

2008 Year-End Market Commentary: The Audacity of Hope – Investor’s Version

***By Bob Marshalla
January 12, 2009***

Nowhere to Hide

The year 2008 was about as bad as it gets for investors. Every risky asset class and sub-class in which we invest or monitor was clobbered, with most of the damage coming after September 19, the weekend the Lehman Brothers, Merrill Lynch and AIG fiascos all came to a head at the same time. The S&P 500 lost 37% for the year, but unlike the three-year bear market following the dot com crash, this time there was no place to hide. Of the nine equity asset categories we track (see Table 1 and Figure 1), the year’s decline ranged from minus 34% to minus 54%. Only domestic small caps did marginally better than the S&P 500 index; the other seven categories performed even worse. No respite was offered by other asset classes either. As shown in the table and Figure 2, commodities fell 36%, while domestic and international real estate declined by 38% and 52%, respectively. Even fixed income, which is supposed to provide ballast in a bear market, performed terribly in some sectors, such as high yield bonds (-26%), bank loans (-30%) and

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some foreign fixed income types (as low as -15%). Near the end of the year, the yields on Treasuries plummeted, but the credit spreads for every other type of fixed income skyrocketed, causing them to lose significant value even as Treasuries advanced. As a result, even some diversified investment grade-bond funds were hammered¹.

It’s true, diversification failed to save us in 2008. To be charitable you could credit diversification for keeping us away from the low end of the minus 34% to minus 54% range in which all of the non-fixed income asset classes fell, but that’s cold comfort. Nonetheless, I still believe in the value of widespread diversification for long term investment portfolios as much as ever. The alternative, trying to pick the specific winners from amongst individual stocks or sectors or commodities, would be as foolhardy now as ever.

¹ For example, the Loomis Sayles Bond Fund, run by highly respected fixed income manager Dan Fuss, lost 21.8% for the year. We have no investments in that fund, but we do have some in Western Asset Core Bond Plus, which lost 9.9%. In contrast PIMCO Total Return, which is our largest holding amongst diversified domestic bond fund by far, gained 4.8%. The magnitude of variation in returns within a single diversified bond fund category is unprecedented.

