Some Markets Are Shocked; Some Are Used To It

Markets With Recent Sharp Losses Are The Most Vulnerable

There is an old Wall Street adage, the only kind, observing that when the police-wagon arrives on the scene, the entire building and all the inhabitants thereof go for a ride. Okay; you probably have heard a more direct version wherein a piano player gets mentioned, but this is a family Website.

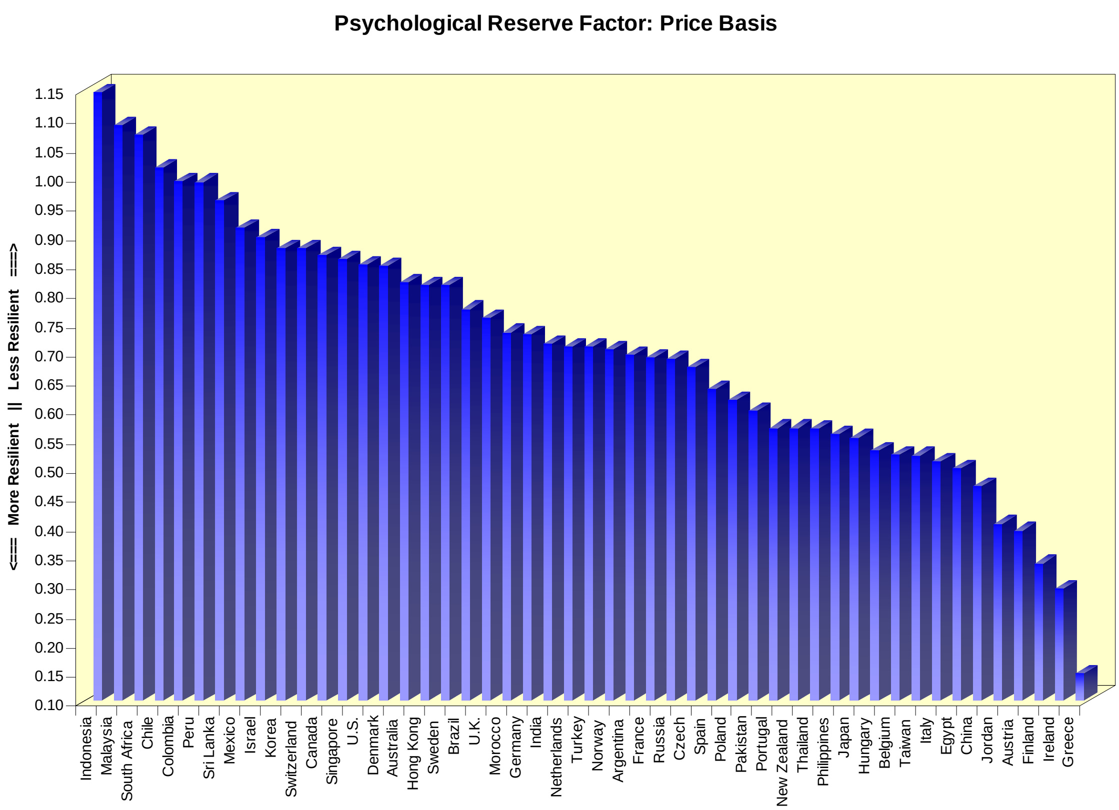
A second Wall Street adage observes that in a time of crisis, you do not sell what you should; no, you sell what you can. This is why some of the largest and most liquid stocks, the Apples (AAPL) and the ExxonMobils (XOM) of the world, get hit the hardest when the going gets tough, whether or not the tough get going at the same time.

A third observation, one I can remember and therefore am well ahead of certain politicians, is it is far easier to sell something and take a profit rather than sell it and take a loss. The behavioral finance guys have been living off of "insights" such as this for thirty years; they will tell you and be correct the only thing that should factor into the decision is the stock's prospects. When this inhuman human trader is born, I will be the first to let you know.

