



Market Comments November 21, 2008

So, let's make it unanimous – Japan is now officially in recession, and essentially the Eurozone is as well. The Philadelphia Fed announced in the last few days that it believes the U.S. is also in a recession, has been since this past spring and, further, that it expects the downturn to last 14 months. By the way, just a note about Japan in this period. Even though technically in recession, all is not bad for the second largest economy in the world. Jason Clenfield (Bloomberg.com) noted recently that after a boom 20 years ago Japan went through a period in which the Nikkei 225 lost almost 70% of its value, and the country suffered a decade long malaise. That was then and now is now so to speak. Now almost a quarter of the companies listed on the Tokyo Stock Exchange are debt free compared to 6% a decade ago. Japan's banks have deposits that exceed the value of their loans by a third, and lenders also stayed clear of the risky investments that have decimated Wall Street. As to sub-prime loans – whether just plain good luck or otherwise, the Japanese banks essentially did not globalize. Losses from sub-prime loans are approximately \$15 billion – a fraction of what exists at U.S. banks, or estimated at 2% of the world total.

The same cannot be said for U. S. markets. Over the past month or so, equity markets have been in close to free fall – in October alone U.S. markets lost almost 17%. While the news during this period has been very poor, the fact is that most all economic news has really been “old” news. The world-wide downturn, retail sales (through October this measure is now down 4.1% versus a year ago, the worst one-year comparison on record), initial claims for unemployment and so forth – most all of this is old news. Markets are just not going to be surprised by deteriorating economic news – markets know all of that. What markets do, or try to do, is to discount future events, and while the news of the day is not good, much of it is not new news – most all of this sort of news is priced into current levels.

So, what is the “new” news, or put another way, what are markets now pricing or attempting to discount? Well, the answer is, of course, the still lingering impact from the paralysis in credit markets and the duration and depth of the current world-wide economic contraction. Put another way, markets do not know the exact or precise configuration of economic downturns, and so, as in the past, we are left with forecasts by some pretty high octane folks about the expected extent of the downturn. While economic forecasts might be viewed by some as more of an art than a science, the industry does produce opinions that range from the very positive to those that are extremely negative. This sort of division of opinion is the very nature of markets of course – those who believe that these difficult economic times will be fairly short-lived and not especially deep are optimistic and on balance, buyers of stocks, while those with a more dire view of the economic landscape will have a more negative take on things and might well continue to be sellers of stocks.

For our part, we continue to believe that the economic impact of the perfect storm of sub-prime lending/housing weakness/credit crunch is finally beginning to thaw a little. We can see this in spreads in credit and debt markets, and also in recent loan data from banks. In October alone, banks increased commercial and industrial lending by 4.2%, real estate loans by 3.4% and consumer loans by 2%. So, while securitized non-bank lending is still at a standstill, other lending is showing some life. This would also suggest that for some weeks world-wide equity markets have moved on, to a degree, to pricing the next part of the problem, which is the resulting world-wide recession. We have also pointed out that one might be forgiven for viewing this task – pricing securities that are going through a cyclical downturn - as slightly better than having to discount or price assets that are being marked down due to an almost collapse of credit markets. Markets have priced the former for over a hundred years, while markets have almost never had to discount or price the latter.

Not surprisingly, we tend to view the glass as half full, rather than half empty in this sort of debate. We can say this because we expect markets to behave in this instance similar to periods in the past – that is, begin to recover long before actual economic activity begins to show strength, and by a time period of 6 to 12 months. Therefore, if we assume that negative growth will continue for another 9 months or even a year, we can be increasingly optimistic about the expectations for markets from this point. In short, if the world is likely to experience some economic recovery by late summer or the fall of 2009, we would expect equity markets to begin to recover over the next several months.

There is also the very compelling story now with regard to cash. Money market fund assets totaled \$3.5 trillion at the end of September versus \$13.3 trillion of stock-market value valuation. This level leaves the ratio of liquidity to market value at a near record of 25%, representing significant demand. As to valuation levels – the current decline leaves U.S. markets at 12 times trailing 12 month earnings, levels not seen in 20 years.

Lastly, we may very well see a slight re-play of the environment that existed for a good part of 2008 – that the U.S. was being helped along economically through the year by the strength in the Eurozone and in Asia. The OECD recently issued its forecasts for recession in the U.S., Asia and in Europe over the coming months. Not surprising, their estimates are for the U.S. to experience a greater contraction than either Europe or Asia. This is not all bad – we do exist in a global economy, and should it turn out that other parts of the world recover faster than the U.S., the effects will aid recovery in the U.S., ultimately driving earnings and a recovery in stock prices. In this sense, the relative strength of the Japanese economy is good news for the U.S. In the end, while it may well be difficult to see clearly the precise duration of the economic downturn, it is possible to venture an opinion about the parameters, and therefore the likelihood of a bottoming process for equity markets. We are increasingly optimistic about that prospect and expect a much better environment for stock prices over the next few months.

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