



Boston
Washington, D.C.
West Palm Beach
Naples

Perspectives

October 15, 2008

Brian Katz, Chief Investment Officer

Seth Hieken, Managing Director

With U.S. financial markets experiencing volatility of an unprecedented magnitude, the debate regarding whether the U.S. economy is in a recession has shifted to a debate regarding the duration, severity, and scope of the recession not only in the U.S. but also abroad. As we wrote last quarter, the short-term future of our economy and financial markets remains clouded. Yet, our analysis for the longer term suggests reasons for optimism. This outlook is bolstered by several factors, including constructive, coordinated intervention by global policy makers, lowered inflation expectations, reduced interest rates, and historically attractive valuations. Past experience implies that we are in the capitulation phase of this bear market and that we are at or near a bottom. While we have taken certain defensive positions during the second half of 2008, we are poised to capitalize on more positive conditions when they occur.

REVIEW

The year 2008 will be remembered as one of the more dramatic, volatile, and atypical years in Wall Street's long history. General market forces

have been brought to ground by a credit crisis that has affected even the most venerable of businesses, requiring massive governmental intervention on a global scale to combat the ensuing emotional panic that has so distorted valuations and the basic economic principles of supply and demand.

U.S. Equities. Starting in late September and accelerating in October, investors began to discount a systemic collapse of the global financial markets, causing steep price declines. As of the date of this newsletter, the S&P 500 Index is down 32.0% year-to-date, while the Dow Jones Industrial Average is down 29.8%. The NASDAQ Composite has had equally disappointing results, falling 32.9% for the year.

October, in particular, has been a devastating month for the markets. Through October 10th, the U.S. equity markets declined every day without a single positive day. The week of October 6th was the second worst week since 1928 for the S&P 500, which declined 18.2%.

U.S. Fixed Income. Fixed-income investors have continued their panicked flight to safety,

insisting on placing their money in risk-free Treasury securities and avoiding corporate debt at almost any cost. Indeed, this phenomenon of risk avoidance has reached such extremes that it has caused extraordinary distortions in the credit markets.

Corporate spreads – the incremental yield offered by corporate bonds over Treasuries – have shattered all previous records. In fact, the short-term credit markets effectively have stalled altogether, leaving corporations unable to issue commercial paper and forcing unprecedented measures by the Federal Reserve and lawmakers, such as directing the purchase of commercial paper by the U.S. government.

Simultaneously, interest rates for the private sector (including for jumbo mortgages, new car loans, home equity loans, 5-year ARMs, 3-month LIBOR loans, and bank loans with durations between 5 and 10 years) have continued to rise, despite falling yields on government securities.

Commodities. As investors increasingly have worried that problems in the credit markets will exacerbate the global economic slowdown, commodity

prices have been hit especially hard. Fears of inflation have waned and, in some cases, turned into fears of deflation.

The Dow Jones AIG Commodity Index has fallen 39.1% from its 52-week high and is now down 21.7% for the year. Last quarter, we wrote that the price of oil had risen 37.8% during the second quarter, the largest percentage gain since the first quarter of 1999. We are now reporting that the price of oil has fallen 45.9% from its 52-week high and is down 18.1% for the year. Even gold has given up much of its earlier gains, off 16.6% from its 52-week high, and is now ahead by only 0.2% for the year.

U.S. Dollar. The U.S. dollar has been buoyed by forecasts for slower growth outside the U.S., the perceived relative safety of investing in the U.S., and the proactivity of U.S. policy makers. Continuing its recent positive trend, the U.S. Dollar Index is now up 6.4% for the year.

International Markets. International policy makers have been slower than their U.S. colleagues to ease interest rates, inject fiscal stimuli, and use non-conventional policy to alleviate the financial crisis. As a result, the international equity markets generally have been hit even harder than their U.S. peers. The MSCI EAFE Index is down 38.9% this year, and the Dow Jones World Index is down 36.4%. Excluding the U.S., the latter index is down 39.5% year-to-date. Based on data from Bloomberg, global equity markets have lost \$8.3 trillion in market capitalization since the start of October and \$27.3 tril-

lion since the start of the year.