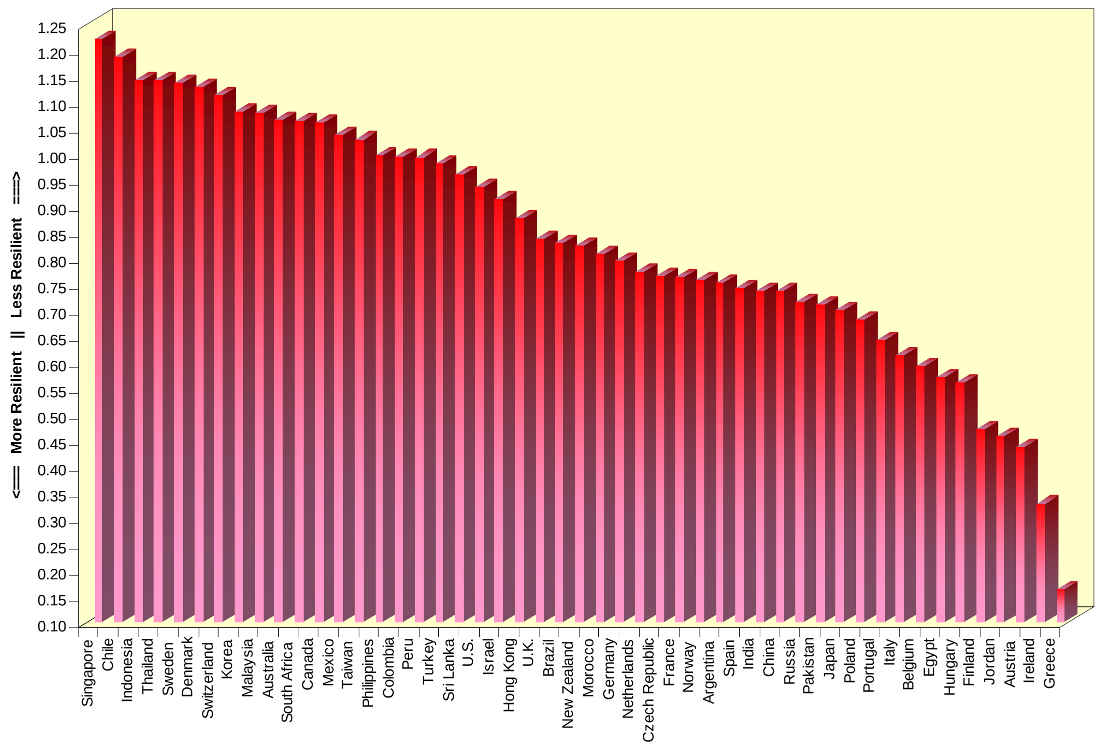
Time Heals All Wounds

One way to measure the loss a trader feels is retracement of gain (GR), or the percentage drawdown from the market's high. However, this is a flawed measure when the high came a long time ago, as has been the case for Japan or the NASDAQ. I like to adjust this retracement by dividing by the square-root of the year-fraction since that high was made to account for the reality even the most self-flagellant amongst us feel less pain with the passage of time. For example, if the market's high occurred two years ago, the adjustment factor would be 1.414; if it was six months ago, it would be the square root of one-half, or 0.707.

If I combine these two measures' complements in a ratio of $(1+GR)/(1+GR_{adj})$ for a set of 49 global markets as measured by MSCI-Barra, I can rank them in descending order of their downturns' freshness. The charts below display these rankings both on a price basis and on a total return basis.



Psychological Reserve Factor: Total Return Basis



The conclusions are quite intuitive. The most fragile markets psychologically now are the recently hot emerging markets such as Indonesia, Malaysia, South Africa, Chile and Colombia. The most resilient to further downturns primarily are Eurozone markets such as Greece, Ireland, Finland and Austria.

Not so coincidentally, this analysis confirms the fundamental conclusion I reached in November's Emerging Markets' Reliance on Cheap Dollars Is Growing. While last week's expansion of dollar swap facilities ended the vicious cycle of dollar carry trade unwinding for the moment, it very well have been nothing more than a short-term solution to a long-term problem. The modern political and economic systems worldwide seem to specialize in that maneuver, do they not?