

3rd Quarter 2008

GREED & FEAR

Investors that didn't understand what these two words meant, as it relates to the stock market, do now. I have been in the financial services industry since the summer of 1972 and this industry never ceases to amaze me. Wall Street, as I have said many times, is the worse managed industry in America. My opinion has been vindicated once again. The events of the last few weeks have been historic.

The "credit crisis" is still with us in spite of the \$700 billion bailout of the banks. Will the bailout work or not? No one knows. As far as the measures taken by the Federal Reserve and the Treasury Department go, Anna Schwartz (93 years old), one of the most respected economists of our time, says the bailout plan is too opaque and ad hoc to work. She says, "The chief problem is that the Treasury can responsibly provide capital only to solvent institutions, but should not recapitalize insolvent institutions. The current program offers no way of determining who is solvent and who is insolvent."

We have even bigger problems than the temporary illiquidity of the banking system. Decades of living beyond our means, poor government oversight and excessive speculation have culminated in a financial disaster of epic proportion. The present financial chaos is only the outer band of the economic hurricane yet to come. The economic fallout that follows a period of excessive debt increase and subsequent restriction of credit availability will carry over to the real side of the economy in the form of lower production, sales, jobs and profits. The winds of this economic downturn began long ago, and will not be meaningfully allied by federal or monetary authorities.

Time will eventually cause this storm to pass, and prosperity will return, but two or three years of economic difficulties are unprecedented in modern times. The most critical problems are:

First, the economy is nine or more months into a recession and the Leading Economic Index (LEI), a

premiere guide to economic activity, is declining at an increasing rate. Sales and income both peaked in October of last year, while employment peaked in December, and production peaked in January of this year. This indicates the economy has been in recession since the first quarter of 2008.

Second, major foreign economies are in as much trouble as the U.S., resulting in a world that is on the verge of a synchronized downturn. Real domestic demand in the fifteen large countries outside the U.S. rose just .9% in the latest four quarters, down sharply from the peak of 2.8% registered in early 2007. The OECD's World Leading Economic Index has slumped 3.3% in the past twelve months. Declines of this magnitude have always been associated with global recessions. Global conditions will continue to deteriorate as imports to the U.S., -1.1% for the twelve months ending July, continue to fall, sending our recessionary impulses to the rest of the world. At some point the foreign downturn will feed back to and reinforce the U.S. recession.

Third, monetary policy has been extremely active in pursuing expansionary activities through a series of innovative actions designed to liquify markets or inject liquidity into the system, yet it has not gained traction. Unfortunately, unique financial circumstances indicate that the Fed's response will, for a time, be unsuccessful in spurring the economic growth. For example, M2 has expanded sharply in recent weeks, but this increase has been unable to stimulate borrowing and lending because velocity, or the turnover of money into the real sector, is estimated to have declined even more sharply. Velocity is outside the Fed's control, and is determined by the rate of change in financial innovation. To say financial creativity has ceased would be an understatement; thus, it is logical to assume that velocity will continue to plummet.

Recent massive increases in bank reserves, which under certain circumstances could lead to inflationary growth, have lost their power as the increase reflects a "seizing up" of the financial markets rather than the start of a new borrowing

and lending process. Thus, the banks refused to re-lend funds obtained over the discount window and froze all the reserves placed in the system. Banks went to the Fed's discount window to fund their existing positions and made no further use of these borrowed reserves because the counterparty risk is perceived as too great. A necessary, but insufficient, condition for a return to financial market normalcy would be a willingness on the part of the banks to make loans with these massive levels of excess reserves they are currently holding. Instead of lending they are making acquisitions.

Fourth, in real terms, wealth of the household sector have declined an estimated \$4.5 trillion from the second quarter of 2007 to the third quarter of this year. The loss in stock market wealth has exceeded the fall in housing sector wealth. In the third quarter alone, the losses in stock market values actually exceeded those on homes by a ratio of about 2.4 to 1. Ultimately, the damage to housing wealth should be far worse since a massive overhang of unsold homes remains on the market, suggesting that the bottom of house prices remains in the distant future. In the latest month a twice normal 10.4 month supply of existing homes was on the market, while there were 2.4 million units of unsold new homes, also twice the average since 1971. In addition, the U.S. mortgage foreclosure inventory was a record 2.8%. In spite of substantial reductions in new housing starts, the industry has been unable to cut production as fast as demand has fallen. By 2010, the real wealth loss of the household sector, from homes and stocks, could exceed \$7 trillion, thereby posing a major restraint on consumer spending for both domestic and imported goods.

