

Half-Empty or Half-Full? Revisited

“When written in Chinese, the word ‘crisis’ is composed of two characters. One represents danger and the other represents opportunity.” *John F. Kennedy*

Review

Didn't 2008 seem to go on forever? In 1931, 77 years ago the stock market fell 43.3%¹. With a drop of 38.5% by the Standard and Poors 500 last year was the second worst in the record book. Other records we may prefer to forget for 2008 include:

Dow Jones Industrials	-33.8%
Wilshire 5000 (total market)	-38.7%
Russell 2000 (small company)	-34.8%
Morgan Stanley EAFE (international)	-45.1%

The wealth of American families plunged nearly 18% in 2008, erasing years of sharp gains on housing and stocks – marking the biggest loss since the Federal Reserve began keeping track after World War II². The Fed said that U.S. households' net worth tumbled by \$11 trillion – a decline in a single year that equals the combined annual output of Germany, Japan and the U.K.³.

It is important to recall that the 2008 net worth decline follows a generally successful period where the S&P 500 realized a compound average growth rate from 1988 to 2008 of 8.8%⁴.

Except for 10-year plus Treasuries, the bond markets in 2008 also suffered. Corporate 'junk' bonds fell 26%. Investment-grade corporate bonds lost 7% while the average investment-grade municipal bond lost 4%. Securities backed by sub-prime mortgages, auto loans and credit-card receivables fell 21%⁵. The Fed cut its key interest rate several times in 2008, from 4.25% to a target of 0 to 0.25% in December, a historic low – which is the current rate today.

With a larger perspective, the S&P 500 hit an intra-day high October 11, 2007 of 1,576. Last Friday March 27th the index opened at 813, a market decline of more than 48.4%. We all witnessed the failures of many significant financial enterprises including Bear Stearns, AIG, Fannie Mae, Freddie Mac, Lehman Brothers and others may follow such as companies in the automotive industry.

Current Perspective

As of March 26, the year-to-date return of major market indices are as follows:

Dow Jones Industrials	-11.7%
Wilshire 5000	-9.2%
Standard and Poors 500	-9.9%
Russell 2000	-14.6%
Morgan Stanley EAFE	-11.2%

Also for the year so far:

Crude oil is \$52.77/barrel	+18.32%
Gold at \$935.40/troy oz.	+5.86% ⁶

Also, the U.S. Labor Department has reported that the total number of people claiming unemployment benefits jumped to 5.56 million, higher than expected, and a ninth straight record-high⁷. The Commerce Department reported today that the economy shrank at a 6.3% pace at the end of 2008. Many feel the economy will continue on this path through the second quarter of this year; a pace of minus 5 to 6%.

Historically, the equity markets begin their recovery about 6 months prior to economic recovery. We note that only 20 days ago the Dow Jones Industrials bottomed at 6,469 – currently up nearly 20%. Similarly, the Standard and Poors 500 has recovered 22% since its March 6 low of 666. And, since March 9, the Russell 2000 has risen 24.5%.

We are seeing a bit of “light at the end of the tunnel” in recent days. The Commerce Department reported that durable goods orders and new home sales unexpectedly rose in February. Orders of big-ticket items expected to last at least three years climbed 3.4% last month, far better than the expected 2.5% fall⁸. New home sales rose 4.7% after falling for seven straight months⁹.

Productivity is soaring. Fourth quarter 2008, output per hour (non-farm) increased at a 3.2% annual rate, even as output declined 5.5% due to cuts in payrolls¹⁰. Over the past year, output per hour grew a solid 2.7%, a pace that offset most of the additional labor cost arising from the 3.5% increase in workers’ payroll benefits¹¹.

We are seeing price gains in commodities other than crude oil, which is also true for the stocks in commodity-exporting countries such as Brazil. Copper is up about 5% while tin prices have risen 7% so far this year. Investors call this reflation trade – a bet that the global businesses will successfully stave off both depression and deflation¹².