Figure 1 - Equity Categories Prices 2008

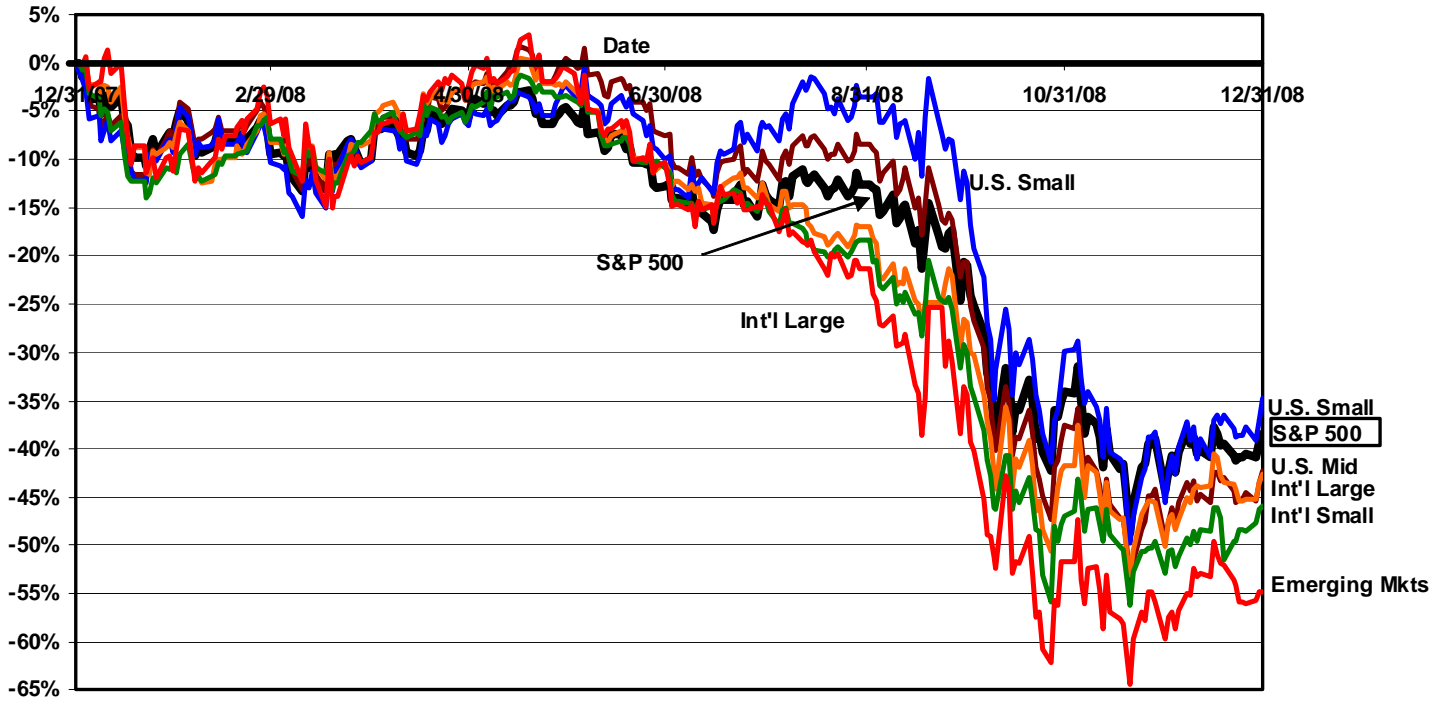


Figure 2 - Asset Class Prices 2008

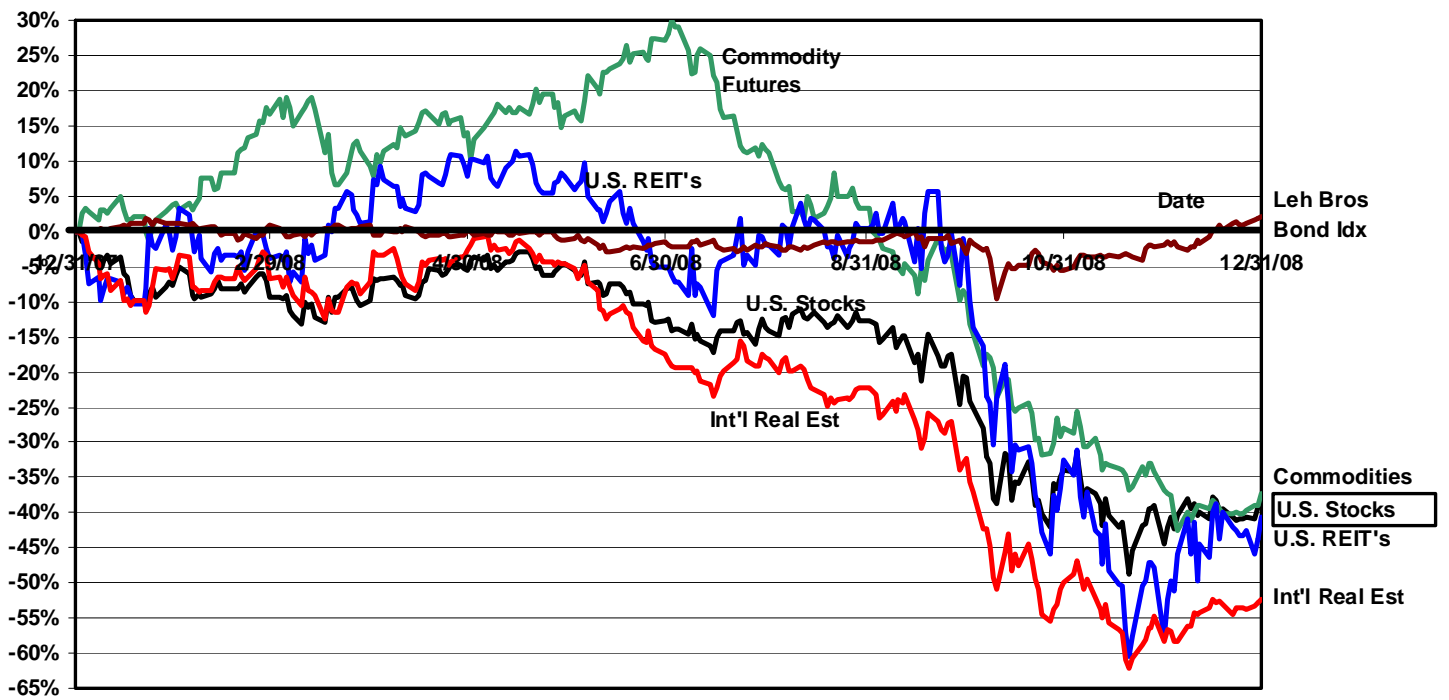


Table 1 - 2008 and Previous 5 Years Returns

	Representative Index or Fund (blue font)	Year 2008	Prev 5 Yrs 2003 - 2007	Full 6 Yrs 2003 - 2008
U.S. Equities				
Full U.S. Market (98% by MC)	Russell 3000	(37.31)	13.63	2.91
By Market Cap				
Large Cap	S&P 500 (incl. dividends)	(37.00)	12.83	2.38
Mid Cap	Russell Mid Cap	(41.46)	18.22	5.15
Small Cap	Russell 2000	(33.79)	16.24	5.83
Micro Cap	Russell Microcap	(39.78)	15.87	3.89
Value & Growth				
Growth Stocks	Russell 3000 Growth	(38.44)	12.42	1.69
Value Stocks	Russell 3000 Value	(36.25)	14.69	4.00
Economic Sectors				
Best in 2008	Consumer Staples	(17.66)	10.32	5.48
Worst in 2008	Financials	(56.95)	7.89	(6.40)
Best for Past 5 & 6 Yrs	Energy	(35.93)	29.36	15.40
International Equities				
Large Cap	MSCI - EAFE	(43.38)	21.59	7.05
Small Cap	MSCI - EAFE Small Cap	(47.01)	26.37	9.33
Emerging Markets	MSCI - Emerging Markets	(54.48)	37.02	14.03
Real Estate				
Equity REIT's - Domestic	NAREIT Equity Index	(37.73)	18.17	6.20
	Morgan Stanley US Real Estate	(38.07)	n/a	n/a
Equity REIT's - Foreign	EPRA Global ex US Index	(52.00)	n/a	n/a
	Eur. Investors Int'l Property	(48.47)	n/a	n/a
Commodities				
Commodity Futures	Dow Jones AIG Com Index	(35.65)	14.26	3.83
	PIMCO Commodity Real Ret	(43.33)	n/a	n/a
Fixed Income				
Investment Grade Bonds	Lehman Aggregate Bond Idx	5.24	4.43	4.56
Inflation Protected (TIPS)	PIMCO Real Return Fund	(6.42)	6.36	4.11
High Yield Bonds	CSFB High Yield Bond Idx	(26.17)	10.97	3.69
Floating Rate Bank Loans	Eaton Vance Floating Rate	(30.25)	4.57	(2.25)
Int'l Bonds, Developed Mkts	PIMCO Foreign Bonds	(4.03)	7.49	5.48
Emerging Mkts Currencies	PIMCO Developing Local Mkts	(14.55)	n/a	n/a
Short Term Money	3 Month T- Bills	1.51	3.12	2.85

* Based on mutual fund returns. Others are costless market indices.

The fact is, the benefits of diversification have always been manifested over longer time periods. It is actually commonplace for correlation coefficients to converge towards the value one² during market crashes. What is different this time is the degree and the duration of the convergence. There was simply a near complete loss of confidence amongst market participants in any kind of investments that involved risk; there was almost no discrimination. Moreover, a large amount of the trading activity was *forced* selling as highly leveraged hedge funds and financial institutions were required to raise equity fast to make up for write-offs from bad and endangered mortgage securities and other debt instruments. In this environment, the usual fundamental investment procedures of evaluating stocks and economic sectors based on valuation metrics and earnings growth prospects were rendered useless. Everything was going down, and for some stocks and sectors the reasons had nothing to do with their fundamentals. The only kind of diversification that paid off in this environment was that between cash equivalents or Treasuries and everything

² If the correlation coefficient for two asset classes is 1.0, this means they move together in perfect lockstep. A value of zero means there is no relationship between their movements, while values between zero and one imply a partial relationship. As we have seen clearly this year, correlation coefficients are not static.

else³. Still, going forward and assuming investment horizons well beyond five years, I cannot emphasize enough that diversification over asset classes and within them (i.e., different kinds of stocks and investment strategies) remains critical to achieving the best risk and return possibilities.