Most countries and geographic regions have been hit as hard, if not harder, than the U.S. The European-centric DJ STOXX 600 Index is now down 36.3% for the year. Likewise, the Dow Jones Americas and Dow Jones Asia-Pacific Indices are down 33.1% and 37.2%, respectively, all exceeding the losses in the major U.S. indices. The once high-flying emerging markets have been hit the hardest. The Dow Jones CBN China 600 Index is down 62.9% in 2008. The Bombay Sensex and Hang Seng averages are down 43.4% and 39.5%, respectively, while the Dow Jones Russia Titans 10 Index is down 58.5%.

ANALYSIS

It is important to understand some of the root causes of the current crisis. Simply stated, the housing boom of the past decade was fueled by an abundance of credit, which, in turn, was offered to unqualified borrowers. The loans made to these borrowers, which are now known as “subprime loans,” were frequently packaged into high yielding securities that could be sold to investors in the U.S. and abroad.

The value of these bundled securities was dependent on the continued payment of principal and interest on the loans. Declining home prices, however, led to defaults and, ultimately, a decline in value of the investments tied to these loans. Losses were exacerbated by the use of leverage and the issuance of derivative securities, such as credit default swaps, by financial insti-

tutions. A credit crunch resulted from the realization of these losses, causing the evaporation of available capital around the world. As the crisis intensified, declines in the broader financial markets ensued, led by the financial, banking, and housing industries, and the end result was widespread investor panic.

The reality of this debacle is undeniable, as is the economic pain that it has caused. Is this crisis, however, sufficiently different from prior crises to justify the wholesale abandonment of rational adherence to fundamental asset allocation strategies and investment discipline? We certainly do not hold that opinion.

The current crisis on Wall Street is not unprecedented.

There is no better word to describe the current conditions on Wall Street than “panic.” Investors increasingly have acted based on hysteria and not on rational observations of the markets and the fundamental economic environment for those markets.

Panics are nothing new to Wall Street. They come and go, sometimes with greater frequency than others. Yet, some irresponsible reporters, politicians, and inexperienced investors have exacerbated the current panic by suggesting that, in fact, this crisis is some sort of new paradigm – something completely different in nature and magnitude than anything we have seen before.

Most responsible investment professionals do not agree. As recently stated by the well respected economist and former

professor John P. Hussman, “It is just mind-boggling to hear financial reporters and Wall Street ‘professionals’ foaming at the mouth that the difficulties we are observing today are wholly new and unprecedented. We’ve seen these before.” More pointedly, Dr. Hussman observed that “the badly reasoned and childish panic coming out of Wall Street analysts these days is an embarrassment to the investment profession.”

We have been here before. As we noted in a previous communication to our clients, the current conditions are analogous to several other housing-related financial crises of the past, such as the Savings and Loan Crisis that led to the creation of the Resolution Trust Corporation in the late 1980s. In fact, as a percentage of gross domestic product, the funding given the RTC was greater in size than the recently adopted \$700 billion bailout plan.

Our financial markets and economy have endured and recovered from myriad other crises throughout our history. It is important to gain some perspective by reflecting on some of the other crises that failed to take down our markets during the past century: World War I; the Great Depression and associated bank failures; World War II; the wars in Korea, Vietnam, and Iraq; the 1973 Oil Embargo; the Crash of 1987; the Savings and Loan Crisis and ensuing collapse of the real estate market; the Asian Financial Crisis of 1997-1998; the attacks of September 11, 2001; and the bursting of the Internet and technology bubble.

We recovered from every one of these crises, and, ultimately, those who lost the most in the context of these circumstances were the investors who panicked. Conversely, those who gained the most were the investors who refused to panic and who instead adhered to longer-term investment strategies and discipline.

Remember that markets can move up as quickly as they can move down and that bear-market periods typically are shorter than bull-market periods. Consider the fact that during the bear market of January-May, 1970, the market fell 35.4%. Between May, 1970, and January, 1973, however, the market gained 124.0%.

The year-long bear market that began in April, 1981, yielded a decline of 24.7%. Between March of 1982 and June of 1983, however, the market gained 71.7%.

Between July and October of 1990, the market fell 22.4%. Starting in October of 1990 and ending in July, 1998, however, we enjoyed a 330.7% bull market!

In the last 50 years, there have been 15 bear markets. On average, they have lasted for only 10 months and yielded declines of 29.4%. In contrast, during this same period of time, there also have been 15 bull markets. On average, they lasted 3 times as long, 30 months, and yielded advances of almost 4 times as much, 112.5%.