Mortgage applications surged 32.2% for the week ending March 20. Mortgage rates fell 26 basis points to 4.48%, a record low. Refinancing of mortgages surged 41.5% for this week¹³. The drop in rates can be in response to the \$75 billion mortgage relief plan presented by President Obama two weeks ago. Its objective is to keep as many as 9 million Americans from losing their homes to foreclosure. Of the 52 million U.S. homeowners with a mortgage, about 13.8 million or 27%, owe more on their mortgage than their house is now worth¹⁴.

Current Legislation

The compromise \$789 billion U.S. economic stimulus plan, along with last year’s \$700 billion Troubled Asset Relief Plan appears to be the most ambitious (and expensive) effort in U.S. history to rebuild the financial health of millions here and abroad.

Last week Fed chairman Ben Bernanke announced the Federal Reserve will buy nearly \$1.2 trillion in U.S. Treasury obligations, to fight a deflating economy by increasing money supply. In effect, the Fed intends to monetize the Treasury debt in an amount that exceeds the entire pre-2008 monetary base of the U.S.

March 23rd, Secretary of Treasury Tim Geithner, unveiled the administration's "Public-Private Investment Program" where taxpayer funds will help private investors leverage their money to buy up toxic assets such as bad mortgages and other debt held by banks across the U.S. The government will then share in the risk, but also in the reward if those assets make a profit. The Treasury Department is looking at a nearly \$1 trillion price tag for the program to get credit flowing again. An example presented by Mr. Geithner would be the purchase of a batch of bad mortgage loans with the private investor investing up 6% of the cost with the rest provided by the government - the FDIC covering 85% of the cost with a loan and the remaining 9% coming from funds from the \$700 billion bailout program. The same day the stock market rallied 7% on news of this new program to unfreeze credit. Our concern of this plan is the determination of value of toxic assets and the price paid for them by investors, and more significantly, the FDIC and the Treasury Department, along with the banks selling the assets.

According to the March 20, 2009 International Herald Tribune, all of the President's budget proposals, if carried out would, "produce a staggering \$9.3 trillion in total deficits over the next decade"¹⁵. I have heard on the evening news that these proposals and legislation total more than all the spending of all previous presidents in U.S. history! The president's budget proposal for the next fiscal year beginning in October totals \$3.6 trillion. The Tribune reports that the national debt currently stands at \$11 trillion, with about \$6.5 trillion owed to individuals, corporations government and other lenders¹⁶.

Outlook

Because so much has happened in the last four months in the business sector, in Washington D.C., and around the globe, it is a challenge to stay current on events. The economic situation is generally negative. The nation lost 651,000 jobs during February, the third straight month in which job losses exceeded 650,000¹⁷. The economy has lost nearly 4.4 million jobs since the recession began in December 2007.

We anticipate GDP to fall 5-6% this first quarter followed by a more moderate drop in the second quarter. Car sales, manufacturing and consumer confidence remain low. There are bright spots namely in real estate with the number of unsold homes falling, along with growing demand for single family homes. Retail sales excluding autos, were up 0.7% in February, which surprised several analysts¹⁸. Also household debt dropped at a 2.0% annual rate last quarter, the first decline in many years.

We at Marathon are uncomfortable looking to Washington on a daily basis to get additional understanding of where the markets and our economy are heading. Are we headed into a depression? Is the Obama administration in the process of over inflating our economy or is it handling it like Goldilocks.... 'just right' with the proper amount of stimulus? What will be with the skyrocketing issuance of government bonds... Will there be enough buyers to keep interest rates low?

The elephant in the room of course is the growing debt and the service on that debt. According to the Investors Business Daily over the next decade, the administration's plan will produce annual deficits averaging 5.3% of the economy – compared with a post-war average of 2%¹⁹. Some analysts anticipate national debt doubling to \$15 trillion over the next decade. Again, the question is open whether or not an economy that gains its footing and grows (we

anticipate that it will) can generate the necessary tax revenue to service and eventually pay down the national debt.

