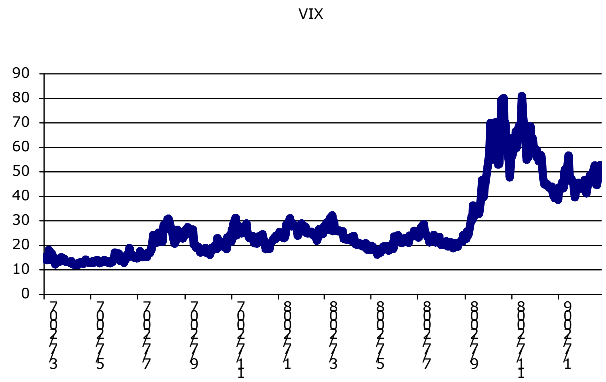
What We Know and Don't Know
3/5/09

Never before have we seen the level of fear among investors this high. On some level, who can blame them? Who is giving them any reason to be hopeful that the economy will turn around, and do it soon? Certainly not the government, thanks to our President's "negative jawboning." Even his latest attempt to restore confidence to investors sounded downright lame: "What you're now seeing is profit and earnings ratios are starting to get to the point where buying stocks is a potentially good deal." Starting? Potentially? Delayed policy responses to crises in the financial system haven't helped. Corporate America has turned to bunker mentality. And the rest of us? Analyze the conversations people have these days…someone who lost their job, a company whose orders have fallen off a cliff, a retiree whose fixed income is no longer fixed thanks to low interest rates and dividend cuts. And then there's the media.

Our impression is that we've all, individually, picked up bits and pieces of this economic crisis, but we're having some difficulty putting it all together. Think of it as a puzzle, where all the pieces are here, but only a PhD has the ability and temperament to be able to see how they fit together. We are not proclaiming to be that PhD, and we, too, have struggled mightily in digesting what has been a stream of economic news far worse than we had foreseen. But we're going to try anyway. Our last comprehensive "think-piece" that we authored was last June, about the speculative oil bubble. While we weren't exactly on the mark in predicting what would be the straw that broke the oil bubble's back, we nonetheless were timely (okay, lucky) in foreseeing its demise. We can only hope and pray our timing here is as good.

We believe that the mistake investors are now making is that they have progressed from fearing something <u>known</u> to fearing the <u>unknown</u>. Tangible fears have limits: "I'm worried about the safety of money market funds." That fear can be taken care of, whether by market forces or by government help. Fear of the unknown has no known antidote. While it makes sense on some level, in that nobody can guarantee that the collapse of our economy won't happen, fear of fear is nonetheless irrational, and is always the #1 cause of bad financial decisions. As you will see below, we don't know when the market will bottom, nor at what level, but that doesn't mean one should avoid stocks "until the smoke clears."

WHAT WE DON'T KNOW



1. Whether the market has bottomed, or when it will bottom, or at what level. Fear is gripping the market, not fundamentals. Yes, the fundamentals right now are bad, but not as bad as the market would indicate. The market is also being dictated by technical traders—those who believe that if the market goes down below a certain price, it will go down further. Unfortunately, the market has broken down through every support level so far, so we must assume we're headed to 0. But seriously, one concern among short-term traders now is that the market is hitting new lows <u>without</u> capitulation. Capitulation is when the greatest number of investors throw in the towel and all sell at the same time. The VIX is known as the "fear index;" it actually measures expected volatility implied from prices of options on the S&P 500. Notice how the VIX hit its peak last October, but has not returned to that peak, even as the market has fallen below where it was in October.

2. When the economy will hit its low point, or how much contraction we'll see until then. But, as you will read later, we believe the extraordinary growth in money supply, combined with stimulus spending, <u>will</u> inspire growth.

3. Why everybody is so transfixed by the prospect of bank nationalization. The FDIC has already taken over roughly 40 banks, including a couple large ones, like IndyMac and Washington Mutual. And yet the debate rages on as to whether the FDIC will take over a mega-bank like Citigroup, or simply decide to take ever-larger stakes in the bank. There even exists a group (it's hard to tell whether they're far-left or far-right) who believe the government should take over every bank in the U.S., which is the only reason why the debate over bank "nationalization" has become so heated.

