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Market Review & Update

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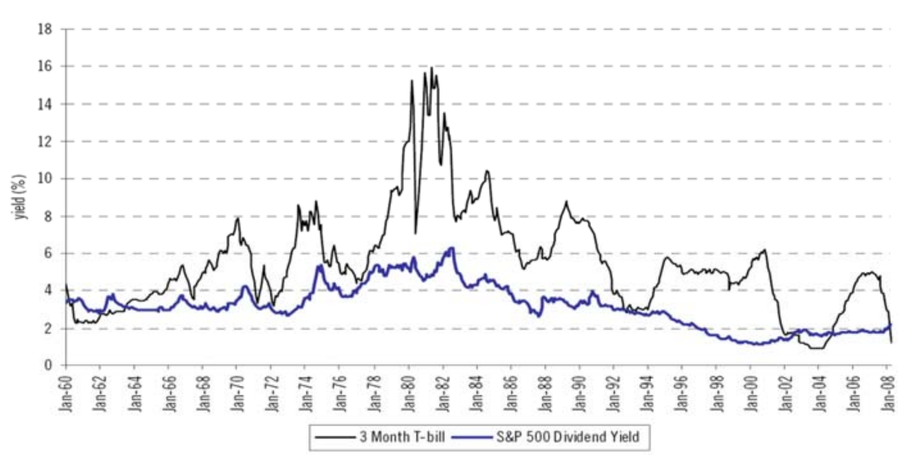
The 2nd Quarter of 2008 began with the Dow Jones Industrial Average posting a gain of nearly 400 points. This occurred on a day when several banks and investment firms confessed their sins via updated earnings releases. Markets rarely spend much time wading in current events except at times when uncertainty and fear instill the deer in the headlights reaction. As one noted economist once said, “there are no intellectual lows”. Most often markets are anticipatory, trying to distill the future to seize opportunity. We should probably stop here to paraphrase the aforementioned scholar, “there are also no intellectual peaks”…as investors, when in periods of overconfidence will become too certain about their ability to predict the future. Back to April 1st. On a day of what many would consider negative news, the markets staged a substantial rally. It is quite likely that we will look back on the 1st Quarter of 2008 as the period that the Fed, and all other market participants, took full measure of the nature of the real estate and subprime mortgage credit environment, assessed the size and longevity of the problems and came forward with an aggressive palette of unconventional tools to provide the requisite liquidity to restore the balance between fear and greed and once again allow investors the latitude to look forward. And as we have noted in recent writings, looking forward provides us with a much different picture of the world than looking in the rear view mirror. Lets take a more detailed look at the various factors influencing the current environment, as they will likely guide us to where we are headed.

For quite some time we have been opining that stocks were the least expensive asset class. Just this past December a noted strategist pointed out that stocks had not been this fairly priced in nearly a decade. Previously, we have noted that P/E ratios have contracted each year since 2002. A dollar today buys more earnings growth than it has in 6 years! Normally, such valuations point strongly toward rising market values. If we look at implied earnings growth rates from an historical perspective, at such levels the equity market has in excess of a 95% probability of rising for the next 12 months. We see similarly confirming trends evidenced in the level of the VIX volatility index and various proprietary economic models. Sometimes it is beneath us to point out the overly obvious, but perhaps the most basic valuation metric to trip over is that a 2 year Treasury now has a yield below that of the S&P 500 dividend payout. This means that if stocks simply sit where they are they will outperform US T-Bills. (see Figure 1.) We are standing at a point when the signs are fairly obvious, stocks are inexpensive and government bonds are not.

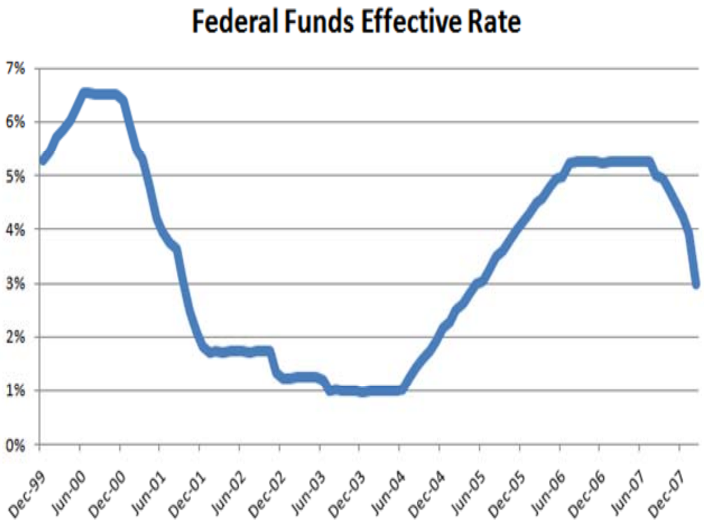
The Fed made one brief but critically important statement. Bernanke, in recent testimony before Congress, noted that the Fed expected a rebound in economic activity in the 2nd half of this year and stated “we will do everything necessary to keep the credit markets functioning”. That may well go down in history as the stick in the sand, the turning point for action, results and most important at this juncture, sentiment. Since the tools the Fed and other agencies employed were so unconventional, it is worth specifically noting them. Credit ceilings were raised and quality standards lowered for both institutions and individuals. And, notably, throughout this period, the Fed Funds Rate has been aggressively decreased. (see Figure 2) As you look at the chart of the Feds Funds Rate it is interesting to note that current action to cure the problem (Bernanke) is to bring rates down to the previous low

