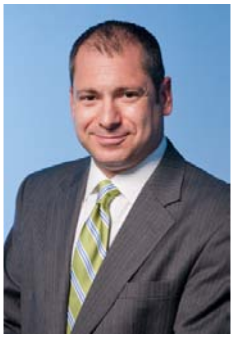

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The whole stock market, economy and TARP explained in very simple terms…Positives abound…

Recessions always have a recurring theme; over capacity in almost everything. You must read this quick and abbreviated economics lesson to start:

First, companies figure out how to become lower cost manufacturers.

Second, these low cost manufactures cut prices to consumers in order to grow demand.

Third, the market for the product of the low cost manufacturers becomes saturated.

Fourth, sales growth slows or stops and profit margins erode.

Fifth, companies cut costs.

Sixth, the weak players go out of business and excess capacity is removed form the market place.

Seventh, the remaining players regain ownership of their respective market by becoming the “last man standing”. Often, they enjoy a period of higher prices and high profit margins.

Eighth, new low cost manufacturers enter and start to steal market share form the industry dominators with lower consumer prices. Sometimes these new competitors are foreign companies.

This scenario certainly describes the automobile industry. This country used to have hundreds of auto manufactures. It consolidated and the few survivors enjoyed market dominance for decades. Then came the Japanese manufactures. You know the rest.

Look at past recessions and you'll see that each one of them started with a period of over capacity. **1990** was marked with over capacity in real estate. Easy credit and lax lending standards were common place. **2000** was marked with over capacity in the technology and communication sector. Easy credit, lax lending standards, and an over abundance of IPO's were common place.

With too much capacity, companies and even entire industries, feel forced to become more aggressive to incentivize consumers to keep buying more products. **Easy credit and lax lending standards are the tools of choice.**

Today's recession is marked with too much capacity in financial services, automobile manufacturing, personal computer manufacturing, home building, and chemicals – on a global basis. If one needs to find something unique to the current recession, this is the first truly global one. Until recently, few realized that there is a G20 (Group of 20 nations with the biggest economies), let alone the old G8. In past recessions, excess capacity was removed from the market place through bankruptcy or mergers & acquisitions. The economists describe this cycle with the term **"creative destruction"**. This term is the basis of the law of *survival of the fittest*.

Mergers and acquisitions is a much more palatable way, both from a political standpoint and from a consumer standpoint, than bankruptcy. This is why Treasury Secretary Paulson is using the TARP (Troubled Asset Recovery Plan) to inject funds directly into strong banks while pushing weak banks into the arms of stronger competitors. The automobile sector is now pleading its case for TARP funds. Insurance companies are purchasing small Savings & Loans so that they too can have access to TARP. Goldman Sachs, Morgan Stanley, and American Express have converted to commercial bank status so they too can access TARP funds. When too many financial companies try to raise capital from too few willing investors, it is a sign of overcapacity – someone has to fold. Unfortunately, we're stuck in a period when the natural course of economic principles is being artificially slowed. No one wants to see or hear the word "Bankruptcy", even though it is a critical step toward economic recovery.

Ultimately, TARP is the Government's kinder and gentler way of getting this nation through its economic perils. It is the blue print to remove excess capacity of all kinds in this country. Will it work? For now, I'm saying yes. The RTC (Resolution Trust Corp) of 1989 and the bailout of Chrysler in 1979 are two examples of bailout success. It will help smooth out shocks to the economy while dismantling capacity utilization in an orderly way.

Going forward, the key statistic we all need to watch is Capacity Utilization (CU). This goes for CU in national manufacturing, specific industries, and for individual companies. When this figure rises, we'll have no doubt that things are on the mend.

But make no mistake about it; those companies who simply cannot exist any longer will eventually cease to exist, except perhaps in name only. AIG, I'm sure, will be an example of this. The airline industry is an example of how an industry can shrink; it went through its own draw down of excess capacity over the last 7 years.

Folks, this is what happens in EVERY recession. There is no new paradigm. Every economic problem that we have today – believe it or not – we've seen before. The recessions always end too. Yes, the problems are bigger, but so too is the global economy. The state of too much capacity ends; companies and industries right size themselves, new technologies emerge, existing factories become obsolete, and leverage returns to the financial system – EVERY time.

The answer we're searching for is when. I think in 2009 – sometime in Q3 or Q 4 you'll see signs. Here are a few signs to look for: increased M&A activity, consolidation of mature industries, stable real estate market, and a trend of rising capacity utilization. Since the stock market is a discounting mechanism, it will rise and fall based on when investors collectively anticipate these signs. When investors anticipate these signs sooner, the stock market will rise. Conversely, when investors anticipate these signs later, the stock market will retreat. Yes, it is actually as simple as that.