4. When any kind of news—good or bad—will be taken as anything but bad news.

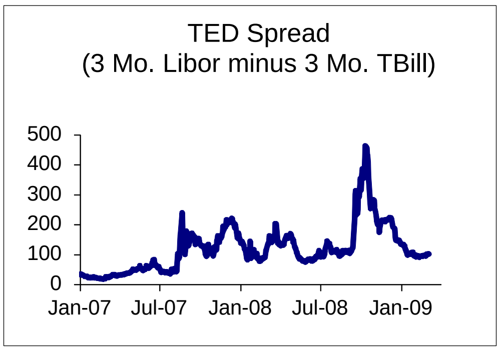
5. When bank stocks, or GE, will bottom. GE's CEO and CFO have taken to the streets in the last couple days to tell the market that GE's current stock price represents the "opportunity of a lifetime," that GE

Capital will be profitable in the first quarter, and that management has just bought yet another round of stock for themselves.

WHAT WE DO KNOW

Credit Markets

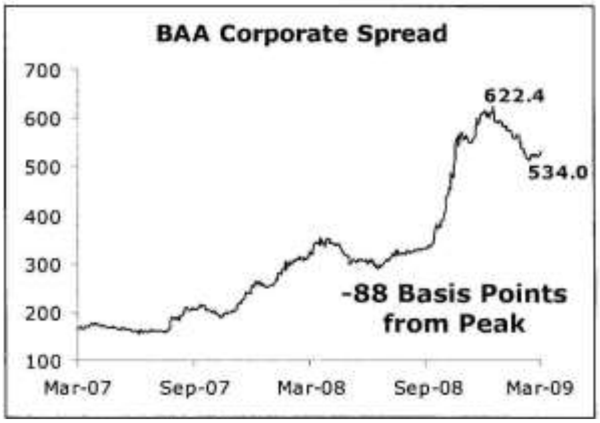
The first step in stabilizing the economy is stabilizing the credit markets. Remember when everyone and their brother agreed that healing credit markets would be the first, and toughest, step toward economic recovery (last fall)? **This has already happened!** Largely thanks to government assistance and increased demand for bonds (at the expense of stocks), one by one, credit markets have healed.



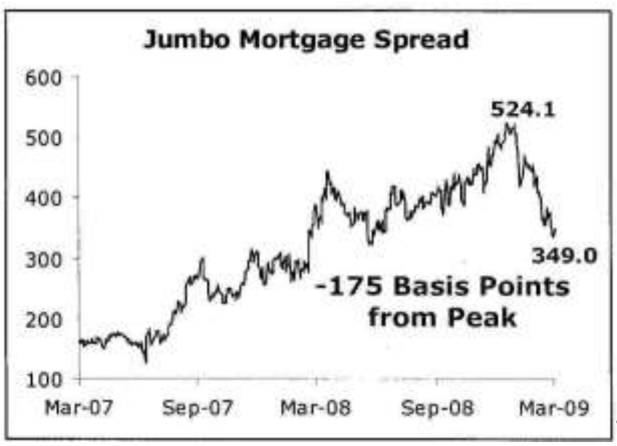
1. First was interbank lending, as can be measured by LIBOR. Recovery began in October and was pretty much complete by January. The following chart shows the spread—that is, the difference in yield—of LIBOR over Treasury bills, and is known as the "TED Spread." Don't worry about trying to rationalize the variables here; just know that the higher the spread, the greater is the concern among banks.

2. Next was unfreezing commercial paper markets, which is short-term debt issued primarily by companies. This, combined with temporary guarantees on some money market fund assets, helped to stabilize flows into money market funds. These were accomplished by November.