Our Predicament: How We Got In It and How We'll Get Out

This is no garden variety market decline. 2008 was the worst calendar year for stocks since 1931. But unlike the dot com bust, this story is not really about the stock market. The stock market is just one of the casualties of a larger and more serious financial predicament. In this section I will give my take on this predicament, discussing how it came to be and what we must do to get out of it. Although we face serious problems, it remains possible to be pessimistic about the current state of the economy while still being an optimist about long term investing. To back this up, in the following section I will offer some good reasons for investor hope for the future. Finally, in a concluding section, I will offer some very brief remarks about our strategies going forward.

Housing Was Only the Start - The initial catalyst leading to our current dire financial predicament, was the stalling and then reversal of housing prices starting a bit more than two years ago (see Figure 3). The end of the inexorable upward march of housing prices began to lay bare the vast network of ill-advised mortgages and over-leveraged

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consumer balance sheets that had built up over the earlier years of the decade. Many of these mortgages were ticking time bombs even in the best of circumstances, but the reversal of housing prices greatly magnified the extent of the resulting mortgage crisis.

This was bad enough, but the housing bust per se turned out to be only the tip of the iceberg. Investor losses since October, 2007 are already greater than the total value of all outstanding U.S. mortgages⁴. The credit crisis quickly spread to all corners of the fixed income universe (other than U.S. Treasuries). We soon came to see how incredibly interconnected everything has

Figure 3
Median (Existing) Home Values



From: Golub Market Insights, Monthly Market Monitor Year End 2008, p28
Source: US Census Bureau, National Association of Realtors

³ Of course there are some other types of investment categories or strategies that we do not invest in or monitor that did OK last year -- some select long-short type hedge funds (though the word "select" is key), some managed futures strategies, artwork perhaps (just guessing on that one)? Gold was up about 5% for the year, although it fell significantly from its mid year peak until year end. But I don't consider gold an investment category or strategy. It is one of the 19 commodities in which we were in fact invested. The others unfortunately didn't fare as well.

⁴ For example, from peak to trough, the losses in market value of U.S. stocks were almost \$9 T. This doesn't count the losses in non-U.S. stocks, which account for 55% of world market cap, nor the losses accruing to bond holders and real estate owners -- and each of those markets is larger in value than the U.S. stock market. The total value of all outstanding U.S. mortgages at the beginning of the year was about \$12 T. Even if a third of all U.S. mortgages went into default, and the lenders ended up recovering an average of only 60% of the balance owed, this adds up to "only" \$2.4 T in losses. Clearly this financial crisis is about more than bad mortgages. A lot more.

become in the credit markets these days. The failure of a given large financial institution was seen to affect not only its own shareholders, creditors and employees, but the financial health and even viability of a wide swath of other financial institutions all over the world⁵.

Mortgages and other types of loans have been increasingly packaged into large, complicated credit instruments with names that look like an acronym soup – MBS, ABS, CMO, CDO. But on top of this, the financial wizards of today's turbo-charged global capitalism have just in the last seven or eight years created a mountain of arcane "OTC" derivatives⁶ like credit default swaps, interest rate swaps and many more. The world of such derivatives was and still is only faintly understood, seeing as it is almost entirely unregulated and unmonitored as a whole by anyone.

Consider the magnitudes of these financial metrics:

- Value of all U.S. mortgages⁷: **\$12 T**, of which at most **\$1.3 T** are considered sub-prime⁸
- GDP of the United States⁹: **\$14 T**
- Market value of the S&P 500 at its October, 2007 peak: **\$13.8 T**
- Total annual outlays of the 2008 federal budget¹⁰: **\$3 T**
- Nominal value of outstanding credit default swaps¹¹: **\$60 T**
- All outstanding OTC derivatives¹²: **\$600 T** (at the start of the year)

All of these numbers are incomprehensibly large, but what is mind boggling about this list is the comparison of the last two numbers to those that precede it. Although not a direct measure of the amount of leverage in the system, it is indicative of it. It starts to become understandable how modest percentage changes in liabilities can have dramatic effects on much smaller underlying equity levels¹³.

Bail Out Policy - That the housing bubble had burst and that a mortgage credit crisis was at hand had become abundantly clear by July, 2007. Our perceptions of the severity of the problems and investor confidence varied along an up and down path between then and September of 2008, with the high point being in October of 2007 when the S&P 500 reached its all time high, and the low points probably coming when Bear Stearns failed last spring, and again when Fannie Mae and Freddie Mac went into government receivership last summer. But the sense of crisis reached an altogether unprecedented level beginning with the weekend of September 19, which was the weekend when the imminent failures of Lehman Brothers, Merrill Lynch and AIG all came into sharp focus at the same time. The federal government let Lehman fail, found a white knight for

⁵ Records from Lehman Brothers bankruptcy proceedings show that Lehman had 900,000 OTC derivative contracts outstanding at the time of its bankruptcy. As another example, the nominal value of OTC derivatives in which JP Morgan Chase is involved amounts to an astounding \$80 trillion. (See Fortune, 1/19/09, p 73-74)

⁶ These types of derivatives themselves are not that new, but the amounts in play have mushroomed in value since 2000 by a factor of more than ten. "OTC" means "over the counter", the term used to designate direct private, party-to-party transactions, as distinct from the public, exchange traded derivatives like CBOE options and futures.

⁷ Federal Reserve data, found at: www.federalreserve.gov/pubs/supplement/2008/01/table1_54.htm - 58k

⁸ Ben S. Bernanke. "The Subprime Mortgage Market" [[Chicago, Illinois]], Illinois (2007-05-17).

⁹ Getting to Know the GDP, October 17th, 2008 by Kyle Rankin, found at:

<http://blackandwhiteprogram.com/report/getting-to-know-the-gdp>

¹⁰ Guide to the Markets, 1Q09, JPMorgan Asset Management, p. 17

¹¹ Letter from the Chief Investment Officer, Sept 12, 2008, Jeffrey Gundlach, the TCW Group

¹² Ibid.