Let's look at a few of the positives:

1. Starting next quarter (Q1/2009) and the one after that Q2/2009), year over year corporate earnings **comparisons** will start to get easier. For example, you may recall Goldman Sachs reported a record quarter just one year ago. Fast forward to today and the year over year drop in corporate earnings is particularly acute. This is no more evident than in the industries that were hammered the most; financials, home builders, and automobile manufacturing. By early next year, the year over year decline will most likely continue, but the decline will be much less acute.
2. **Consecutive quarterly earnings by Q3 and Q4 of '09 now have potential to increase, let alone be flat.**
3. Earnings and revenue **forecasts** will most likely be ratcheted down so much that companies and even entire industries should start meeting and beating expectations. Just like the emotions of greed and fear, Wall Street forecasts tend to over shoot to both the upside and the downside. This has always been the case.
4. **Inflation** is not only low, but in almost every category except for higher education, it is moving lower. The savings to the domestic economy, due to the recent price drop in gasoline is now approximately $700,000,000.00 – per day! Now, that's one heck of an economic stimulus. Sure, demand destruction in

energy is taking place due to the global recession. But cost cutting is a very big part of balance sheet repair for consumers and businesses alike. Some of it will most likely be spent too! Notably cheaper are materials, agriculture and apparel; basically everything we could possibly spend money on! A potential upside surprise? With expectations so low and potentially factored in, the upcoming Holiday Season may actually be better than expected. Remember what this author just wrote about expectations? Want evidence? Wal-Mart announced today (11/18/08) that customer traffic is increasing due to falling energy prices.

5. Recent policy actions on behalf of the Fed, Treasury, and foreign central banks have only just started to reach the economy. The TARP (Troubled Asset Relief Plan) has only very recently been started as recently as October 27th. 146 Billion Dollars have thus far been injected into banks. The resulting benefits of all this **monetary and fiscal policy** will be felt eventually; I'm thinking just a little of it starting sometime in Q1 or Q2 of '09 – less than 2 months away! More important, the bulk of the bail out hasn't been spent yet. While this may not be the quick solution investors are craving, it is still a positive. Put simply, the banking system needs to heal itself before it can loan money to businesses and consumers.
6. The Fed and foreign central banks have cut interest rates, some more than once. If it takes 6 to 9 months for **interest rate cuts** to reach the economy, then we should expect the positive and stimulative effects to start hitting us just about now.
7. Citigroup recently joined other banking giants like Bank of America, JP Morgan, and Wells Fargo in halting foreclosures. These banks are choking on residential real estate and they finally decided it is better to modify loans than to claim more homes through the costly foreclosure process. While this may not be fair to the responsible homeowners, **it does help forestall a lot of potential new inventory from hitting the saturated housing market.**
8. The FDIC on November 14th unveiled a plan to prevent an additional 1.5 million foreclosures. This is still a developing story, but it underscores the urgency and determination to prevent more homes from hitting the housing market. What would you expect with less new inventory hitting the market and an increase in affordability? You guessed it – a stable real estate market.
9. **Interest rates are low and will very likely remain low for the foreseeable future.** Again, we are in a recession, so interest rates are low due to reasons we'd rather not have right now. But low interest rates are stimulative to the economy!
10. The commercial paper and money market asset classes have been back stopped by the Fed.
11. Hewlett Packard affirmed that it will exceed Q4 2008 earnings expectations and it raised guidance for 2009.

To pull this together, we need just one more thing – **TIME**. You may ask "with all of these positives, why is the economy still declining and why is the stock market still going down?"

1. All of these positives will take time to reach us. **Remember, we just had a credit shock and a stock market crash over the last six weeks.** The Fed's nightmare scenario of systemic failure in the financial system has been side stepped. Based

on certain measurements of the credit market, the credit freeze is showing signs of thawing.

2. The stock market has already gone down. It is, in my opinion, going from bottoming process to range bound. **Bottoming is not an event; it is a process – which is underway.** This too will take some time.
3. It takes time for excess capacity to be removed.

Politics: This is not meant to be political. This is meant to be an objective observation of a pattern that I'd like to point out. It is also the topic of conversation of the day, so it is only reasonable that it should be addressed.

Presidential cycles and economic cycles aren't always congruent and are often only correlated – meaning we can't always easily assign cause and effect to Executive Branch policies and economic conditions. **But it would seem that investors have done well to invest for the long term when new Presidents are elected during recessions.**

This has to do with the Fed and Treasury actions that took place during the time of the outgoing Administrations. Presidents who seem to have presided over economically good times were Presidents Reagan (following Carter/troubled economy) and Clinton (following H.W. Bush/spent most of his term in office during a recession and real estate bubble burst). Presidents who seem to have presided over economically tough times were Presidents H.W. Bush (following Reagan/strong economy), W. Bush (following Clinton/strong economy).

How about the incoming President Elect Obama? With massive economic stimulus, a weak economy, a stock market down by almost 50% from peak levels, one can make the very simple case that this is a good time for him to become President. The heavy lifting of Fed and Treasury policy has already been initiated. Since history is a repeating mechanism, one could argue that history is squarely on the side of investors. In fact, today's environment is so strikingly similar to that of 1992, from cabinet posts to a severe real estate glut; one can argue that history is not in the making to the extent that we may think. It is actually just repeating itself. To go from correlation to actual cause and effect, the negative economic statistics (rising unemployment, declining earnings, and even bank failures) at the ends of the Presidency's during recessions, as it turns out, are lagging indicators. This may bode well for investors, both blue and red.

Thanks for reading this. Please forward this to anyone you know who may find it interesting. Please reply me if you'd like to comment.

Interested in becoming a client? Call me. Let's talk about it.

(Disclosure: This is solely MY opinion. Of course, you are welcome to share your opinions with me too. If you act on any of this without speaking to me first and you lose money, don't blame me. I may be wrong. I reserve the right to change my mind about any of this whenever I want and without warning. We're NOT totally out of the woods yet! Have a great day! ☺)

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