3. Next was conforming mortgages (i.e. not subprime, nor jumbo—over $417,000—mortgages). Rates on conforming residential mortgages (those that conform to the relatively stringent standards of the government agencies, like Fannie Mae) started falling last November. This was partly thanks to government purchases of conforming mortgage-backed securities, which gave comfort to investors in these securities, and allowed mortgage credit to flow again. Rates are now quite low.

4. 

Next was corporate bond spreads, as can be seen on the chart (remember: 100 basis points = 1%). Again, the government has stepped in to guarantee some financial company bond issues (3 years or less) through its TGLP program. This, combined with attractive borrowing rates (thanks to ultra-low treasury rates), has helped to jump-start corporate borrowing. Investment-grade spreads are still historically high, but much lower than they were, and new debt issues for healthy companies have grown significantly since January. This indicates that investors' appetite for corporate bonds is very strong. Even some junk bond deals are getting done; spreads are very wide, but have stopped getting wider.

5. 

The latest market to recover is jumbo mortgages. Left out of the assistance for conforming mortgages were jumbo mortgages—those over $417,000. With no help from the government, jumbo mortgage spreads have fallen significantly, just in the last two months, and should be taken as a measure that banks are more willing to lend.

6. The latest endeavor is TALF. The Term Asset-Backed Securities Loan Facility will provide low-interest loans for funds who want to buy securities backed by assets such as credit card loans, auto loans, and student loans (basically, large loan markets that aren't real estate). These funds are hungry to buy such asset-backed securities, but have

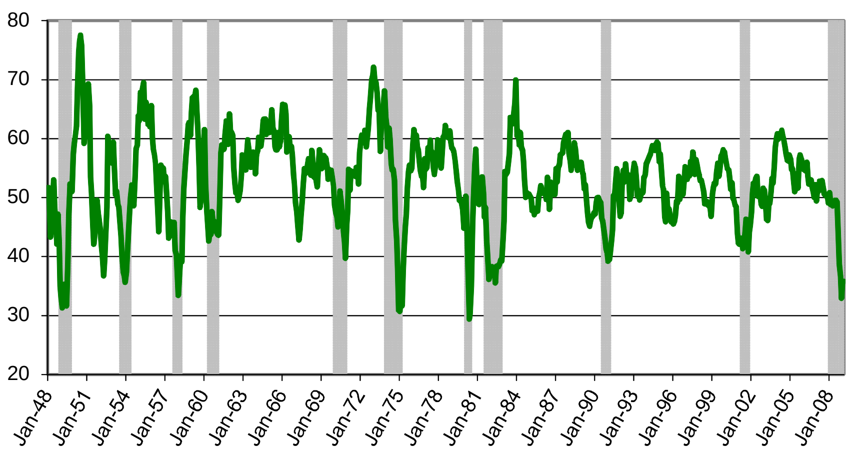
been unwilling to accept risk; with the government accepting some of this risk, they're ready to buy. This will hopefully allow some consumer loans to be made that have been denied in the last few months, because finance companies (like banks) didn't want to take them onto their own balance sheets, and nobody wanted to buy securities.

The Economy

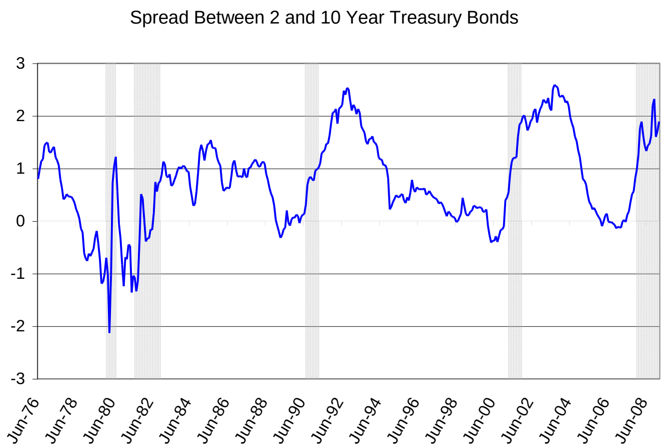
There are signs that the economy is no longer contracting as quickly as it was in the 4th quarter and the beginning of the 1st quarter. Of course, there are some signs that point the other direction, but alas, here's what we see now:

