

Ten pieces of good news in the gloom

How to think beyond the excessive pessimism in the market

By Dan Richards

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Few have had as many quotes attributed to them as Winston Churchill. One of his expressions seems especially relevant right now: “Pessimists see problems in every opportunity. Optimists see opportunities in every problem.” These days, there’s certainly no shortage of difficulties to point to – the only saving grace is that the vast majority of these problems appear to be priced into the market.

In fact, a strong case can be made that the pendulum has swung to the point of excess gloom. At a lecture I attended a few years back, a prominent professor of business history commented: “There has always been good news and bad news out there. Only two things vary at any given point in time: First, the balance between good and bad news and second, what people focus on.” The tech mania of 1998 to 2000 was a classic period in which we only focused on the good news and ignored the bad; arguably we’re seeing the opposite take place today as all that people talk about are the negatives, neglecting anything remotely positive. When thinking about all the bad news



that faces us, here are 10 “good news stories” to consider:

Attractive market valuations

Depending on who you talk to, stock valuations are generally seen to be at either normal historical levels (which should lead to returns in the 8 to 10 per cent range) or at extremely attractive levels, which would result in returns well above that. Of note are recent actions by Prem Watsa of Fairfax Financial, an insurance holding company that made over \$2-billion betting against U.S. financials.

Throughout 2008, Fairfax had its equity portfolio fully hedged, eliminating exposure to the stock market – but on November 20, Mr. Watsa announced that they had removed the hedges saying: “While the recession may be long and deep, we also believe that stock prices

may have discounted the worst of the economic decline. As value investors, we are finding an incredible number of investment opportunities across the world.”

Another skeptic who has changed his views is Robert Schiller of Yale, who predicted both the tech collapse and U.S. real estate meltdown – and now says that market valuations have returned to normalized levels.

The impact of lower oil prices

The dramatic drop in oil prices has put many more dollars in the pockets of businesses and individual consumers. No matter how dire economic prospects might appear, they’d be much worse if oil was still at \$150 a barrel (unless of course you happen to be employed in the oil patch – this is a classic example of the same news being positive for some and negative for others.)

A return to the old virtues among banks

At one time, banks stood for prudence, risk management, oversight and transparency. It’s clear that too many banks got away from these – and also clear that we’re seeing a return to these traditional virtues that will ultimately leave the banking system stronger.

Strong political leadership around the world

The challenges we’re facing today will test the leadership of all of the major economies. The good news is that it’s difficult to remember a time when we had leadership that was stronger and more collaborative and open to new

directions than we see today with Gordon Brown, Angela Merkel, Nicolas Sarkozy and Jean-Claude Trichet in Europe; Barack Obama, Ben Bernanke, Tim Geithner, Paul Volcker and Larry Summers in the United States; and Hu Jintao in China and Manmohan Singh in India.

The early response to Mr. Obama’s new administration is especially positive – as he and his team promise to boost confidence among American investors, consumers and businesses, something sorely lacking over the recent period.

The sole exceptions to strong leadership among major powers are Japan, which has suffered from a leadership vacuum since Junichiro Koizumi retired in 2006 and Vladimir Putin in Russia – while there is little question about his strength, his openness to new directions and willingness to collaborate is another question.

A co-ordinated global response by central bankers

In the past, difficulties similar to today’s would have led to a fractured and fragmented global response. That’s a sharp contrast to the co-ordinated and co-operative response we’ve seen from central banks and the economic leadership in place today. Indeed, there appears to be a steadfast commitment to do whatever it takes to keep the financial system afloat and to provide the stimulus to get economic growth restarted.

Pruning of weak players

The economist Joseph Schumpeter is best known for the concept of “creative destruction”,

the dynamic process whereby new ideas supersede old ones and innovation leads to the collapse of traditional market leaders. While it's intensely painful if you have the misfortune to work for or invest in one of these companies, a key reason that the U.S. dramatically outperformed every other major economy in the 20th century was its flexibility, adaptability and willingness to allow losers to die.

Whether in the automobile industry, retailing or banking, we'll be better off as consumers and the economic system will be stronger when marginal players are consolidated into stronger survivors – setting the stage for new upstarts to emerge and challenge the remaining incumbents. In countries such as the U.S., France, Germany and the United Kingdom (Canada being a notable exception), an important byproduct of recent events is that weaker banks have disappeared from the scene, with the surviving banks becoming stronger as a result.

Opening of economies and growth of entrepreneurial drive

We've all heard the expression "You can't put the genie back in the bottle." In the past 10 years, we have seen a remarkable outpouring of entrepreneurial spirit and energy in countries with historically closed economies, ranging from China, India and Vietnam to Eastern Europe and South America.

While the current economic downturn represents a setback, there is no disputing the fierce work ethic and drive to succeed that have been

unleashed – and while some Western companies and industries will struggle to adapt to the heightened competition that has resulted, it's indisputable that the global economy will be a big winner as a result. As a side note, not long ago South America and Eastern Europe were seen as economic and political basket cases. In large measure due to the opening of economies and a renewed commitment to democratic government, countries like Argentina, Brazil, the Czech Republic, Poland and Hungary are now poised for strong economic growth.

The commitment to global trade

When faced with tough economic periods in the past, one response was to resort to raising trade barriers – this was a key contributor to the Great Depression. The good news is that there have been no signs of a global trade war – and indeed we continue to see movement towards reducing trade barriers (albeit slower than some would like.)

The continued payoff from technology

Since the commercialization of the Internet in the mid 1990s, we've seen hundreds of billions of dollars invested in the technology that permeates our personal and work lives. While this technology has led to compressed margins and severe pressure on some industries (think travel agents and newspapers, for example), on balance, it's continued to be a huge driver of increased productivity – and with higher productivity come heightened profits. Another benefit of technology is higher return on research and development - the impact of

processing power and instant communication is paying immense dividends in making research dollars more efficient, as information on new discoveries is disseminated in real time.

A shift in focus by the best and brightest

The best talent migrates to those fields offering the most recognition and highest pay. As a result of stratospheric compensation in the financial industry, an entire generation of the best and the brightest young people aspired to be financial engineers. There are already signs that the return to reality on compensation levels is leading to some of that same talent becoming real engineers, where their drive and abilities are going to be put to better use.

None of this is to say that we don't continue to have real issues ahead of us and that unwinding some of the excesses of the recent past won't continue to be painful. Thinking about investment prospects going forward, however, it's important to bear in mind that we seem to be in that part of the market cycle where the problems seem overwhelming with any offsetting positive ignored ... and that it's exactly these kinds of environments that have historically represented some of the very best times to invest.

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