¹³ Here is a much simpler example about leverage. If you buy a house with only 10% down, a 10% decrease in the house price wipes out 100% of your equity. And this is with only 10:1 leverage. Prior to this crisis, investment banks had routinely held portfolios with 30:1 leverage ratios.

Merrill, and saved AIG itself with massive federal loans and subsequent additional capital injections and guarantees.

Now the genie of fear had come out of the bottle. The Federal Reserve chairman and the Treasury secretary, in closed door meetings warned Congressional leaders that we were on the precipice of a major financial catastrophe. Only dramatic and immediate government action could head it off they said. Whether this was true or not, the perception of fear that the statement created made it true. Investors, financial executives and government officials worldwide were all on the edge of panic. Credit markets of all kinds, even commercial paper, froze up. No one was lending money to anyone, not even banks to other banks. So clearly something had to be done. Even if that something didn't amount to a hill of beans in substance, I am convinced that the absence of a dramatic government response at that time would have been disastrous. It would have made Herbert Hoover look like a wild eyed activist.

Then Congress got caught up in presidential politics (McCain swooping in to save the day), and this contributed to another week's delay in deliberations. This was enough for investors to lose another trillion dollars of stock market value, but eventually Congress did get around to passing the infamous \$700 B TARP program. And even though nothing was actually done by the Treasury in the first few weeks thereafter, market participants caught their breaths and avoided the kind of panicky self-reinforcing downwards spiral that could have made the aforementioned financial catastrophe a reality.

The kindest way I can characterize the actions of the Paulson and Bernanke led government effort since then is "puzzling". The \$700 B¹⁴ was supposed to be used by the Treasury to buy troubled assets (the genesis of the "T" and "A" in "TARP") directly from the teetering financial institutions. But they never actually bought any. Several weeks later, they decided to instead inject capital directly into the largest banks in return for dividend paying preferred stock. This was supposed to provide the capital needed to enable the banks to begin lending money again. But the Treasury omitted a key feature: any kind of requirement or meaningful incentive for the banks to actually do that. This omission turned out to be critical. The banks simply accepted the money and sat on it. Essentially, they said, "thanks, that makes our balance sheets look a lot better."

Monetary Policy - Meanwhile, the Federal Reserve continued to pull out all the stops in the realm of monetary policy. In addition to their usual open market operations (which is how they control the Fed Funds rate and the money supply), they unveiled an array of new policies, including lowering the discount rate and opening the discount window to additional parties, guaranteeing interbank lending, and guaranteeing private money markets and even commercial paper markets. Ultimately, by last month they had lowered the Fed funds rate to somewhere between zero and 0.25%. Even ten year treasury yields fell as low as 2.25%.

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As for monetary policy, this was probably all good and necessary. But the Fed has by now used up virtually up all its ammunition. You can't set short term rates lower than zero. Long term Treasury rates are about as low as they have ever been, and yet the spreads between them and any other kind of debt of similar maturity have increased to all time highs. The Fed has succeeded in expanding the money supply greatly, but the catch is this: economic activity is the product of money supply times money velocity. And money velocity has fallen as fast as the money supply has risen. You can't make money any easier, and yet no one seems to want to use

¹⁴ Actually half now, and half later, subject to Congressional reauthorization.

it. It seems that further expressions of monetary policy levers could be like the proverbial “pushing on a string”.

Fiscal Stimulus - There are three “prongs” to our government’s attempt to improve the financial situation. So far I have discussed the first two: “bailout” policy (the TARP and related government rescues) and monetary policy. So what is next? It is fiscal stimulus of course, and it appears to be just around the corner. President-elect Obama is initially calling for a stimulus package of tax cuts plus infrastructure and other government spending amounting to about \$800 B over the next two years. This would be on top of a deficit that is already running over a trillion dollars per year.

Those who took introductory macroeconomics will recall the fundamental national income equation:

$$\text{GDP} = \text{Consumer Spending} + \text{Net Investment} + \text{Government Spending} + \text{Net Exports}$$

Keynesian economic theory says we can stimulate our way out of a recession (which is falling GDP) by directly increasing one or more of the components on the right. You can directly increase Government Spending of course. Or you can indirectly increase Consumer Spending by cutting taxes, although some of the tax cuts will surely be saved or used to pay down debt, which thereby avoids the desired stimulus effect. Further, the stimulus is claimed to be more than a one time shot; there is a multiplier effect. For example, if the government pays to have a bridge built the construction companies, the workers and the material suppliers all get paid. They in turn use some of that money to buy other things or to invest, and that counts as spending too. Standard estimates generated by economic models suggest that a dollar of public spending raises GDP by about \$1.50.¹⁵ The impact of tax cuts is generally estimated to be only about 2/3 as effective as direct spending, although this is very dependent on the kind of tax cut and the particular economic model used.

When I was studying economics in college there was a great debate about the relative merits of monetary versus fiscal policy for managing the economy. But beginning with Paul Volcker’s

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everybody seemed to agree that monetary policy was the only way to go. And plain vanilla monetary policy (just setting Fed Funds rate and monetary growth targets) seemed to work pretty darn well for about three decades.

success in ending the stagflation of the 70’s using monetary policy, the debate began to shift towards the monetarists, and by the 90’s it appeared the debate was over. Economists, policy makers, citizens –

Until now. This time the Fed has pushed “plain vanilla” policies as far as possible, as well as having added in all kinds of new and creative flavors. But it has not been enough. As a result, we have re-invited John Maynard Keynes to the party. To illustrate, I’ll quote a passage from well known economist Paul Krugman in last week’s New York Times¹⁶:

“If we don’t act swiftly and boldly,” declared President-elect Barack Obama in his latest weekly address, “we could see a much deeper economic downturn that could lead to double-digit unemployment.” If you ask me (Krugman speaking), he was understating the case. ...

¹⁵ “The Obama Gap”, by Paul Krugman, January 9, 2008, New York Times, p A23

¹⁶ “Fighting Off Depression”, by Paul Krugman, January 5, 2009 in the New York Times editorial page. Paul Krugman won the Nobel Prize in economics this year for his work on the theory of trade. For full disclosure I should note that Krugman is considered to be in the “left wing” amongst political economists.

We weren't supposed to find ourselves in this situation. For many years most economists believed that preventing another Great Depression would be easy. In 2003, Robert Lucas of the University of Chicago, in his presidential address to the American Economic Association, declared that the "central problem of depression-prevention has been solved, for all practical purposes, and has in fact been solved for many decades."