1. ISM. Every month, the Institute of Supply Management surveys purchasing managers at thousands of companies to ask them whether they are increasing or decreasing orders (in a nutshell). The result is a "diffusion" index, and a reading of 50 or more indicates a healthy, expanding economy, 45-50 means subpar growth, and under 45 means the output is shrinking. ISM divides their survey into two parts: manufacturing companies and non-manufacturing (services) companies. We have found the ISM manufacturing survey (shown above) to be one of the best leading indicators to the economy. The survey rebounded from a depressed level of 32.9 in December to 35.8 in February. Don't misunderstand: 35.8 is still recessionary, but it is an improvement. Similarly, the non-manufacturing survey has shown a bounce of about 4 points from its low in November, but was down in February from January. Obviously, a sustained improvement in these is necessary, but notice that in all past recessions (shown by the shaded vertical lines),

ISM Manufacturing Index



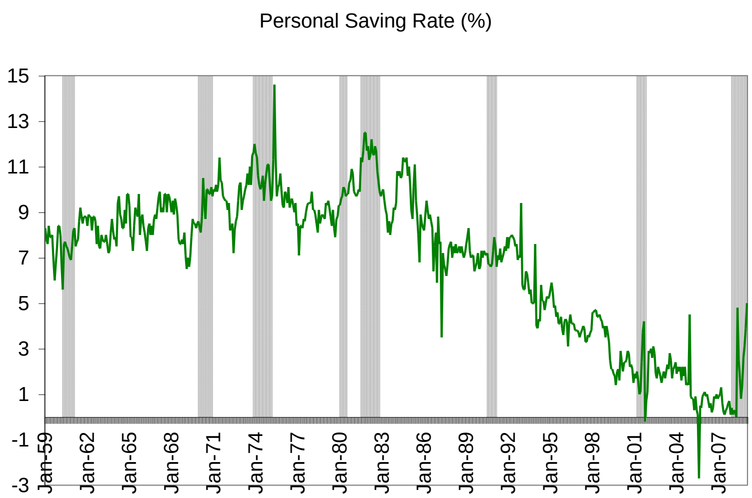
the ISM almost always plummets in the middle of the recession, and it goes up at the end of the recession. Obviously we are watching the ISM indicators like a hawk.



2. The treasury yield curve is now steep, which always presages a growing economy. This chart shows the spread (difference) between the 10-year treasury bond yield, and that of the 2-year treasury bond. Again, the shaded vertical lines are recessionary periods. Notice how the spread typically hits its low point well before a recessions starts; this is when the curve is inverted. The spread then increases through the recession and usually peaks 1-3 years after the end of the recession. This time, however, the slope is already nearing the peak steepness it saw in 1993 and 2004. We're not sure what to make of that.

3. Oil consumption is now declining at a slower pace.

4. Doctor Copper. Since bottoming on December 24, copper prices have risen 44%. Copper has long been a fairly good indicator of turning points in the economy.



5. Consumer spending is improving since December, per the Fed's Beige Book report yesterday—at the same time that the personal savings rate is

increasing. Note in the chart below that, historically, spikes up in the savings rate usually occur in the late stages of recessions (2002, 1990, 1974, 1970). This happens as consumers hunker down (believe it or not, this is **NOT** the first time consumers have hunkered down since the Great Depression). Then, either through pent-up consumer demand or bargains that prove irresistible, consumer spending ramps back up.

The Government

The government's numerous fiscal stimuli will boost growth. This is a topic of endless debate among everyone from Congress to talking heads on TV to everyday investors like you and us. And the talking won't end until the recession ends. If we could boil down the disagreements among the optimists and the skeptics, the residual that would be left is known as "the multiplier effect."

