Fear Itself

With apologies to Pink Floyd...

Mother do you think they'll drop the bomb? / Mother do you think they'll light the sun?
Mother do you think my stocks will fall? / Mother should I build the Wall?
Mother I will trust my president / Mother I will trust my government
Mother will they put me in the firing line? / Ooooo Is it just a waste of time?

Hush now traders, don't you cry / The market won't make all your nightmares come true
The market won't put all its fears into you / We'll all try to keep you under our wing
You probably did cry, it's now time to sing / But money can't keep you tender and warm
Ooooo baby ooooo baby ooooo baby / Never, ever build the Wall

Armageddon can't be delegated, and it sure as hell won't be won by the side gripped in fear. I frequently insert lessons from military history into my discussions of trading and markets not out of any morbid fascination with human sorrow, but rather in recognition that people and their institutions must be studied at the margins to understand who and what they really are. Nothing else matters. No one today remembers Churchill's wandering in the political wilderness in the late 1920s and early 1930s, and there's a reason why Americans so often turn to war heroes as political leaders.

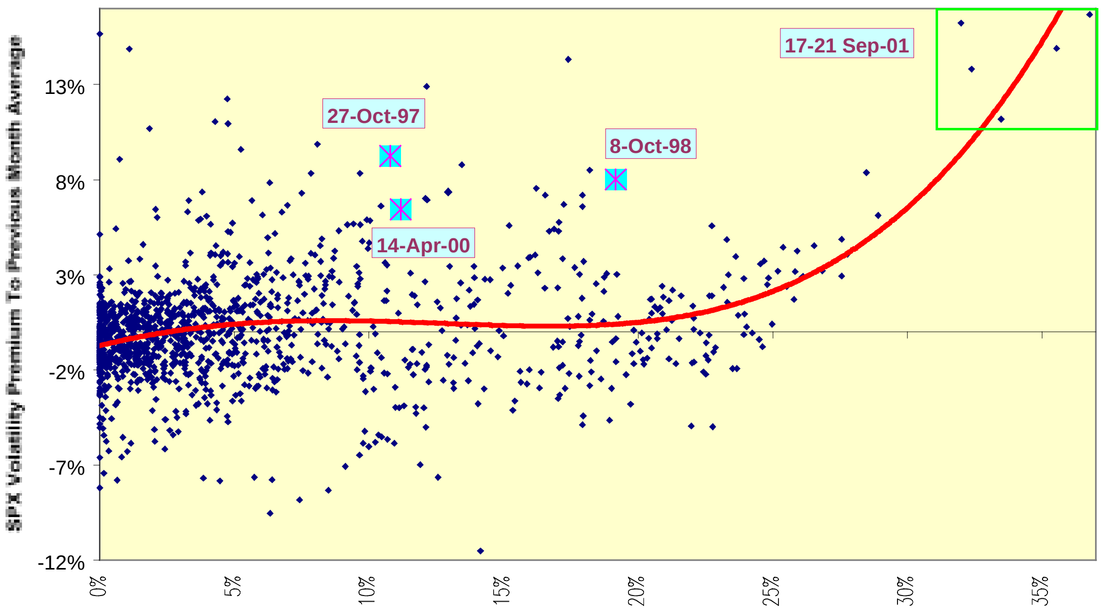
Defeat and impending defeat often produce wildly divergent psychological outcomes. Let's take two examples of rescue from calamity, one successful and the other not. The British evacuation at Dunkirk in May 1940 was a stunning national triumph on top of a catastrophic defeat; even though their army was kicked off the Continent, the salvation of so many troops instilled a sense of confidence into the teetering nation. On the other hand, fear and acceptance of an inevitable defeat creates a self-fulfilling prophecy. By all accounts, Gen. Friedrich von Paulus of the German Sixth Army trapped at Stalingrad in the winter of 1942-1943 first relied on unrealistic hopes of rescue, and then in a fit of depression came to accept defeat as inevitable. Soon it was so.

Investor behavior during the week of September 17-21, 2001 exhibits both characteristics. Some assessed the best course of action as getting off the beach to fight another day. Others clung to hopes and history, and said this, too, shall pass. Both actions are defensible in prospect; only one will be correct in retrospect.

Nostradamus Doesn't Live Here Anymore
Forecasting is difficult, especially of the future. The whole art and science of market analysis depends on the repetition of relationships that have held in the past and which have some justification in financial and economic theory. But, the stunning rise from October 1998 to March 2000 defied logic. Who doesn't remember analysts scrambling to justify valuations and constructing "new metrics," whatever they were? The swoon in 2001, even prior to September 11, confounded the many analysts who expected a series of interest rate cuts to stabilize both the economy and the market.