Milton Friedman, in particular, persuaded many economists that the Federal Reserve could have stopped the Depression in its tracks simply by providing banks with more liquidity, which would have prevented a sharp fall in the money supply. Ben Bernanke, the Federal Reserve chairman, famously apologized to Friedman on his institution's behalf: "You're right. We did it. We're very sorry. But thanks to you, we won't do it again."

It turns out, however, that preventing depressions isn't that easy after all. Under Mr. Bernanke's leadership, the Fed has been supplying liquidity like an engine crew trying to put out a five-alarm fire, and the money supply has been rising rapidly. Yet credit remains scarce, and the economy is still in free fall.

Friedman's claim that monetary policy could have prevented the Great Depression was an attempt to refute the analysis of John Maynard Keynes, who argued that monetary policy is ineffective under depression conditions and that fiscal policy — large-scale deficit spending by the government — is needed to fight mass unemployment. The failure of monetary policy in the current crisis shows that Keynes had it right the first time. And Keynesian thinking lies behind Mr. Obama's plans to rescue the economy".

It appears that Congress will pass some kind of large fiscal stimulus package within the next month or so. Whether it, combined with the two other policy thrusts, monetary policy and "bailout" policy, will succeed or not remains to be seen. But it is not even widely agreed what to

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"succeed" means. I'll venture an answer. To me it means slowing and eventually reversing the fall of GDP and the rise of unemployment without igniting inflation in the process, to the point that a year from now we can say we are at least marginally better off in all three areas than we are now, and with the trends headed in the right directions rather than the wrong ones are they are now. Wait, even that's too tough. I'll give them a year and a half, but no more!

Alice in Wonderland? - I cannot end without commenting on the strangeness of the situation we have gotten ourselves into. We are in an Alice in Wonderland world, where nothing is as it seemed before and things keep getting curiously and curiously. Everything we thought we weren't supposed to do and all the stuff that got us into this mess in the first place is now said to be exactly what we must do to get out of it.

- We need the banks to loosen up and start lending more money to more people and companies. But of course, loose lending standards was the original problem that led us into this mess.
- We have to get consumers to save less and spend more. But consumers spending beyond their means was one of the central maladies of our society, and long term it will still be so.

- We need a huge Keynesian stimulus to jump start the economy, deficits be damned. I have always prided myself on being a deficit hawk. But now my biggest concern is that Obama is being too timid. I fear that \$800 B over two years will not be enough to do the trick. After all, with GDP at \$14 T, adding \$400 B per year in stimulus is less than 3% of national income.
- Monetary policy was supposed to be the only tool the government needed to manage the economy. And it worked (when done right), except for the 30's and now. The Fed funds rate is at zero. Ten year Treasuries are yielding about 2.3%. Interest rates can't go any lower. We've flooded the system with money, but the velocity has gone down faster than the money supply has gone up. Further use of monetary policy is like pushing on a string.

How do we make sense of all this? The best analogy I can think of is a pendulum. The pendulum has swung from one extreme to the other. Now we need to push it in the *opposite* direction that we needed to before. Continuing the analogy, once we finally do get the pendulum swinging back the other way, the huge new challenge will be how get it to stop in the middle rather than continuing to swing back even farther in the other direction. In other words, how do we avoid having the cures for our current problems transforming them into their opposites once again? To wit, we need to avoid these transformations:

- Deflation → inflation
- no lending → anything goes lending
- Too much consumer saving → too much consumer spending
- Too little government oversight and regulation → overbearing and counter-productive regulation and oversight
- Temporary gigantic government deficits → permanent gigantic government deficits

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I don't know the answers. The medicines we are applying have fearful side effects, no question about it. But I believe we have no choice. We have to take the medicines now, and resolve to fight the side effects down the road. This is really hard for me to say, since I have always favored doing things now for their long run rather than their short run effects. But when the short run risk is the possible death of the patient, focusing on the short run for now is essential.

Reasons for Investor Hope

While the news on the economy continues to be dark, there are definitely some indicators that provide hope for investors. Here are nine of them to consider:

- **Rising Stock Prices** –It seems to have been lost from the public dialogue, but the stock market perked up a good amount in the last six weeks of the year. The S&P 500 gained 20% from November 20 until the end of the year, and other stock indices did even better. Domestic small caps were up 30%, while mid-caps and foreign stocks (large, small and emerging markets) each gained between 20% and 30%. True, there have been a couple of other upward lurches in the past few months that quickly fizzled, but this one has now held

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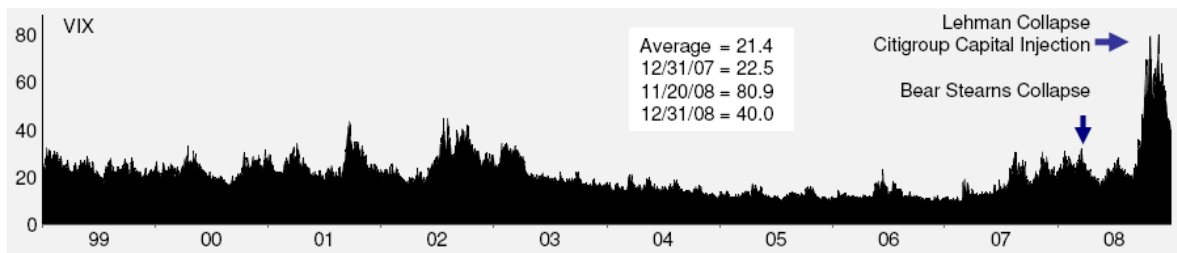
up for a longer time. We can only keep our fingers crossed, but maybe November 20 will go down as the ultimate trough of this bear market.

- **Declining Volatility** - Stock market volatility is a crucial measure of investor risk and market turmoil, and this indicator has certainly lived up to its billing. In the 53 years leading up to the middle of last September, there were 17 times in which the S&P 500 moved up or down by more than 5% in one day. In the last three and a half months of the year, there were 18 more such occurrences! In 53 years, more than half of the plus or minus 5% days have occurred in just the past three and half months.