These measures strongly suggest the need to maintain a longer-

term perspective. They also suggest that, by historical standards, we may be nearing an inflection point or market bottom.

There is reason to believe that we are past the point of maximum risk for the equity markets. We have been writing for some time that inflation fears have been overblown and that, while headline inflation had been growing, inflation at the core (*i.e.*, excluding food and energy) was tame. That thesis is now a reality as commodity prices have retrenched, particularly due to demand destruction, and concerns regarding prices are now more focused on deflation than inflation.

Other factors, too, suggest an eventual and inevitable return to relative normality. The U.S. dollar is stronger. Sideline cash is at record levels. Corporate spreads are at historic highs. Global policy makers have been willing to take dramatic steps to restore confidence. Valuations are at historically attractive levels, with the forward price-to-earnings ratio of the S&P 500 at approximately 10 (compared to the mean of over 17).

If history is any guide, we are in the capitulation phase of the current bear market. The VIX Index, a measure of the S&P 500’s expectation of volatility over the next 30-day period, is at record levels. Generally referred to as the “fear index,” the VIX typically rises with increased uncertainty. In the past, a VIX of greater than 40 has coincided with the occurrence of a market bottom within 3 months. The VIX recently exceeded 75 and currently

stands at over 50, indicating that we could be near the point of maximum fear and, consequently, a market bottom. As Warren Buffet recently reminded us, “good investors are fearful when everyone else is greedy, and greedy when everyone else is fearful.”

Policy makers will continue to be proactive in their efforts to solve the credit crisis. Acclaimed economist Stephen S. Roach, long known for his bearish views on the markets, recently noted that “[t]he most important thing about financial panics is that they are all temporary. They either die of exhaustion or are overwhelmed by the heavy artillery of government policies.” While it is unclear when the current panic might “die of exhaustion,” it is clear that the governments not only of the United States but also of the world’s most powerful economies will utilize their collective “heavy artillery” to end the panic.

Witness the economic power of our government when it chooses to act:

- Federal funds rate cuts of 375 basis points since September, 2007, including coordinated rate cuts with foreign central banks
- Enactment of a \$168 billion stimulus package
- Proactive currency policy
- Facilitation of the J.P. Morgan acquisition of Bear Stearns
- Facilitation of Goldman Sachs and Morgan Stanley becoming bank holding companies
- Seizure of several banks and

the bailout of AIG

- Temporary ban on short selling of financial institutions
- Temporary insurance of money market funds
- Creation of a funding facility to purchase commercial paper
- Enhancement of FDIC insurance
- Facilitation of interbank lending
- Creation of the \$700 billion TARP to buy troubled assets

Perhaps equally important is the fact that the governments of countries around the world seem united in their willingness to follow the lead of the U.S. government in its efforts to avert a longer-term crisis. The resulting global coordination is occurring at unprecedented levels and portends an eventual end to the crisis.

CONCLUSION

As we have written in the past, the current turmoil can end only when the flow of credit is restored and the housing sector has been stabilized. On the positive side, however, we note that many of the other conditions for a recovery already have been satisfied.

We also are encouraged by the efforts of global policy makers and central banks to stave off a longer-term recession, but only when the effects of these efforts are fully integrated into the markets will we know for sure whether they have been sufficient. Accordingly, we remain defensively positioned until such time as we are comfortable that

the credit and housing markets have been stabilized.

In our equity portfolios, we have raised cash, remained underweight the financial, consumer-discretionary, and housing sectors, and lowered our relative volatility. In our fixed-income portfolios, we have raised cash, remained committed to higher quality municipal bonds, reduced our exposure to preferred stocks, proactively monitored the credit quality of corporate bonds, and avoided Fannie Mae and Freddie Mac. In our mutual fund strategies, we have increased our exposure to large-cap equities and absolute return investments and reduced our exposure to international equities and emerging markets funds. We also have moved our money market holdings into money market funds invested primarily in obligations of the U.S. government, its agencies, and its instrumentalities.

In all cases, we remain prepared to become even more defensive in the event of any new developments. At the same time, we believe that we are well positioned to take advantage of a stabilization and eventual economic recovery when it occurs.

In the meantime, we encourage all of our clients to use this downturn as a gauge for reevaluating their risk tolerance and longer-term needs for capital. The financial markets inevitably will rise again, but they also will fall again. Times like these reinforce the need for responsible asset allocation and diversification planning, which remains the best protection against market volatility.