Obviously, every extra dollar that the government spends goes into the economy in some way, but it has to be funded by something. This could include higher taxes, or borrowing (which eventually will be paid back with either higher taxes or reduced government spending down the road). The "alchemy" of fiscal stimulus is whether the increased government spending also stimulates other spending. For example, if $100 million is allocated to building a brand new road, that $100 million will go (directly and indirectly) to: laborers of the engineering firms, laborers of the construction firm, laborers of all the subcontractors, purchases of new machinery (which trickle down to employees of the machinery manufacturer, and to the producers of the machinery raw materials, like steel, engines, tires, hydraulics, other parts), profits for owners of all those firms (some of which will be spent by the owners). In other words, the $100 million does go somewhere; it doesn't vanish. What happens next is most important. Does that spending stimulate other spending, such as the laborers increasing their spending, or the machinery manufacturer buying a new software program to handle its dealings with the government, or new stores being built along the new road? If it doesn't, then the efficacy of the $100 million new road must be compared with alternative uses for that money, such as tax cuts. While we like tax cuts as much as the next guy, we must agree at least a little with the Administration's point that the risk of cutting taxes is that cash would flow straight through taxpayers to the banks. This is known as "deleveraging," where consumers pay down debt, which decreases loans. This is not what the government is trying to accomplish.

We view the stimulus spending as a "band-aid" for the economy. It will stop the bleeding in terms of economic contraction and rising unemployment. And borrowing at 2-3% interest rates at a time when the U.S. dollar is strengthening against EVERY major currency makes this plan palatable. But we are less sanguine about the multiplier effect in the short-term, simply because of the consumer's propensity to delever.

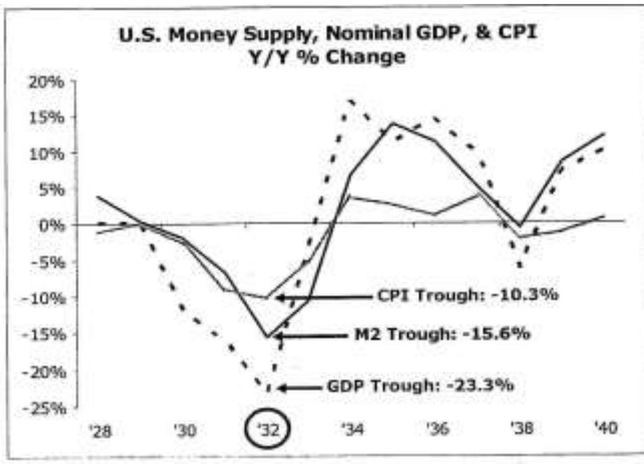
These arguments open up a great big can of worms on whether we should be cheering for deleveraging or against it. What is the optimal amount of debt? This is a question for consumers, companies, and the government. But since companies (aside from financial companies, who are burning through their equity, and companies which got taken private in LBOs—leveraged buyouts) weren't highly leveraged at the peak of the economy, and quickly moved to store up cash, we aren't concerned about corporate debt. As for government debt, obviously we all wish for less in the long-term, and hopefully we'll get it, but for now, debt is going up and that's a good thing.

The biggest variable is how much the **consumer** will choose to delever. Some consumers are being forced to delever, as they lose their houses, or face personal bankruptcy, but the vast majority of consumers have the option to delever; it is voluntary. And many definitely are, as the personal savings rate spiked up to 5% (as previously mentioned). Surprisingly, this report also showed that personal incomes rose, and personal spending rose at a much slower pace. How could anybody have designed a more bullish report? Incomes are still growing, spending still growing, savings rate rising toward a "safe" level.