Abnormal times produce abnormal outcomes. As noted above, how people and systems perform under extreme conditions is the only thing that matters. Let's take a look at just how abnormal things are right now with a combination of measures demonstrated twice before, once just after the April 2000 selloff and again in October 2000 after the attack on the *USS Cole*. First, we can measure the surge in anxiety by comparing current volatility, the market's price of uncertainty, to the previous month's average volatility. Second, we can compare the current value of the market to its last new high; this is called retracement of gain, and is often a useful measure of how much pain we feel.

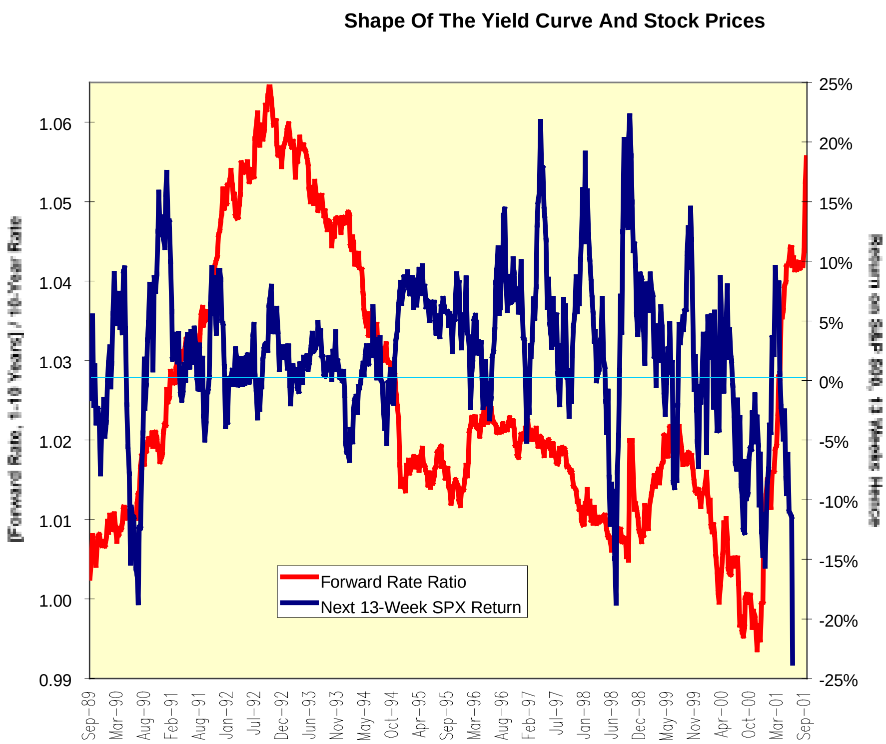
A New World Order: SPX Volatility As A Function Of Gain Retracement
May 1996 - September 2001



Previous capitulation bottoms are highlighted on the chart, and a trend curve is added to demonstrate how excess volatility accelerates as losses mount. The week of September 17-21 is easy to identify. All five days are in the upper right hand corner of the chart. In terms of both excess volatility and retracement of gain, we exceeded all experiences of the past five years, and probably exceeded those of any time other than the Great Depression.

Who Shall Rescue Us?

As a longtime critic of central banks, let me give credit where it is due. The Federal Reserve recognized its duty to forestall a liquidity gridlock in the banking system, and its actions of the past two weeks are to be commended. But, beyond forestalling an immediate credit crunch, can monetary policy produce the desired outcome in equity prices? The recent history is not at all encouraging. Let's take, as we have so many times before, the ratio of the forward rate from one to ten years, the rate at which we can lock in borrowing for nine years starting a year from now, to the ten-year rate itself.



The abrupt steepening of the yield curve in 2001 produced by the Fed's easing policies is unprecedented. The last easing cycle ended in 1992, but stocks didn't break out to the upside until the end of 1994. The Fed's trying to ride to the rescue, but those infamous long and variable lags associated with monetary policy are going to force us to wait.

If the Dunkirk analogy to last week's market is correct, things will get worse before they get better, even if a rescue of historic proportions occurs. If the Stalingrad analogy is correct – and let's hope it's not – we will hunker down to no avail. Bluntly, waiting this siege out from behind your own Wall makes sense only if you can afford to do so.