There is a day-by-day statistical indicator called the “VIX” that traders and other investment professionals have long used as the key indicator of stock market volatility. The graph in Figure 4 shows the time path of the VIX over the past ten years. We can see

Figure 4

Equity Volatility



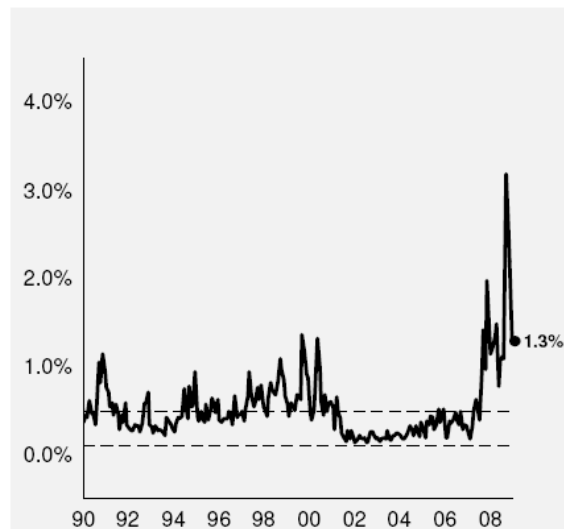
From: Golub Market Insights, Monthly Market Monitor Year End 2008, p12
 Source: Standard & Poor's Corporation; CBOE

that this fall the VIX shot up to totally unprecedented levels. By November 20, it reached a level of 81, which is almost four times its long run average of 21. But like stock prices, things have taken a turn for the better in the last six weeks of the year, and the level of the VIX has fallen by half, ending the year at “only” 40. This is still twice its normal level, but the direction of change has been strongly favorable for investors.

- **Falling TED Spreads** – The TED Spread is the difference between the three month LIBOR and the three month Treasury Bill yield. The LIBOR is the interest rate that banks charge to lend from one another. It is normally very close to the three month T-Bill rate. A widening TED spread indicates an unwillingness of banks to lend to one another. This is important because short term inter-bank lending is among the safest varieties. If there is reluctance to lend even in the inter-bank market, it is a sure fire indicator that lending will be severely constrained if not frozen in almost any other kind of credit market. Simply put, a wide TED Spread is a key indicator of a credit crisis.

As Figure 5 shows, the recent story for the TED spread is similar to that for the VIX. The 20 year average for the TED spread has been 55 basis points (i.e., 0.55%). It came to exceed 100 bps for the first time in a decade

Figure 5
Ted Spread (Libor – 3 mo Treasury)



From: Golub Market Insights, Monthly Market Monitor Year End 2008, p39
 Source: Reuters, Bloomberg

in August, 2007, about a month after the housing downturn had begun to morph into a credit crisis. But it wasn't until September, 2008 when things got really serious. The TED spread eventually soared to as high as 464 bps on October 10. But since then, it has been declining rapidly, and had fallen to 128 bps by January 8, roughly equal to where it was a year ago. 128 bps is still very high by historical standards, but it is dramatically lower than it was a few months ago, and it still seems to be moving in the right direction.

- **Attractive Relative Dividend Yields** – Since dividend payouts are much less volatile than stock prices, the average dividend yield of a stock index is considered an important valuation metric. While dividend payouts can and often are cut, on average they tend to grow at a rate similar to corporate earnings. So if you can get the same dividend yield on a portfolio of stocks as on bonds, it is highly likely you will receive more income over a long term investor's horizon, say ten years, from the stock portfolio than from the bond portfolio. And this is independent of what might happen to stock prices. Thus, it is not surprising that stock dividend yields, even for mature blue chip stocks, have been lower than bond yields for a long time. Until now that is. The average dividend yield for the S&P 500 has now come to exceed the interest rate paid by ten year Treasury bonds. And this is the first time this has been true in over 50 years.

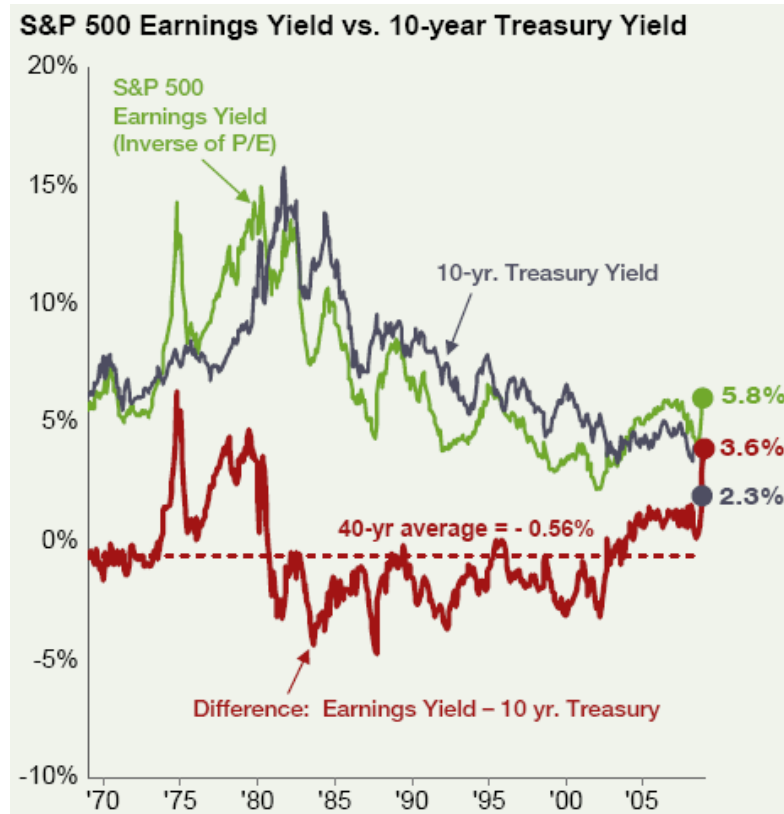
Dividend yields are high today because stock prices are low, not because dividends have been raised. And of course, Treasury yields are now absurdly low. But looking forward, the way that dividend yields will return to normal is mostly through stock price increases (although there will undoubtedly be some dividend cuts as well). And if and when investors expect Treasury yields to move back up, this means the current holders of Treasuries stand to lose value. This provides them with the incentive to invest their assets elsewhere, with stocks being one of the choices where some of that money will go.