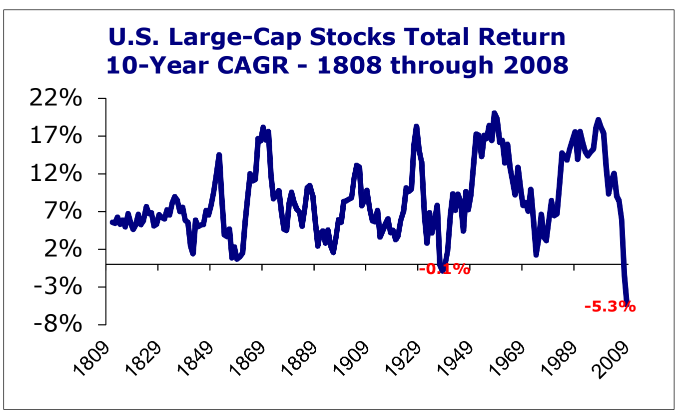
It goes without saying that a rising savings rate is good for the long-run, bad in the short-run. Should the government encourage the economy to swallow the pill of an ugly economy (and troubled financial system) in the interest of a higher savings rate? Or should the government, knowing that consumers probably have too much debt, encourage consumers to spend away and not delever? It appears that the administration acknowledges both, but is siding with choice #2, choosing the short-run over the long-run, in the interest of protecting our economy from the possibility of an economic Armageddon.

The government has a vested interest in seeing both the economy and stock market come back. Despite the impression that President Obama is talking down the economy and telling all of us that we were fiscally irresponsible, conspiracy theories suggesting that the government would like to take over the economy are absurd. While we can all throw the "S" word (socialism) around in a free country, this administration understands that capitalism is the foundation of our economy. That said, we do expect the government to continue to tinker with certain parts of the economy, as it is now doing with Medicare insurance and student loans.

Comparisons with the Great Depression



The market has pretty much stopped comparing this recession to anything but the Great Depression, or Japan's "lost decade" of the 1990s. The similarities are many: the Roaring 1920s were spurred on both by asset bubbles (stocks, real estate) and a credit bubble. During the next few years after the Crash of 1929, consumers deleveraged, which led to deflation. Banks failed because of the deleveraging, but also because there were few safeguards for protecting banks. But the two solutions, when they finally arrived, actually did work. Those were money supply growth, and fiscal stimulus, funded by a massive increase in debt. Money supply didn't even start increasing until 1933, as the chart above shows. Notice that as soon as money supply (M2) growth turned up, GDP growth turned up. For reference, the Fed has been cranking up money supply since October and it is now +9.9% from last year at this time.



The Great Depression statistic that gets the most headlines is that stocks fell 89% from peak in 1929 to trough in 1932. So, the decade got off to kind of a rocky start. But thanks to dividends and to massive rebounds that followed 1932 and the subsequent bear market in 1937, the very worst that an investor could have gotten out of stocks in any 10-year period that included the Great Depression was –0.1% per year (so, that's –1% total return in 10 years). That assumes the investor had the fortitude to hang in there and not dump stocks during the tortuous 1929-32 bear market. –1% isn't good, but it put bread on the table. Compare that to today: owning stocks for the last 10 years netted an annual return of –5.3%. That, by comparison, is simply atrocious. This is not intended to bum us all out, but to point out how off the charts this is in contrast to **200 YEARS** of history in the U.S. stock market. It's easy to point out the flaws in all of this, such as the fact that dividends are actually decreasing now. But please understand that, going into this bear market, there was no awesome bull market. Stocks weren't overvalued 2 years ago (financial company earnings were, as it turns out).

The Market

Financials hold the key to the recovery. We believe the market will not recover without a recovery in financial stocks. They are way too important a piece in the economic stimulus plan.

There is an unbelievable opportunity in safe stocks. We agree with the theory that the winners in the next few years will be stocks that are just strong enough to survive, without needing to raise dilutive common stock from outside sources, such as the government. But there are so many healthy companies, the strongest of the strong—earnings are still growing, their competitive strengths are increasing, they have either no debt or more cash than debt—that there is no chance they won't survive even a Great Depression II. And their stocks have been smashed, maybe not as badly as the overall market, but still are available for purchase today at valuations never, ever, seen before. While naming names is always dangerous, we would hold out as examples Medtronic, J&J, Walgreen, P&G, and ADP. While we're not sure where the market is headed in the short-term, we would not hesitate to tell anyone that we would be buyers of these stocks today.

