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Wealth

The worst is yet to come – time to flee to quality

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Recent announcements on manufacturing activity, household income and employment have made it painfully clear that the US economy is struggling. For investors, however, the relatively arcane debate over whether we are in a recession or not is largely irrelevant. Today's stock prices discount future expectations, and it is the extent to which reality ends up exceeding or falling short of those expectations that drives future stock performance.

In tackling the more relevant question – "where does the economy go from here?" – I should point out that I don't usually spend much time on macroeconomic forecasting. It is difficult to get right and generally my time is more productively spent focusing on a bottom-up analysis of individual companies' prospects. If one takes the long-term view that the US economy is resilient and will continue to grow over time – as I do – it is the company-by-company calls that will determine investing success or failure.

From time to time, however, some macroeconomic trends – especially when they seem to be underappreciated by the market – are too important not to factor into our investing strategy.

Such is the case today in assessing the bursting of the housing and credit bubbles. Is the worst over or is there more trouble to come? Sadly, my take is that we have seen only the tip of the iceberg: an enormous wave of defaults, foreclosures and auctions is about to hit the US economy. In fact, I expect it to get so bad that large-scale federal government intervention is likely.

Sean Dobson, chief executive of Amherst Securities Group, kindly shared with me the extensive data he has collected on every mortgage that was securitised in the US this decade. The frightening story these tell is clear: mortgage lending standards became progressively worse starting in 2000, but really fell off a cliff from early 2005, led by the unprecedented writing of subprime loans with two-year "teaser" rates. These loans made in early 2005 began to default in high numbers in the first quarter of 2007, which not surprisingly was the beginning of the turmoil in credit markets.

The crisis has worsened as even lower quality loans made over the remainder of 2005 reset over the course of 2007, triggering more and more defaults. Because it takes an average of 15 months from the first missed mortgage payment by the homeowner to a liquidation by sale or auction of the home, it is only now that the first wave of foreclosures and auctions, from loans written in early 2005, is starting to hit.

Given that lending standards became much worse in late 2005, continuing through the first half of 2007, the wave of defaults leading to forced home sales is only in its early stages. The impact on housing prices will be devastating. Most homeowners can (and do) choose to keep living in their home if they can't sell it for the price they want, but lenders are different. When they foreclose on a home, they need to monetise it as quickly as possible, generally via an auction, which results in a true market-clearing price. These distressed prices will be much lower than the price declines so far reported.

Amherst's data show that the wave of foreclosures and auctions will build massively this year and peak in 2009 and 2010. It's laughable that the National Association of Realtors is projecting a 1.2 per cent decline in housing prices this year. Merrill Lynch may even be conservative in forecasting a 15 per cent drop in housing prices this year, with a further 10 per cent drop in 2009. Needless to say, this decline will have a strongly negative impact on household wealth and spending.

With such a sobering outlook, what is an investor to do? For one, we have reduced our net exposure to the market by increasing our short positions, primarily among richly valued consumer-related companies and financial companies with exposure to subprime mortgages.

We have also tended to focus on the long side on good companies whose stocks have simply become too cheap to ignore. Barnes & Noble, the book chain, is representative of the retail stocks in our portfolio. The stock was down 17 per cent in February and, after the company said this month that it expects profits to be flat this year (hardly a disaster), has fallen further. The company has a market capitalisation of $1.65bn and, after deducting year-end estimated cash of $380m, an enterprise value of $1.27bn. We expect it to reach $380m in earnings before interest, taxes, depreciation and amortisation this year, with free cash flow of about $190m. With the stock around $28, it trades at about 3.4 times ev/ebitda and 8.8 times free cash flow, for a cash flow yield of 11.3 per cent.

We think a private buyer would pay double these multiples for this high-quality business. While there are always competitive threats, we do not believe the book superstore business is declining. We think Barnes & Noble can grow at a low- to mid-single digit rate for several years – but at this price, we don't need any growth whatsoever for this to be a successful investment.

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