- **Ultra-High Earnings Yields Spreads** – The earnings yield of a stock is the earnings per share divided by the stock price. (It is just the inverse of the price-earnings ratio.) It is a meaningful metric because it shows the net company earnings generated per dollar of shareholder investment. What an investor buys when he buys a stock is, after all, his pro-rata share of the future stream of earnings that the company will generate.

Perhaps the longest tenured and best known valuation model for the overall stock market is the Fed Model. It is based on comparing the earnings yield of the S&P 500 to the yield on a ten year Treasury bond. It is a simplistic model to be sure, but it has intuitive appeal. With a Treasury bond, the coupon you receive is guaranteed to never increase, but over a ten year period, most companies' earnings do increase. And this is especially true for an aggregate index like the S&P 500, even if the ten years contain a couple of bear markets. So the model's theory is, if the earnings yield is greater than the Treasury yield, then stocks are a better buy than bonds.

For the past 40 years, the spread between the earnings yield and the 10 year Treasury yield has averaged -0.56%. In other words, the bonds have yielded about 0.6% more than stocks' earnings yield. But now, the spread has reversed sign and moved to a strongly positive value of 3.6%. As shown in Figure 6, this is by far the highest it has been in some 30 years. By the Fed Model's reckoning, this is a strong bullish indicator for stocks.

Figure 6

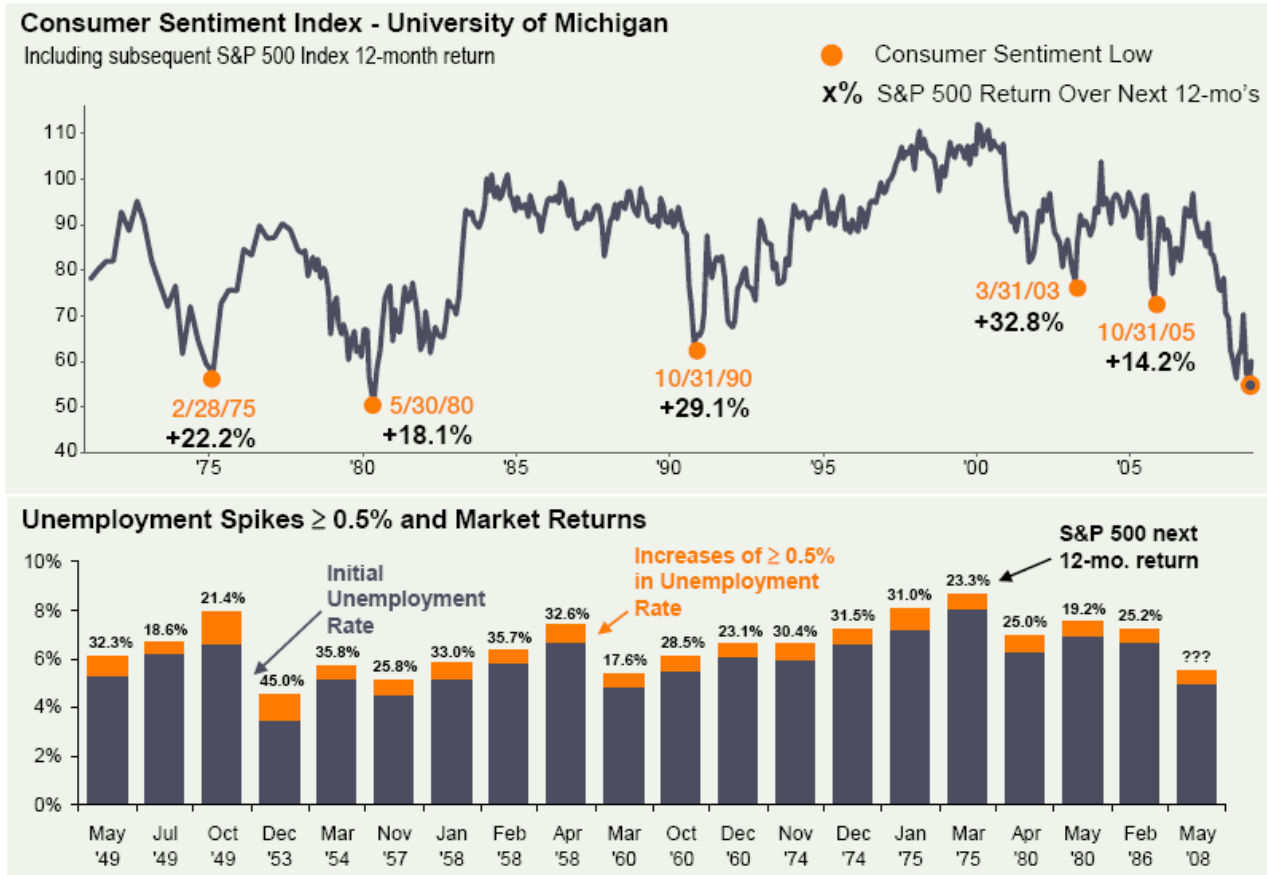


From: JP Morgan Market Insight Series, Guide to the Markets: 1Q09, p8
Source: Standard & Poor's, Compustat, EcoWin, FactSet, JPMorgan Asset Management

- **Low Consumer Sentiment: A Contrarian Indicator** – The Consumer Sentiment Index, a metric compiled for decades by the University of Michigan, has fallen to its lowest level since 1980. It might seem kind of backwards to consider a low level of consumer confidence to be an optimistic indicator for stocks. But this index has long been interpreted as a contrarian indicator. Figure 7 shows its values over time since 1970. At each of its local low points, the figure also indicates the total returns from the S&P 500 for the subsequent twelve month period. There are four such troughs of consumer sentiment shown, and the subsequent 12 month stock market returns have ranged between 14% and 33%. There is no proof whatever that this relationship will continue, but that it has worked in the past is probably related to the fact that the day after the low point of every bear market is the first day of the next bull market; or more colloquially, the night is always darkest just before dawn.
- **Unemployment Spikes: Another Contrarian Indicator** – Another contrarian indicator (one that I had never seen before) is related to spikes in unemployment. This is shown in the lower part of Figure 7. The graph shows every month since World War II in which there has been a spike in the unemployment rate of 0.5% or greater, along with the S&P 500 return over the twelve subsequent months. There were 19 such occurrences prior to the current slump, and I find it amazing that the market return was at least 17% over the next 12 months in every case, and ranged as high as 45%. Again, this is a statistical observation with no cause and effect justification nor assurance of continuation. But it is

nonetheless a pretty compelling factoid. It is no doubt related to the idea of buying stocks when prices are low (during recessions).

