thing, declaring, in part: "A nation that issues debt denominated solely in its own currency, and which is in full control of its monetary policy, cannot default unwillingly... One could thus argue that the rating agencies shouldn't even bother to rate U.S. sovereign risk."

The site also points out that other countries that currently boast AAA ratings, but which have less stable finances than the U.S., may have to be downgraded just to maintain consistency.

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France is the prime suspect--and the site notes that a downgrade of French sovereign debt might start a "chain of events which can only make things worse in an already crisis-hit Eurozone." Thank you S&P...

The point for real investors (as opposed to gamblers in the investment marketplace) is that stocks are now attractively priced relative to bond yields, which is almost always a better time to buy than to sell. There seems to be no purely economic reason for the selloff--after all, corporate profits are still high, the U.S. economy is recovering (albeit slower than some of us would like), and consumer balance sheets are greatly improved over three years ago.

This appears to be a classic emotion-driven downturn, made worse by a breathless media that always seems to amplify the mood of the moment. History has shown that these times of panic are dangerous to long-term returns; they are fundamentally an urgent invitation to sell at a market bottom to somebody with a clearer head and stronger nerves.

Sincerely,

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