Courier Capital Corporation

Market Review & Update

FALL 2008

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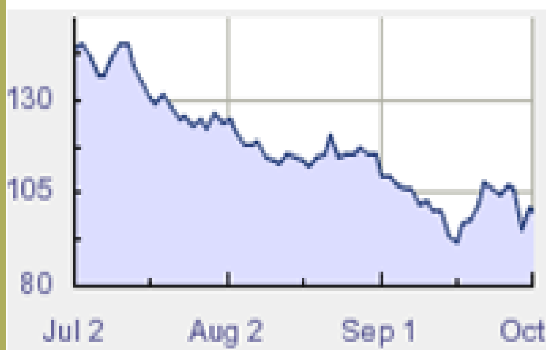
Treasury Secretary Henry Paulson suddenly became the most powerful person on earth. The reason for this is that he may have been one of the few people willing or able to accept the power that just happens to be coincident with the most thankless job on the planet. A devout Christian Scientist, eschewing alcohol and tobacco, he may well find his stimulation is facing the challenge of the hour, or putting up with Congress…

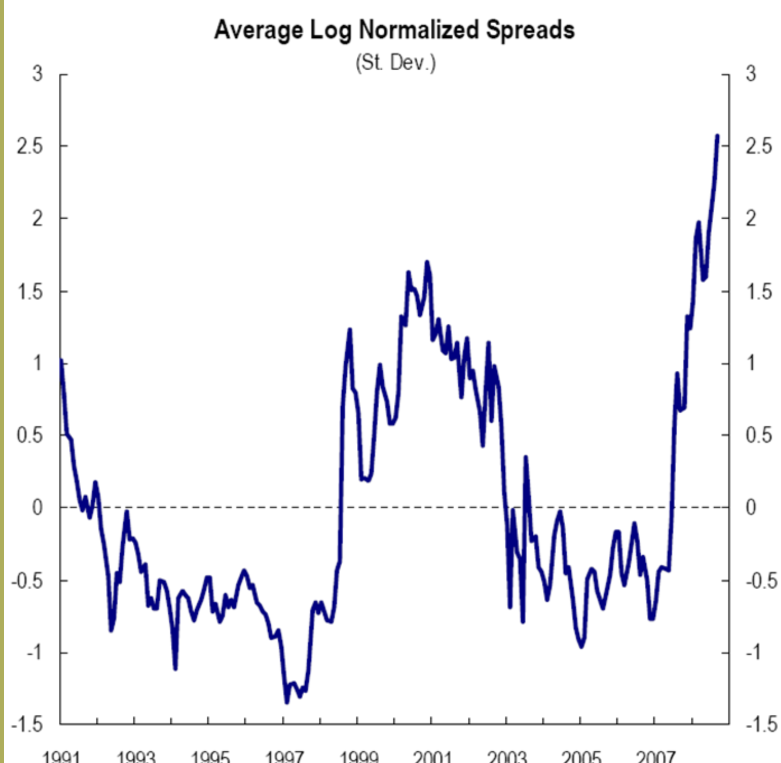
If we look back over the last year, the rate of change in both the velocity and direction of major trends manifests the difficulty corporate management has encountered in trying to manage what came before them. A year ago the world was a quiet place. A few short months ago consumers were facing rising food prices and, along with businesses, were feeling the impact of $145 per barrel oil and rapidly rising commodities in general. The Fed's posture was to fight this building trend toward inflation with potential increases in short term interest rates as their weapon. Global growth was the steam driving this engine. In a matter of weeks, oil declined from $145 to below $100 (Figure 1.)…with other major commodities following in lock-step and the dollar appreciated versus major world currencies. Inflation quickly fell off the table as the Fed's primary concern. It seemed as though the world was reverting to the mean.

Figure 1. Oil prices declined dramatically



Little did they realize that the "mean" being sought was not the average, but the attitude. A storm rose up in the credit markets, fueled by a rapidly cascading re-evaluation of collateralized debt obligations, credit default swaps and the feral pests of the markets, short sellers. Congress, years ago, created something called the Sarbanes Oxley Act, meant to bring discipline & disclosure to the wild world of corporate finance. That act is now regarded as having imposed an impressive and costly burden on large companies and such an oppressive burden on the small that is has effectively stopped hundreds of companies from ever going public. Buried within the ACT is a little provision called FASB 157. This accounting regulation requires companies to "mark

Figure 2. Credit Spreads have widened



Note: Average of log normalized spreads for investment grade and high yield corporate bonds, conventional mortgage and asset-backed securities, agencies and swaps. Sources:

Credit Spreads
(basis points, figures in parenthesises are percentiles)

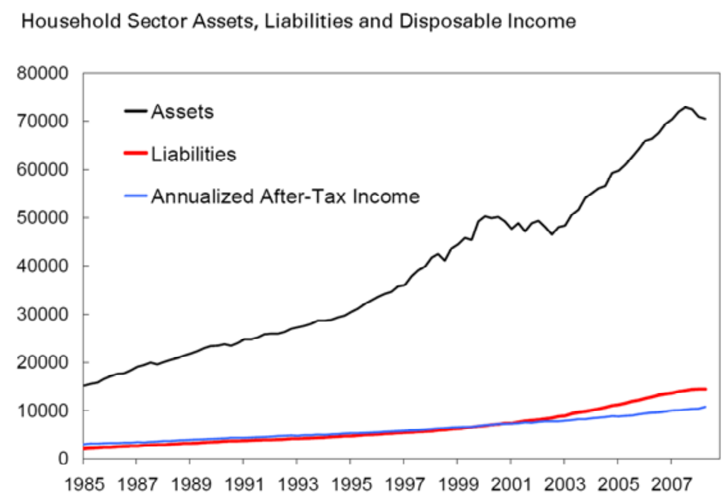
	May-07	29-Sep
Corporate Bonds		
Investment Grade	90	310
	(30)	*(100)*
High Yield	244	1080
	(10)	*(100)*
Swaps	49	116
	(58)	*(100)*
Conventional Mortgage-Backed Sec.	57	103
	(57)	*(94)*
Agency	22	99
	(27)	*(100)*
Asset-Backed Sec.	56	310
	(51)	*(100)*
Emerging Market Sov. Bonds.	139	387
	(0)	*(28)*