Figure 7



From: JP Morgan Market Insight Series, *Guide to the Markets*; 1Q09, p23
Source: Standard & Poor's, BLS, FactSet, University of Michigan, JPMorgan Asset Management

- Cash on the Sidelines at All Time High** – “Cash on the sidelines” can be defined as total money market assets as a percentage of overall stock market value. If there is a high level of cash on the sidelines, this can be a powerful force for stock price increases once investor sentiment turns around. By this definition, cash on the sidelines has been climbing sharply for a year and a half and has now reached a value of 33%, which is an all time high for this measure¹⁷. Previous peaks were 23% in 1982 and 30% in early 2003, the dates of which turned out to be the onsets of two powerful and prolonged bull markets for stocks.

Cash on the sidelines is at all time high ... the dates of [the two] previous peaks turned out to be the onsets of two powerful and prolonged bull markets for stocks.
- Hope for the Obama Stimulus Plan** – As discussed, the third major thrust of our government’s economic rescue and recovery attempt will be a large Keynesian style

¹⁷ This observation and all the data in this paragraph are from the Litman Gregory company’s Advisor Intelligence service, found on the website www.AdvisorIntelligence.com, in the section “Asset Class Review: U.S. Equities”, Dec 9, 2008. I don’t know how long this series has been tracked, but it has been at least since 1982.

fiscal stimulus. Will it be work? The better question is how well will it work. Even in the worst case, it will almost certainly have some positive short term effects on economic activity.

The proposed plan is pretty ambitious. And of course everyone has different ideas about how it should be structured and just how big it should be. But I think it is noteworthy that it has not –yet at least – gotten too bogged down in ideological wars. David Brooks, who is generally considered a center-right journalist, has the following to say about it:

This is daring and impressive stuff. Obama's team has clearly thought through every piece of this plan. There's no plank that's obviously wasteful or that reeks of special-interest pleading. The tax cut is big and bipartisan. Obama is properly worried about runaway deficits, but he's spending money on things one would want to do anyway. This is not an attempt to use the crisis to build a European-style welfare state¹⁸.

There is no reliable historical precedent for the efficacy of a major fiscal stimulus such as we are about to apply. The last and only time it was attempted in a really big way was in the 30's under FDR, but that effort was seriously diluted by two contradictory policy thrusts. First, monetary policy was applied in exactly the wrong and counterproductive fashion. It was made more restrictive instead of more accommodative (we simply didn't know what we were doing in that realm at that time). Second, state and local governments ran fiscal policies that were 180 degrees out of phase with the stimulative federal policies. They tightened their belts so to speak, decreasing spending to the bare bones, and thereby worked in contradiction to the various federal policies. I also might add that there was no bailout policy for banks in that decade. Banks were allowed to fail by the hundreds. So all in all, the 30's do no provide much of a precedent to judge current efforts.

There is no reliable historical precedent for the efficacy of a major fiscal stimulus such as we are about to apply. ... This truly is a grand experiment.

This truly is a grand experiment. How effective Obama's plan will be, in whatever shape it finally emerges from Congress, is unknowable at this time. But we sure as hell don't want to follow in Herbert Hoover's footsteps and do nothing. Scary as it is we have little choice but to boldly go for it. And this is where the audacity of hope really comes into play. My biggest fear is that it will not be big enough to do the job. As currently proposed (about \$800 B), it amounts to "only" 3% of GDP, and nearly half of that is in the form of tax cuts which are not as stimulative as direct spending. But I do have the audacity of hope, and I hope you do too.

Conclusion

Marshalla Asset Management has now completed its sixth year in business. Stocks advanced in each of the first five years, but this year has been the first truly down year and it has been a doozy. If ever there was a test of our patience and belief in the future, this is it. I understand and sympathize with the frustration and even anger that many of us have about the current situation. Unfortunately there was no oracle to warn us of the horrendous events of this past fall, nor is there one to tell us exactly when it will all end and when the recovery will come. At this point, I can imagine that we have three choices of strategies for what to do next:

¹⁸ "The Confidence Surplus", by David Brooks, Jan. 9, 2008, New York Times

- **Get More Conservative** - We can pull in our horns now, and ride out the rest of this storm in the safety of cash equivalents or other less risky assets. To the extent we stay in stocks, we could shift to the most recession resistant sectors like consumer staples and health care.
- **Get More Aggressive** - We could view this as the buying opportunity of a lifetime, and position ourselves to gain maximum returns when the markets do come back. In this strategy, we would buy the kinds of assets that have been hardest hit and which have the most snapback potential: housing related stocks, some financials (not all!), energy stocks, commodities, REIT's and high yield bonds that now have unprecedented spreads over Treasuries.
- **Take a Middle Course** - We can stay with a middle strategy such as we have now. As I have written about extensively this fall, our asset allocation targets for all types of investors have been dialed down the risk scale to a modest extent, but our basic strategy is still very much based on measured long term optimism about the economy and the investments that depend upon it for their success.

The problem with the first strategy is that most of the horses are already out of the barn. And when recovery ultimately does come, such an investor would not be positioned to gain as much on the upside relatively as she or he lost on the down side. The second strategy *might* turn out to be extremely profitable a few years down the road. But I wonder if any of us has the stomach for doubling down now given the still dark status of the economy. The trouble with this strategy is that it could bear dreadful additional losses over the next year or more if the economy fails to respond to the policy measures being implemented.

I think the most sensible and prudent thing for most of us to do is to continue with the third, middle course strategy. Nonetheless, this may not be the strategy that best suits each of us. If anyone is tempted to consider one of the other two approaches, please do talk to me about it.

I would be crazy to offer a definitive forecast for how this financial and investment situation will play out. But if you asked my opinion about investing in stocks right now (or commodities or real estate for that matter), I would say that in the short run, it is little better than a coin flip. In other words, six months from now there is only a little more than a 50:50 chance that you will be ahead with such an investment. But if we imagine being four years or so down the road, I do believe that investments made today will look like real bargains.

Best Regards,

Bob Marshalla
Your Financial Advisor