Fifth, fiscal policy is often considered to be a powerful tool because it supposedly worked in the great depression. That assessment is incorrect. The dismal conditions of the 1930s only improved materially after Europe and Asia went to war, thus benefiting the U.S., initially a non-combatant selling to both sides of the conflict. The massive Treasury bailout could actually make conditions worse than doing nothing, and in any event will be ineffectual. Recall that the tax rebate/stimulus package earlier in the year was supposed to be a

panacea, yet failed to spur economic activity, and merely left the government with greater indebtedness. The Washington/Wall Street pundits predict similar success for the bailout, yet it will also fail and another ill-conceived package will likely be enacted. Part of the reason for their ineffectiveness is that the government is robbing the private sector of sorely needed resources via its massive issuance of debt to fund these programs.

Failing Fiscal Policy

Unfortunately, highly visible fiscal actions such as tax rebates or Wall Street bailouts raise such household expectations that the government is on the job working to solve problems. When those actions do not work, hopes will be dashed and consumer confidence could fall even more sharply, putting the economy at greater risk than if hopes were not raised in the first place.

Total U.S. debt in the second quarter jumped to 357% of GDP, up from an average of 195% from 1916 to the present. In less than five years, the total debt to GDP ratio jumped more than 50%. The high until now was 300% in 1933. The current peak, however, was reached due to a surge in debt, while the 1933 peak reflected a dramatic fall of nominal GDP, the denominator of the ratio. The new record level of debt in the second quarter reflected the worsening situation among corporations, both financial and nonfinancial. Clearly the magnitude of the debt problem is unprecedented and years, not months or quarters, will be required to bring debt into some reasonable relationship with economic activity. As long as this situation persists, the U.S. faces a difficult economic environment. This is due to the fact that over the past four decades every additional dollar of debt created 86 cents worth of GDP, and with debt shrinking, GDP will struggle to generate positive growth. Consumers must start to pay down debt, causing the economy to slow.

In spite of numerous monetary and fiscal policy actions taken well before the bailout, recessionary forces have intensified and the leading indicators indicate that this process is worsening. The

Treasury bailout bill's miracle cure will be equally disappointing. With aggregate demand continuing to falter, the risk of deflation is far greater than the risk of inflation. Since commodity prices and rents are now falling, negative readings on the monthly inflation gauges may occur before this year ends.

Conclusion

We are witnessing the deleveraging of the consumer and the global economy that must take place if we are to get back into a sound financial environment. The consumer is finally tapped out as far as credit is concerned. The consumer has maxed out its home mortgage/equity debt, credit card debt, auto debt and retail debt. We all know that at some point, and it has arrived, consumers must pay debt down. While they are doing that there is no money to buy goods and services. Therefore, the economy slows, resulting in low earnings for corporations, resulting in a lower stock market.

The stock market has dropped dramatically to levels seen in 2003. Valuations of stocks look pretty reasonable, even assuming marked earnings declines. The S&P 500, at 876, is trading for just 10 times 2007 operating earnings of \$85. This year's profits will be a disaster due to write-offs and losses, and the 2009 earnings outlook remains uncertain. Citigroup analysts see \$79 in S&P earnings, but even assuming \$70, the index is valued at less than 13 times earnings. The dividend yield on the S&P 500 stands at 3% and the price/book ratio is 1.8 times, versus 3.3 a year ago. In severe bear markets the P/E Ratio usually bottoms out in single digits, not 13-15x.

European stocks are even cheaper, trading with a 6% average dividend yield and at just 1.2 times book. European equity yields haven't been so attractive relative to European bonds in 50 years.

This sounds good, but Felix Zulauf, of Zulauf Asset Management, characterized the coming state of the world economy as "a soft depression," thanks to the gargantuan deleveraging and credit contraction efforts, offset somewhat by aggressive government interventions. His expectation is a 5%-7% cumulative drop in world GDP from peak levels, a 50% or greater collapse in global corporate earnings, and a ultimate low in the S&P 500 between 500 and 600 versus 876 now.

We hope Mr. Zulauf is wrong.

As this situation has unfolded we have guided our clients to protect your principal. In July, after a good second quarter lead by the energy sector, we suggested that you lower your equity exposure to 40% stocks and 60% bonds. Energy was lowered to 10%-15% depending on the client. As the market continued to deteriorate we suggested in late September and early October that stocks be reduced to between 20%-30% depending on the type of funds and your risk tolerance. This is where we are now. We continue to be concerned about the economy and its effect on the stock market. The pundits on television and the newspapers keep talking about capitulation and a bottom in the market. They talk about technical bottoms. In the end it is fundamentals that matter. The economy and earnings will eventually determine where the stock market goes. We believe that getting out of the market completely is not prudent for two reasons. First, bear markets usually experience very strong rallies, and we want to take advantage of that. Second, no one knows when the market will turn and move up. We want to participate when it does.

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