Figure 1. Comparison of S&P Dividend Yield and 3-Month T-Bill Yield



Source: Citi Investment Research – U.S. Equity Strategy and Haver Analytics level that actually caused much of this problem (Greenspan). Yes, Alan Greenspan, author, economic rock star, and frequent commentator of the current state of the credit market, did much to actually cause what we are now experiencing. Funny how he left that out of his book. The period on the chart when interest rates were below 2% from 2001 to 2004 created the speculation on mortgages and real estate, as well as fueled the "carry trade" which is basically free money in Japan to enable greater speculations by hedge funds and investment banks. Give human beings free money, whether they be a nice couple in Florida or some hedge fund "gurus", and they will most definitely not respect risk enough to act intelligently. Remember the aforementioned "no intellectual high" it definitely extended to rapid run-ups in the prices of homes in certain markets and also in the coincidental run-ups in leverage by genius investment bankers-please note at this juncture that at the moment that the Fed "seized" Bear Stearns that the firm's capital was leveraged some 30 times…think of that as the institutional version of too much mortgage, on too much house, in too hot an area, chasing a profit that had "no apparent element of risk"…it's fairly apparent now. So, the Greenspan Fed left money cheap for much too long, creating an asset bubble in real estate and other leveraged assets that is now being unwound and ironically, the cure being employed by the new Fed management is the same medicine as the cause. Not that unusual though, after all they do make anti-snake venom by milking poisonous snakes, don't they…?

Figure 2. Federal Funds 12/99—3/08



Where does that put us now? Well, we know much has been done, is being done and the Fed has loudly stated "we will do <u>everything</u>". The path to the solution appears more clear as some of the fear and uncertainty is removed from the environment. Financial companies, the most rightfully punished in this period, have begun a rebound. Interesting as we watched the write-offs of subprime loans that were still largely performing in the new world order of marking assets to market. While that seemed like a nice idea when Congress passed the new reporting standard, marking something to market has at its foundation the concept that a rational market will be available to value what is being marked. That "no intellectual low" thought once again rears as we witnessed an effort by financial institutions to mark to market mortgage assets that there was suddenly no rational market for…The result was most likely a grand over-reserving by many banks for negative results that may never occur. This will ultimately result in the recovery of future earnings by these institutions. We are now standing at a point where the Fed has now stated that we will see a recovery in the 2nd half of 2008, Standard & Poors announced that we are more than half way through the negatives of the credit issues.

For the last few years we have repetitively droned on about the persistence and magnitude of the momentum of global growth. Many were worried that the U.S. was so omnipotent that if our economy caught a cold, everyone else would get pneumonia. That simply has not occurred. Global growth trends are in tact, have been largely untouched by the current environment and are likely keeping our economy in better stead than if we were not actively participating in global trade. (See Figure 3)

As many companies have just reported 1st Quarter earnings, one powerful message is loud and clear. Companies that do a substantial amount of their business overseas are strongly benefiting from the pace of global growth and secondarily, benefiting form the added catalyst of a low dollar which makes U.S. goods and services relatively cheap on the global market. The persistence of this trend is not to be underestimated

The magnitude and longevity of the current credit problem's impact on the U.S. economy became most accurately delineated in the 1st Quarter of 2008. An historically ample amount of stimulus has been brought forth by the Fed and its partners, with more to come. A recovery is anticipated in the 2nd Half and it is widely viewed that we now can see the end to the credit issues on the horizon. And, we stand at this juncture with stocks historically cheap by nearly all measures and government bonds overvalued. That cognitive valuation dissonance has begun to correct as the markets move higher. As near term fears subside, longer term opportunism fills that vacuum.

We'll talk to you soon...

Figure 3. World GDP still growing