



Market Commentary

September 15, 2008

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Equity Markets Stumble: Implications for Strategy

The unprecedented series of events of this weekend, including an expected Lehman bankruptcy, Merrill acquisition by Bank of America, and AIG's appeal to the Federal Reserve for aid is all part of the ongoing de-leveraging of the economy that we have been discussing for some time. The implications of this is that the credit system will remain in a delicate state for an extended period of time, leaving tighter credit conditions, somewhat higher borrowing cost for qualified borrowers, and leaving out less qualified borrowers.

In light of this, our expectation for recovery must now be pushed out beyond the first quarter of 2009. We are not changing our asset allocation based upon these events but have changed the period of time over which we had expected to increase our equity exposure.

At this juncture, we should take a moment to re-examine some of the things that the equity markets have going for them and what continues to work against them:

More Attractive Valuations

The equity market a year ago appeared richly valued with the S&P 500 reaching a peak of 1,565, which was 18.5x our expected earnings figure of \$85 for the full year (keep in mind that consensus wisdom at the time had earnings for the S&P 500 well over \$100). Today, the S&P 500 is down over 20%, with the financial sector down more than twice that amount. During this time, Treasury bond prices have risen and the risk premium paid to own equities, along with many other kinds of risky assets, has increased. Therefore, an incentive for new buyers has been reinserted into the calculus for equity investing.

We estimate, based on a recessionary case for the economy, that S&P 500 earnings will be closer to \$80 in 2008 – a modest decline from last year's actual earnings of \$82.54 as reported by Standard & Poor's on their web site. While analysts continue to expect a 35% earnings resurgence in 2009 to \$106, we find that estimate to be exceedingly optimistic based on what we expect the economy to deliver in coming months.

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Allowing for the lower interest rate environment and factoring in much lower than consensus earnings for 2009, we place a new estimate of the S&P 500's "fair value" range at **1,260** to **1,390**.

Credit Contraction?

This week we should get another installment of quarterly data on credit demand from the economy in the form of the Flow of Funds Report. Our readers know that we have been watching the net new borrowings number from households to provide us a window into the real condition of the American household and as an indicator of how deep this credit-driven contraction will be. We note that, in the past, a two-thirds contraction in net new borrowing typically marked the bottom in terms of a credit slowdown. To date, we have seen new credit demand slip to a 3% annual growth rate after growing at closer to 16% at the peak of the housing bubble. Any outright contraction in this figure would be unprecedented in modern history and would force us to confront an outright deflation – something not seen in the United States in over a generation.

For what it's worth, we now view further rate cuts a near certainty. In addition to this weekend's drama, every ingredient into our Policy Bias Indicator (seen below) now signals rate cuts are needed. Specifically, the forward inflation spread priced into the TIPs market has now collapsed (now below 2%); the term spread has been moving sideways for much of the year (rather than rising); the level of default risk priced into credit markets has been rising; the cumulative advance/decline line for the major U.S. exchanges continues to make new lows; and the trade-weighted value of the dollar has spiked materially since the housing bailout bill was announced in mid-July.

Federal Reserve Policy Bias Indicator



Earnings Slump

The earnings correction continues, and we expect it to continue for several additional quarters. In addition, analysts seem to be far behind the curve in terms of cutting their expectations and outlook. From an economy-wide perspective, for example, after-tax corporate profits through the second quarter slipped to 9.5% of GDP from its prior multi-decade peak of 10.9% achieved in the fourth quarter of 2006. The average ratio has been closer to 6% since the early 1960s and has been as low as 3%. While peak-to-trough cycles for profits can last for several years, typically the negative effect of slipping profits on stock prices abates once investors and analysts adjust expectations accordingly. Unfortunately, we believe that there is further adjustment ahead.

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Confidence on Main Street

Another spot to check is consumer confidence as a barometer for economic conditions and attractive entry points to markets during times of distress. Since past recessions usually last for a year or more, and since markets anticipate economic recovery about halfway through, it is interesting that markets tend to perform best from periods of very low optimism, which are often associated with low points or panic in the economy. Current readings on confidence are very low indeed and near every past recession bottom since 1969. A long-run-oriented and contrarian investor (with much fortitude) would tend to find this environment an attractive one to build positions in anticipation of recovery in years ahead despite the ominous overtones in the economy and media.

Housing Overhang

Housing remains a serious concern to us as the supply of homes for sale remains excessively high and signals further deterioration in prices ahead. Of course, such deterioration is not a welcome forecast for banks and investment banks who are hoping for stability in order to stop the erosion of bank capital. Such erosion has the immediate effect of unleashing the kind of chaos now playing out among venerable Wall Street financial institutions but also has the potential to seriously inhibit a recovery in credit availability and the broader economy in the years ahead. That outcome could materially affect the outlook for equities if such credit availability becomes increasingly scarce.

Conclusion

The events currently unfolding are part of the de-leveraging process that the economy must now endure. The process is far from complete, and the secondary, fallout effects on the economy are not yet fully determinable. What is clear is that this process is not optional, but mandatory, and the ultimate course this will run is unknowable with certainty. We also know that the vetting of issues and the weight of market forces will cause uncertainty to be removed over time one issue at a time.

After a careful review of these and other considerations, we are making no immediate change to our asset allocation as the result of the current volatility. However, we now expect that secondary effects as the result of the fallout of the de-leveraging process will extend the timeline for recovery. Therefore, while we continue to look to add to our equity position over time, the pace of such additions will likely be slower than previously envisioned.

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Recommended Asset Allocation

	Growth	Balanced	Conservative
INCOME & OTHER	14%	39%	64%
DOMESTIC BONDS	11%	30%	49%
Money Market	1%	2%	3%
Short-Term Treasuries	2%	5%	8%
Intermediate Term Treasuries	1%	3%	5%
Inflation Protected Treasuries	1%	3%	5%
Investment Grade Corp Bonds	4%	12%	20%
High Yield Corporate Bonds	2%	5%	8%
COMMODITIES & OTHER	3%	9%	15%
Preferred Equity	1%	2%	3%
REITs	1%	2%	3%
Gold	2%	5%	8%
COMMON STOCKS	86%	61%	36%
DOMESTIC COMMON STOCKS	66%	47%	28%
U.S. SIZE & STYLE	66%	47%	28%
Large Cap Growth	32%	23%	14%
Large Cap Value	16%	11%	6%
Mid Cap Growth	10%	7%	4%
Mid Cap Value	6%	4%	2%
Small Cap Growth	1%	1%	1%
Small Cap Value	1%	1%	1%
FOREIGN	20%	14%	8%
DEVELOPED	13%	3%	5%
EAFE Growth	10%	7%	4%
Germany	3%	2%	1%
EMERGING	7%	5%	3%
Brazil	4%	3%	2%
South Korea	3%	2%	1%
TOTAL PORTFOLIO	100%	100%	100%

Recommended Sector Allocation

	Suggested Weight	S&P 500 Weight*
U.S. Equity Sectors		
Energy	5%	13%
Technology	17%	17%
Materials	3%	3%
Industrials	8%	12%
Consumer Discretionary	6%	8%
Health Care	24%	12%
Utilities	3%	4%
Consumer Staples	13%	10%
Telecommunications	8%	4%
Financials	15%	18%
Total	100%	100%

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