



2008 is in the rearview, what lies ahead?

2008 in Review. What a year...To forget!

To say that 2008 was a very interesting year would be an incredible understatement. Basically looking back we had 3 asset classes in 2008: Cash, Treasury Bonds and Everything else. As the sub-prime mortgage crisis evolved into this 2 headed monster in not only effected the U.S. problem but it became a massive global credit crunch, stock values were cut in half, some conservative strategies lost up to a third and even corporate bonds suffered near double digit losses.

The sting of events looked somewhat like a repeat of the Asian currency crisis of 1998, except this time the epicenter was here in the U.S. and the resulting credit crunch swept along like a global tsunami. Excess financial leverage, courtesy of the hedge fund industry and other institutional investors, triggered a broad financial bust that in the last century has been eclipsed only by the Great Depression.

What is on the Horizon?

To be honest, 2009 doesn't have to be this amazing year to be better than 2008. This past year we saw equities fall to lows that haven't been witnessed since the 1930's and a global economy slid into a recession. We think that 2009 will surprise many with both the economy and the markets doing much better than what has been expressed by many talking heads.

Why do we think this?

1. **An unprecedented stimulus plan from the Federal Reserve.** There is no doubt that the economic shock from the subprime mortgage collapse threatened the viability of the financial system, but in contrast to the 1930's when the Fed refused to provide any help to the banking system, this time they jumped in with nearly \$1 Trillion dollars in loans and guaranteed all deposits. Also the Fed rapidly brought short-term interest rates down to zero, the prime rate down to 3.25% and the 30 year fixed mortgage rates down to 5%. Just think, it took the Bank of Japan nearly a decade to do the same when it was faced with a similar problem back in the early 1990. We will and have done a much better job so far.
2. **More Stimulus on the way.** The Obama administration announced that it will lower tax withholdings rates by about \$300 Billion as well as increase spending on infrastructure as well as create new jobs. As opposed to the policy makers of the 1930's who advocated increased taxes and reduced spending to cut deficits. Exactly the wrong medicine for an economic downturn.
3. **The Decline in oil prices is HUGE.** Last summer it was predicted that an increase in the price of oil from \$65 to \$130 per barrel would cut the U.S. GDP growth by 2% points. The subsequent fall to below \$40 means that not only

has the drag been eliminated, but the drop in oil prices may actually help spur economic growth.

- 4. Capital Markets are discounting a high probability of a complete collapse of the financial system.** Risk premiums have reached all time highs in the fixed income and equity markets. Investors are clinging to treasuries at incredibly ridiculous low rates, since they were the only asset that made money in 1930 that same must hold true today. Well unlike then, a financial collapse will not happen. As soon as investors realize that this dire outcome will be avoided, they will abandon the treasuries and run for the higher yielding assets.

The Deflation Battle

What makes a Bear Market one day and a Bull Market the next can be determined easily by what one person's views on where inflation is currently and where it may be headed. The only way to justify these depressed prices on many stocks at this current time is to assume a severe deflationary depression will continue unfolding in the coming month. What we are witnessing right now is just one of many battles in the war between *inflation* and *deflation* and depending on which way the battle breaks this time will have large consequences for the economy and our stock investments.

Right now, it is clear that the pendulum has swung toward falling prices. We have obviously seen this in the housing market for the last year or so, but equity markets have also declined by roughly half around the world. In addition, we have seen massive declines in most commodities (case and point would be the price of oil, going from \$147 dollars per barrel to less than \$38), as the recession saps the demand against the backdrop of producers, they have little flexibility to cut supply. In fact, in October of 2008, the

consumer price index fell by 1%, and was the greatest drop that this index has seen since the 1930's. During the 1930s, deflation was a most pernicious problem.

Interestingly enough, the volatility in the markets has also created a "flight to quality" among currencies, driving the traditional safe haven of the U.S. Dollar skyward in recent months, exacerbating some of the deflation we are seeing today. There is a saying that "there is a bull market somewhere, you just have to find it," and in late 2008, literally the only things that have gone up in value worldwide are "cash" and "treasuries". It is not too often that the mattress-stuffers of the world will have superior returns that those invested in the markets, but... in recent months the mattress-stuffers have.

Why is deflation so bad for the economy you might ask? Well for one, it can lay shambles to the financial system, as collateral backed loans fall in value, causing loan losses to spike and new lending to dry up as creditors fall back to lick their wounds. This describes in a nutshell what we have seen with the housing deflation during the last 2 years. It's obviously a healthy thing for the economy that banks are no longer giving mortgages out to anyone with a pulse but lower levels of lending are the life blood to new business creation or student tuition and this can have very negative effects, both in the long and short term.

Deflation can also hurt the "Main Street" economy we have heard so much about recently. If consumers see product that they are considering purchasing falling in value, why would they buy it today when they could get a better bargain tomorrow. This delayed purchasing lowers economic trend, causing prices to fall even further and down the spiral we go yet again.

As with any economic trend, there are winners and losers with deflation. Some of those winners are those with fixed sources of

income, such as those with pensions, because the payments of those pensions tend not to change, while the falling prices create a great deal more buying power for existing dollars. The same goes for companies with relatively stable cash flows and or large cash balances of which many of the Consumer Staples are in our portfolios.

