JANUARY 2009: MARKET COMMENTARY

Looking Backward – and Forward: As 2008 draws to a close, I'd like to *briefly* revisit 2008 and spend much more time looking forward to next year.

2008: We all know this story. Economically, 2008 was simply terrible. Markets were terrible with the S&P500 down over 50% from previous highs at one point. We also saw the unusual combination of declining stocks AND declining corporate bonds. Corporate bonds lost value as investors sought to avoid any type of risk. Unemployment is up, productivity is down, spending is way down, etc. etc. etc. We've all heard this story, and we're going to hear more in the coming months. (Keep reading – there is good news later on.)

2009 expectations: Unfortunately, 2009 is likely to resemble 2008 for at least the first half of the year. Housing prices will probably keep going down for various reasons. Unemployment is expected to go up significantly. And the big thud will likely be skyrocketing credit card defaults. And, as credit card companies rapidly reign in credit as predicted, one of the major casualties will likely be small businesses that depend on credit cards for working capital. Many will not be able to survive the combination of a challenging economy and reduced credit. Of course, this will continue to adversely impact the economy in the near term.

The markets have obviously reacted to the continuing stream of bad news. Currently, the U.S. investment grade index is implying that roughly 20% of investment grade issuers will default over the next five years, while the CMBX Index of triple A commercial mortgage backed securities is implying that more than 60% of the underlying mortgage loans will default in their term.[1]

Investor implications: While anything is possible, and current news is undeniably bad, we believe risk aversion in the credit market is overly exorbitant, and has adversely affected nearly all other markets.

So, as bad as the news is, even worse news appears to be factored into the prices of many assets ranging from bonds, to stocks, to various hard assets. And, adding to this is a lack of sophisticated buyers with access to capital. As mentioned in previous commentaries, many of the savviest buyers of assets have been forced to seek out cash at a time when they would love to be buying assets.

Recovery Anyone? Again, anything is possible. However, as normalcy returns to market, which we're starting to see in some markets, and expect to accelerate in 2009, we believe we'll see a good recovery which becomes more likely in the last half of 2009.

Some historical numbers emphasize a positive trend for savvy investors. A study of the last nine bear markets dating back to 1957 showed the obvious – markets decline substantially as the economy contracts. As the market factors in economic recovery, returns have historically been quite substantial the following year, followed by lesser returns in the following two years. The average year 1 recovery was 35%, followed by 12% in year 2.[2] This argues the obvious point – you need to be in the market to experience the strong returns when the market rebounds. We've possibly already seen some of this move with the market up nearly 20% from previous November lows.

One other projection also seems reasonable. Since this downturn has been much more severe than average, it may be sensible to project that the following upturn could also be more pronounced. While there's obviously no guarantee of this, and of course, there's no definite timetable, it seems logical to consider.

Positive Notes: I wanted to review some different facts that I believe paint a more complete view of the U.S. economy. The U.S. remains the world's preeminent economy, and recent events have reinforced rather than refuted this standing. One simple proof is the market for U.S. Treasury bills. In the face of global recession, investors worldwide are flocking to this safe haven, pushing yields below zero in recent weeks. Despite the U.S.' economic problems, investors have greater confidence in the U.S. economy than seemingly any other economy, and feel assured that the U.S. government will pay off its obligations. While we all take this for granted, this is a phenomenal blessing for any U.S. citizen.

Foreign direct investment flows into the U.S. also highlight the U.S. economy's vibrancy: Last year, foreign investors sank $233 billion into business ventures in the U.S… far eclipsing any other economy, including China and Hong Kong combined. And, of course, the U.S. is still three times as large as the next largest economy, Japan. And, at nearly $14 trillion, the U.S. economy dwarfs every other. It's not only three times as large as the economy of Japan, which ranks second, but is also about 4 times the size of third place China, and fourth place Germany.[3]

Strong Productivity Growth is a primary reason for U.S. economic preeminence. Since 1995, American industrial output per hour of labor has grown faster than in most other industrial countries, averaging a healthy 2% increase a year. Among G-8 nations, only the United Kingdom has outpaced the U.S. since 2000, with Japan notching growth just below America's pace with others significantly lower.[4] This bears emphasizing. While the press is talking about all the awful events unfolding in the U.S. and the terrible state of our economy, the key measure of economy performance, U.S. productivity, has continued to shine. The recent slowdown in yearly improvements is temporary and shared by other developed economies. After slipping to 1% in 2006 and 1.4% in 2007, productivity growth should settle into a pattern of 1.5% to 2.25% annual increases which is amazing for a country with an already highly advanced economy.[5]

Continued Strength: Contrary to the seemingly endless stream of bad news, the U.S. continues to be a very strong economy growing at respectable levels. While there's no denying that we're navigating a very difficult storm, so far, we appear to be doing so more successfully than most other countries. I strongly believe that all indicators point to a good recovery once we've weathered this difficult period. To paraphrase Warren Buffet, it's very unwise to bet against America.

Of course we've got lots of problems, some temporary like the credit crisis, and some more permanent like our failing public educational system. However, keep in mind the resiliency of America, and our proven ability to rise to a challenge. Also, remember that during a crisis most issues look worse than they probably are. I still believe firmly that we're in the midst of a panic and market prices of today represent wonderful buying opportunities. While there are no guarantees, I also believe that I have history firmly on my side.

I wish you a happy and prosperous 2009.

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1. AFG Research, 12/17/08, Goldman Sachs Q4 2008 Quarterly Update.
2. Prudential Investment Management Services, LLC, IFS A155910, JD2528, Ed. 10/01/2008
3. The Kiplinger Letter, Vol 85, No. 51
4. Ibid
5. Ibid