As for the overall market, we're still concerned that there will be a lot of casualties for shareholders, but overall, the market is so far below "dirt cheap" that it can't even see dirt cheap anymore. The logical question you would now ask is: "yes, but do you know how bad the economy is?" And we say "probably, yes, we do." Notice on the table below the worst GDP quarters since World War II. Don't be surprised if this quarter checks in somewhere close to –8%. Combined with –6% for last quarter, that puts this recession in pretty limited company. On this list are 2 back-to-back quarter periods: 4Q57 – 1Q58 and 4Q81 – 1Q82. In each case, the second of the two quarters was worse than the first. Interesting how the first of two bad quarters is always a 4Q. But notice stock performance during and after those quarters. Stocks fell 5.7% during 4Q57, but rose each of the next 4 quarters, despite 1Q58 being the worst GDP quarter on the list. 12 months later, stocks were +38.1%. Stocks rose 5.5% during 4Q81, then fell 8.6% in 1Q82, then fell another 2.1% in 2Q82, but then +9.7%, then +15.7%, then +13.3%.

S&P 500 Performance During & Following Weakest Real GDP Quarters

	Real GDP Q/Q % AR	During	+3 Months	+6 Months	+12 Months
1958 - Q1	-10.4%	5.3%	7.5%	18.9%	31.7%
1980 - Q2	-7.8%	11.9%	9.8%	18.8%	14.9%
1982 - Q1	-6.4%	-8.6%	-2.1%	7.6%	36.6%
2008 - Q4	**-6.2%**	**-22.6%**	**-**	**-**	**-**
1953 - Q4	-6.2%	6.3%	8.6%	17.7%	45.0%
1949 - Q1	-5.9%	-0.9%	-6.0%	3.5%	14.8%
1960 - Q4	-5.1%	8.6%	12.4%	11.2%	23.1%
1981 - Q4	-4.9%	5.5%	-8.6%	-10.6%	14.8%
1975 - Q1	-4.7%	21.6%	14.2%	0.6%	23.3%
1970 - Q4	-4.2%	9.4%	8.9%	8.2%	10.8%
1957 - Q4	-4.2%	-5.7%	5.3%	13.1%	38.1%
1949 - Q4	-4.0%	7.8%	3.0%	5.4%	21.7%
Average		**3.2%**	**4.8%**	**8.6%**	**25.0%**

So, it would appear the market is pricing in a really ugly 2Q09, and maybe more beyond that. If that doesn't come to fruition, and the economy actually stops going down, look out above.

Where will new money for stocks come from?
Our friends at Strategas wrote a very thoughtful piece on this subject, which we have available in Monarch's Library. Their conclusion is that a lot of retail investor cash will remain on the sideline for awhile, some has been (and will continue to be) used for paying down debt, and some will never come back. But there are other sources, namely companies, sovereign wealth funds, and private equity funds.

What we expect to see

1. We could yet see another steep correction for stocks, given the lack of technical support.
2. Earnings estimates and guidance by companies will continue to go down, with some ugly surprises.
3. Employment reports will continue to be ugly, including tomorrow's February jobs report, though they will start to decelerate at some point, especially because layoff announcements have started falling already.
4. Deflation will last for at least a couple years, notwithstanding everyone's attempt to jump on the inflation bandwagon, given the massive monetary and fiscal stimulus, and to the massive amount of government debt being issued. Prices will fall, wages will fall, and the average American will temporarily become accepting of a more modest lifestyle.

What we hope for

1. Companies to get enough courage to start to take action…buy companies, buy back their own shares, and start bad-mouthing their miserably low stock price.

2. Long-term, we still believe in the underpinnings that have always allowed our country to grow: population growth, productivity, greed, people just wanting to improve their lot in life, and savings goals (which cannot be achieved with 1% returns!!!).

It has become so clichéd to say "hang in there," so we'll take a pass this time on using it. At this point, it would appear that the risk/reward ratio has never, ever, ever, favored buying stocks more, and especially compared to investment alternatives, such as safe bonds. The short-term risk has dramatically increased, but the long-term risk has dramatically decreased.
We welcome every dialogue that you want to have with us, so please don't hesitate to call us.