The losers in a deflationary world are those that have relatively high amounts of debt, because in this situation, it becomes harder to pay back creditors in the future as dollars become more scarce and valuable over time. This is one of the several issues currently facing many Americans. Plus it's not just the borrowers that suffer in a deflationary world, but also the lending institutions.

To simplify, deflation discourages consumption and high inflation discourages long term investments. Yet we need both consumption and investment in order to keep the economy humming along. The ideal environment for economic growth is one with relatively stable prices and with the inflation rate running between the 1% to 3% range.

So the next logical question would be: Do we think the deflationary death spiral is going to continue? A quick answer for this newsletter would be, "no". Curing deflation is as simple as flicking the switch, the switch for the United States (and many other country's) is to start the printing presses to increase the supply of money. What side of the Inflation vs. Deflation battle do you think the government is fighting for? Just since the start of 2008 and the start of this year, think of all the inflationary actions that have been taken:

- Rebate checks from the IRS were sent out to most families in the U.S. last spring.
- The Federal Reserve has drastically cut interest rates. The Federal Funds target rate peaked at 5.25% in the summer of 2007, it started 2008 at 4.25% and on October 29, it was cut for

the 6th time that year to just a meager 1%!

- The Fed has thrown open the flood gates through various programs to loan out an estimated \$1.5 Trillion dollars to financial institutions.
- The TARP or Troubled Asset Relief Program was passed by Congress. This \$700 Billion program is currently being used to inject cash directly into financial institutions.
- The TALF or Term Asset Backed Securities Loan Facility was created. \$600 Billion is being used to secure the debt created by the Fannie and Freddie debacle, while another \$200 Billion is being used to try and kick start the securitization markets for consumer loans.

The ultimate cost and inflationary impact of these programs is not known at this time, many people think that the government will likely recoup most if not all of the loans and investments that have been infused recently. Yet all of programs that have been used to stimulate the economy are causing the government to essentially print more money, which we mention already pushes the pendulum away from deflation and back toward an environment of inflation.

It is a tightrope that the policy makers in government are walking right now. They need to apply enough stimuli to avoid deflation that could spiral us into a depression but they can't stimulate too much or we generate high inflation down the road.

Ok, here is something to think about for 2009.

We think that the economy may recover faster than expected. Without question the last quarter of 2008 and possibly the 1st and 2nd quarter of 2009 will show a significant decline in the GDP. But the decline in those 3 quarters, which some are predicting to be -7% to -5% respectively, will be milder and the 3rd

quarter may just surprise us and have an uptick. This more optimistic forecast is based on low mortgage rates stabilizing the housing markets and increased lending by banks.

Equity markets may enjoy returns of 20% or higher. And for the first time since the early 1950s, the dividend yield on stocks (at the time of printing it was 2.55% on the Russell 3000) exceeds the interest rate on the 10 year Treasury bond. And this dividend yield already takes into account the dividend cuts announced by the financial institutions and other firms. Accordingly, for the first time in more than a half century investors do not need to generate capital gains in order for stocks to beat bonds (see another silver lining just have to look). Furthermore, President Obama has indicated that he supports continued favored tax rates on stock dividends, so that the after-tax margin in favor is even greater.

U.S. Treasury bonds yields may rise over 3% as the economy improves. Low rated corporate bonds will increase in value as Treasuries fall. The Fed may not be able to hold it's near zero interest rate policy past the summer as the recovery commences.

We wish that we could tell you that all of these things will come to pass, but alas we cannot. There are always risks to any forecast. The Fed must do more to encourage banks to lend to "Credit Worthy, Non Delinquent" customers. And the Obama administration must carefully structure its recovery plans as to not bail out those that have been profligate and penalize those that have been thrifty. Nevertheless, just as 2008 disappointed us all on the downside, we believe that 2009 just might surprise everyone by producing much better numbers than most are now expecting.

Annual Stock Market Returns

Updated through December 31, 2008		Real Returns
Long Term	1802-2008	6.5%
Major Sub Periods	I. 1802-1870	7.0%
	II. 1871-1925	6.6%
	III. 1926-2008	6.1%
Post War Periods	1946-2008	5.9%
	1946-1965	10.0%
	1966-1981	-0.4%
	1981-1999	13.6%
	1988-2008	5.2%

Annual Bond Market Returns

Updated through December 31, 2008		Real Returns
Long Term	1802-2008	3.6%
Major Sub Periods	I. 1802-1870	4.8%
	II. 1871-1925	3.7%
	III. 1926-2008	2.6%
Post War Periods	1946-2008	2.0%
	1946-1965	-1.2%
	1966-1981	-4.2%
	1981-1999	8.4%
	1988-2008	7.0%

Holding Period Comparison

Percentage of Periods when Stocks Outperform Bonds and Bills

Holding Period	Time Period	Stocks Outperform Bonds	Stocks Outperform T-Bills
1 Year	1802-2008	60.4	61.8
	1871-2008	59.4	64.5
2 Year	1802-2008	65.0	65.5
	1871-2008	65.2	69.6
5 Year	1802-2008	69.0	72.4
	1871-2008	71.0	74.6
10 Year	1802-2008	79.3	80.3
	1871-2008	81.2	84.8
20 Year	1802-2008	91.5	94.7
	1871-2008	94.9	99.3
30 Year	1802-2008	99.4	97.0
	1871-2008	100	100

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