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Quarterly Investment Outlook

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2009: Year Two of the Great Recession

Our Wish List for 2009:

- A program enacted to stabilize the mortgage-backed collateral held by financial institutions and get credit flowing. – **The Treasury has taken a huge step in the right direction. See the details of TALF released last week.**
- Modification of the Mark-to-Market rules which would allow banks to rationally price mortgage-backed securities to values (not zero) that reflect their expected holding period. - **Rumor has it that discussions are ongoing in Washington. Our fingers are crossed.**
- The short sale rules that served investors so well for so many decades are reinstated. It's simple: Require short sellers to borrow stock and sell on an up-tick. - **Ben Bernanke's recommendation to do this is now being discussed in Washington. Even Barney Frank gets it.**
- The creation of a Resolution Trust-like entity that will euthanize the zombie banks and insurers while stripping toxic assets from the financial system – **Unfortunately, this will require courage on the part of policy-makers. So far, just talk, no action.**

Just the mention of changes to the rules of the game ignited the biggest one-day rally of the year this past Tuesday. Who knows? Actions, not just words, from Washington could bring an investable rally of significant proportion. The Cyclical Economy would still be in decline and a correction would likely follow, but the stage would be set for a market recovery with a bottom in place.

Broken

That's how we would describe the Financial System. It's the engine that drives a Global Economy that is losing momentum and will coast to a stop unless a fix is applied. We saw TARP (Troubled Asset Relief Program) enacted after much drama and a market crash in Q4 '08. It injected much-needed liquidity into the financial system but was ripe for abuse. The second half of TARP was more efficient, better-targeted, and came with much-needed strings attached. While that may have put gas in the tank, the black holes in bank balance sheets, created by housing-related toxic assets, has kept the engine from firing up. The recently enacted TALF (Term Asset-Backed Securities Loan Facility) addresses the other side of the equation, the collateral underlying the toxic assets on bank balance sheets. As we said in November, credit and the securitization markets will remain frozen until those holes are patched through a systematic pricing mechanism or loan modification program. Taken together, TARP and TALF are a big step toward restoring the flow of credit in the banking system.

A Simple Solution

Unfortunately, restoring the supply of credit won't necessarily create the demand for it. What's missing is confidence: in the system, in the markets, and in the cyclical economy. In our opinion, that can be cured in a matter of days. In the last 15 years, we've seen banks become brokers, hedge funds and renegade insurers

(AIG) escape regulation, lending standards abandoned, impractical mark-to-market practices applied to the securitization markets, and the decades-long short sales rules repealed. None of these alone could have toppled the financial system. Taken together and combined with human nature, the current meltdown was almost pre-destined. If we could do it with a wave of our wand, the items on our wish list would take effect tomorrow morning. We'd also add the reinstatement of the Glass-Steagall Act to that list. It confined the banks and brokers to their respective businesses and was enacted in 1933 in the wake of the last great market crash. Coincidence? Hardly. It was there for a good reason and repealed in 1999 as a result of brokers envying the banks' capital and the banks lusting after the brokers' profits. Their lobbyists went to work and Congress was happy to oblige. Oh yes, one more thing: subject hedge funds, including AIG, to the same regulatory oversight that firms like ours currently "enjoy". There is a common theme here: We favor a return to the regulatory landscape of 15 years ago when things worked pretty well. We'd like to see it happen before the stock market returns to valuations of 35 years ago.

Speaking of Valuations

We shared our worst-case scenario for stocks with clients toward the end of the 2008. We pointed to the historical precedent of the mid-70's as a possibility, not a probability. That was a time when the S & P 500 traded at roughly 10x earnings and .90 of Book Value. Few, outside of those calling for an apocalyptic end to all markets, shared our opinion. Today, those metrics have gained considerable traction on CNBC, Bloomberg, and in the print media. We actually view that as good news since it's precisely what is usually heard near major market bottoms. That doesn't mean we won't see a 500-550 S & P level but it doesn't make it more likely either. Opinion is catching up with the reality of the systemic break in the financial system and the longer-term effects of that on the cyclical economy. Congress can now only plead incompetence and not ignorance in dealing with the problem. If they see it on TV or in the Journal, it must be true. Gentle Ben Bernanke, who has been attempting for the past year to educate Congress along with the current and former administrations, has become Big Ben and finally found his audience. Hearings on modifications to the Mark-to-Market Rule could start next week and Barney Frank teased us this week with a possible endorsement of a return to the old short sale rules. If policy initiatives put a fix on the financial system in the very near future, our worst case becomes a more remote possibility.

Market Bottoms and Portfolio Bottoms

With our worst-case scenario not entirely off the table, we think it's too dangerous for all but the most aggressive investors to attempt to catch the absolute bottom of this market with a full equity allocation. We recommend all investors determine a worst-case level for their personal portfolios by taking their current equity allocation and multiplying that by our worst-case 30% decline in stocks from current levels. They should consider that as the dollar amount that could disappear prior to the market making a recovery and view it as a bet that they'll ultimately recover along with much more three or four years from now. Investors who can't afford that bet should lower their equity exposure to a point where they can. If our wish list were to come true today, we'd expect to see the market rally as much as 20%-25%, driven by short-covering and traders seeing confidence return to the credit system. When the dust settles on that advance we will still face the challenges of a severe slowdown in the cyclical economy that could take unemployment up to levels of 10-12%, further impede consumption, and dampen business spending well into next year. In addition, the housing downturn will be with us for at least five years, possibly more. That makes it likely that any initial rally will be followed by a retrenchment as investors deal with the after-effects of the worst recession in 30 years. It is that pullback that we anticipate will be an opportunity for side-lined investors to increase their exposure to equities in anticipation of an investable rally that should occur with the bottom in and the market looking forward to an economic recovery in 2011.

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