So where do we go from here? We, and others in our industry, do not have definite answers – we do have indicators that we watch and principles that we employ in making investment and financial planning decisions and recommendations.

Some of the positive indicators we look for from Washington and nationally are:

- Following the rule of law, especially property rights – including legal contracts taking into consideration compensation
- A stable U.S. dollar
- Keeping tax rates low – including corporate and payroll taxes
- The ease of starting a new business – many of this country's most dynamic companies had their start during a recession
- Minimal barriers to conducting business, whether overseas i.e. tariffs or domestic (i.e. onerous licensing procedures)
- Growth of high-end innovative jobs based on advanced education such as scientists and engineers - establishing new growth industries such as internet based companies like Amazon.com
- Less emphasis on federal government spending and more private business investing for future growth

In conversations with clients we often mention that after a 55% drop in the S&P 500 index another drop of similar magnitude (based on a point level, not return basis) is impossible since the index would be negative. We need to recognize that 2008 was an aberration from the norm. We need to remember that “stocks work” – that the same Standard and Poors 500 for the last 60 years, including 2008 was positive for 70% of those years while negative for only 30%.

Realize that investor pessimism, at extremes such as now, is a contrary indicator. This happens because investors fail to follow their long-term strategy having suffered significant losses on paper. Historically the average recovery in 12 months after reaching a market bottom is 41.56%²⁰. According to SmartMoney™ if you remained fully invested in the S&P 500 for the 20 years between 1987 and 2007, your average annual return came to nearly 12%. However, if you missed just the 10 best days during that span, your return fell to about 9%. Miss the 30 best days in 20 years... your annual return came in less than 6%²¹. This is why we consider market timing a speculation strategy inappropriate for most if not all of our clients.

Additional recommendations for our clients:

- Avoid information overload i.e. CNBC and business cable stations 24/7. We suggest going to the library once a week or subscribing to Barrons – a weekly financial digest.
- Do not halt retirement contributions
- Stick to your investment objectives
- In the eventual upswing, avoid investing in one industry – expand the diversification of your investments

Finally, remember that currently about \$5 trillion is currently invested in money markets and small CDs. A significant portion of this money wants to go back to the equity markets from where it came from. The various legislative acts currently in and passed by Congress may work. Money supply is skyrocketing yet interest rates (currently) remain low. Consumer and business loans are being made. In fact these loans are running 7.7% ahead of last year, and total commercial bank lending is up almost 5%²².

Finally, we suggest setting meetings or phone appointments to address specific issues and questions you may have. We all realize this is a most stressful and difficult period. As in past recessions and “bear” markets we always recover and reach new highs. Usually when we least expect it, so lets plan for it!

“The most important single central fact about a free market is that no exchange takes place unless both parties benefit” *Milton Friedman*

Yours,

George Gumbiner
President

Footnotes:

¹ Wealth Manager Magazine, December 2008 page 29

² Wall Street Journal, March 13, 2009 PC1

³ Ibid

⁴ Wikipedia.org/S&P500 Market Statistics

⁵ Wall Street Journal, January 2, 2009 page R3

⁶ Wall Street Journal, March 26, 2009 page C4

⁷ www.msnbc.msn.com, March 26, 2009

⁸ Investors Business Daily, March 26, 2009 page A1

⁹ Ibid

¹⁰ Businessweek, February 26, 2009 page 10

¹¹ Ibid

¹² Wall Street Journal, February 2, 2009 page A3

¹³ www.standardandpoors.com, March 26, 2009

¹⁴ www.msnbc.msn.com, February 18, 2009

¹⁵ International Herald Tribune, March 20, 2009

¹⁶ Ibid

¹⁷ The Value Line Investment Survey, March 20, 2009 page 3629

¹⁸ Standard and Poors NetAdvantage, March 20, 2009

¹⁹ Investors Business Daily, March 24, 2009 page A10

²⁰ Fidelity Investments Institutional Services, March 2009

²¹ www.smartmoney.com, March 3, 2009 ad drops

²² Investors Business Daily, March 20, 2009 page A14

