

Redemption Song

By Chris Nelder | Thursday, October 9th, 2008

Well, it's been another breathtaking, bone-shuddering week on Wall Street, and calls and emails have been pouring in from friends and relatives seeking advice on how to react to the worst market since the Great Depression.

I have found myself humming the same song for the last month straight: the Duke Ellington classic, "Do Nothing Till You Hear From Me."

In recent weeks, I've already said "When in doubt, sit it out," and "stay out of the water and wait until there are fewer sharks around," and "This is no time to be a hero. It's a war zone out there, and the better part of valor is to keep your head down and your powder dry, and live to fight another day."

This week, the song remains the same.

Lest you think I'm being disingenuous, I want to make one thing clear. Yes, as little as a month ago I also said that this is a good time to be accumulating long positions in commodities and energy, because they're getting downright cheap. And over the last month, some of my favorite names have crashed 30-60%, to where they now have P/E ratios in the 5 to 10 range—outstanding bargains, historically speaking.

If you are a disciplined long-term investor, buying small amounts of your favorites on say, a monthly basis, you are now averaging down your costs considerably, and I have no doubt that in a few years you're going to be pretty pleased with those positions.

But I have also advised that the markets haven't been working normally for months now.

At the beginning of July, I [wrote](#):

On June 18, the credit strategist for the Royal Bank of Scotland said, "A very nasty period is soon to be upon us - be prepared," and warned that the S&P 500 could tank to 1050 by September—a 28% drop since the beginning of the year. That means that all of the gains made by the index's component companies since the end of 2003 would be wiped out.

Well, 1050 was finally breached in Monday's selloff—six days after the end of September. And indeed, equity valuations have been knocked back to 2003 or worse.

As I have explained ad nauseum in these pages, the counter-intuitive selloffs in energy and commodities have had little to do with the fundamentals of the stocks or their businesses, and everything to do with the mechanics of big money deleveraging and exiting the market, and with the "shadow banking system" that is the global credit market simply seizing up.

Simply chart together a few stocks in oil drilling, steel, coal, large consumer goods, and you'll see almost identical trading patterns for the last several months. That's a big clue right there, with such dissimilar businesses.

Between redemptions by hedge fund investors pulling their money out, and margin calls resulting from unwinding enormously leveraged losing bets, the selling has continued to be indiscriminate and widespread and brutally mechanical, even in the traditional safe haven sectors, gold, and other precious metals. In fact silver and platinum have reached prices at which it's no longer economical to mine!

In short, the selloff has been all about things that mere mortals do not understand, as evidenced by the decision of the mortals in Congress to push through an \$700 \$850 billion bailout plan on Friday night that did nothing to assuage the markets, failed to unfreeze the global credit system, and indeed led to the massive 8% plunge in the averages on the very next trading day...only to be followed by another 500-point tumble on Tuesday this week.

There was another dead giveaway in the reaction to the bailout bill that should give us pause: Although the bill contained an 8-year extension to the expiring 30% Investment Tax Credit (ITC) for solar installations, which was widely anticipated and which should have inspired a rally in the whole sector, solar shares sold sharply with the rest of the market, ending the day down as much as 8% after rising as much as 10% earlier in the day. Such counterintuitive action and volatility tells us that the markets are dancing to a different tune.

I think I know the name of that tune. As I watched the carnage, I had a vision of the CEOs of WaMu and Indymac and Lehman and Merrill skanking down Wall Street together with a thousand hedge fund managers, singing an updated version of Bob Marley's "[Redemption Song](#)":

Old pirates, yes they robbed us
Shareholders were out of luck
Then the big banks they bought us
For pennies on the buck
But our balance sheets were made strong
By the hand of the Treasury
We dumped debt onto future generations
With the help of the FDIC...
Won't you help to buy
These obligations?
Cause all we seem to have
Is redemption songs
Redemption songs...

Next Up: Severe Recession

One of the observers I have been watching closely is NYU professor and economist Nouriel Roubini, who has correctly forecasted the meltdown we are now witnessing, and who correctly predicted that the \$700 billion bailout plan would not restore confidence in the credit markets. He has advocated a much more aggressive and coordinated strategy, including recapitalizing the strong banks and killing off the weak ones, guaranteeing all bank deposits, and cutting interest rates.

Now the Fed and the world's bankers appear to be coming around to Roubini's strategy, but he believes that they have done too little, too late, and a severe recession is already a foregone conclusion. In [today's interview](#) on Tech Ticker, he laid out his *best* case scenario as follows:

"At this point, the recession train has left the station. The financial and banking crisis has left the station. We're going to have a severe recession. We're going to have a severe financial crisis. What we can avoid is a systemic collapse of the financial system. And the corporate sector is going to lead us to something close to the Great Depression or to what happened to Japan, with a stagnation of economic growth for a decade. So at this point, it's going to be ugly regardless, but at this point we can avoid a total meltdown of the system and a multi-year collapse of the global economy."

Worse, he projects that instead of this being a typical 18-month recession, it will probably be more like a two-year recession. If that's the best case scenario, then there is very little reason to want to be in equities right now, period.

I also constantly keep in mind that the absolute global peak of oil production is now probably only a year or two off. If we are struggling to come out of a two-year recession just when oil spikes up and supplies start to become short, things could really get ugly for the American economy.

Accordingly, I have changed my tune somewhat, and adopted a strictly defensive stance.

This has become a horrible negative feedback loop and I continue to believe that the best place to be is in cash. I don't advocate panic selling, but I do try to point out that an \$8 commission is a very small price to pay to protect your capital. This is an excellent time to go to the sidelines, take a breather, and reevaluate, then come back in a month or five, when all this mess has been sorted out a little more.

The only liquid investments I can advocate now are physical (not paper) gold and silver, and the occasional short-term trade in a short side ETF like [QID](#), [FXP](#), or [SKE](#).

There is a very real possibility that after we get through the first part of this crisis, and everybody is in cash, that the value of the dollar could collapse.

In fact, I believe that best investment for the future right now is a piece of productive land where one can grow some food. Real things hold their value in times like these, and it's wise to hedge against the possibility of breakdowns in the food distribution networks due to the ongoing crisis.

It's hard to believe, but those who have analyzed the history of bear markets say that the worst is still yet to come.

Take heed: we're probably only halfway to the bottom in this selloff, and the second half will sell off *even more sharply*. Wholesale panic remains a real possibility.

As I wrote in [my blog](#) last week, "the safe move is not to play at all," and the best advice I can give right now is to "keep yer fool head down."

Do nothing till you hear from me.

Until next time,

A handwritten signature in cursive script that reads "Chris Adler". The signature is written in a dark ink and is positioned below the text "Until next time,".

Chris