Source: Citi

to market" assets on their balance sheets. You will shortly note the irony in Congress' current discussion and potential intent to suspend the burden imposed by FASB 157. You may have noticed that many major financial institutions have reported large quarterly earnings setbacks. Most of this in the last few quarters is a result of "marking to market". Pools of subprime mortgages were forced to be shopped on the street to ascertain a "market" price. Unforeseen problem, there was no market. Major write-downs were required, the major write-downs then effected capital ratios, the capital ratios had to be complied with which forced everything from massive debt & equity issuance, forced sales and mergers, government led rescues and more insolvencies than anyone wished to see. The credit markets seized up. Credit is the life blood of companies and consumers. Credit spreads have widened dramatically in this environment. (Figure 2.) Can't buy what you need to breath that day and life becomes increasingly difficult, fast. (Before we talk more about the important issues, revisit the irony comment as NOW Congress wants to loosen up the FASB 157 accounting noose, NOW in lieu of 6 months ago…).

Enter Henry Paulson and Fed Chairman Bernanke. They rescued a few companies, put a few noteworthy ones out of business and made an impassioned plea to Congress to act quickly to reinvigorate the credit markets via a rescue package of historical significance.

Figure 3. Household Net Worth near all-time high



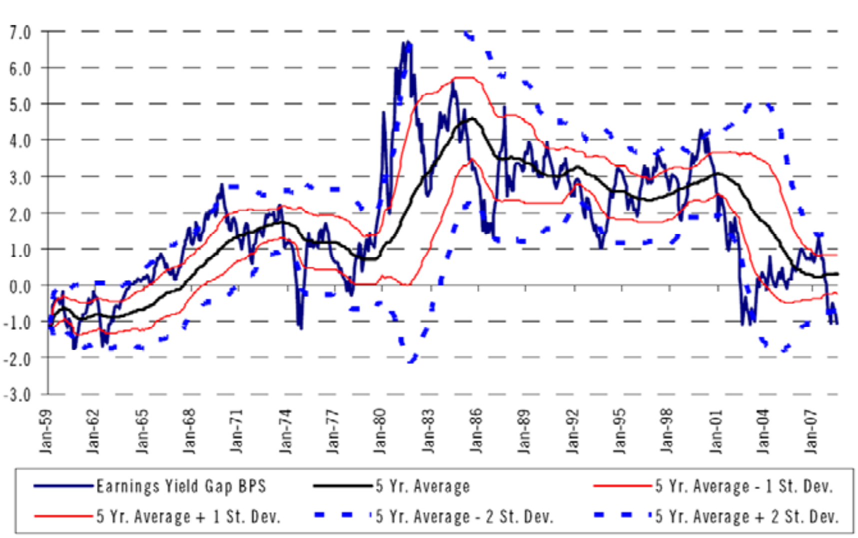
Source: FRB, Bureau of Economic Analysis (BEA)

Recent government activity provided the answer, but the rescue package was not adequately explained to consumers. In theory, the Treasury will purchase the aforementioned securities for which there is no orderly market. Valued at nil today, they do have a cash-flow as a large percentage of mortgage-holders will actually continue to pay their loans. This cash-flow will provide a value in excess of the price paid. This difference will amount to a yet to be ascertained profit that will aid to ameliorate a good portion (some have estimated that the government, aka the taxpayer, could even net a gain from this, once the dust settles) of the rescue dollars. In the interim, however, the new administration will have much less spending flexibility than even the least optimistic campaign speech can muster.

Re-lubricate the credit markets and you re-lubricate business and consumers. From their posture months ago of needing to potentially hike rates to stem the inflation tide, the Fed will now most likely, along with most other central banks around the world, continue to provide massive liquidity infusions along with coordinated reductions in short term interest rates. Remember when we discussed how Alan Greenspan provided the catalyst for this problem by leaving interest rates so low for so long that people went crazy? Well, if rates get pushed low enough now, people and businesses will get just crazy enough to allow for sufficient greed to overcome anxiety. And renewed economic activity levels will occur. We can't wait.

Household net worth and annualized after-tax income are near all-time highs, and could provide support for the economy and the markets. (Figure 3.) A powerful valuation metric, the trailing Price-to-Earnings ratio of stocks versus the yields on 10-year US Treasuries plus the equity risk premium is now back to levels not seen since immediately after 9/11 and the mid-1970's.(Figure 4) The metric is more than one standard deviation below its trend line, and this correlates with a greater than 90% chance that equity markets will be higher over the next twelve months with the average gain being more than 20%.

Figure 4. Equity earnings vs. US Treasury yields & equity premium



Source: Haver Analytics and CIR Equity Strategy

There has been much frustration for all investors in this environment as the market wrestles with uncertainty. Actions by the Federal Reserve, the Treasury, and their counterparts around the world are reinvigorating the credit markets. Credit is the underlying catalyst of economic growth. As credit markets normalize and global interest rate reductions take hold, we should see normalized consumer and business activity, resulting in a resumption of economic growth. We can view Warren Buffett's recent investment in Goldman Sachs and General Electric as a reminder that a disciplined focus on opportunity will ultimately be rewarded.

We'll talk to you soon.