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Investment Matters

For the quarter ended September 30, 2008

Stocks: Cyclical Low or More To Go?

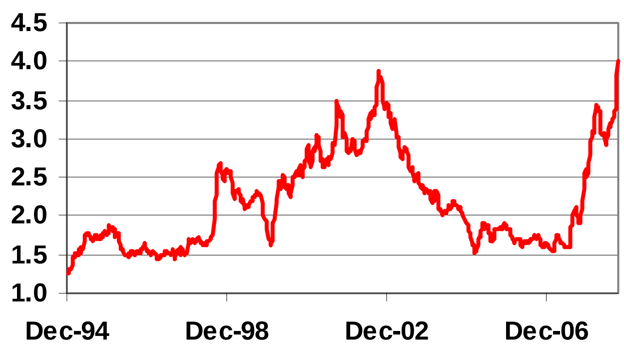
Before inflation was brought under control in the early 1980's, stock prices followed a 3-5 year pattern which matched the ups and downs of economic cycles.

But during the subsequent twenty years, market cycles became far less apparent. First, economic cycles from 1982 until 2001 lasted ten years not 3-5. Second, with falling inflation, stock and bond prices maintained a strong upward bias, smoothing the market price effects of economic fluctuations.

Now, with disinflation over, the stock market appears to be returning to a more cyclical pattern. If this is true, what does the history of past stock market cycles tell us today?

First, classical bear markets have usually gone to gut wrenching extremes. The current stock market is serving up large doses of both, enough to suggest a market bottom.

Second, the low points of classical bear markets have been marked by very low short term interest rates. The current Federal Funds rate is 2%, more than 3% below the level of current inflation. This means that short term money is being lent with little expectation of a real return.



TRIPLE B RATED CORPORATE BONDS PAY A RECORD 4% MORE THAN COMPARABLE TREASURY BONDS

Third, at market bottoms long term interest rates are always somewhat higher than short rates. With 10 year Treasury bonds now yielding 3% more than short term Treasury Bills, the extra yield associated with owning longer term bonds is near the typical extreme of previous stock market lows.

Fourth, triple B rated corporate bonds are now yielding 4.0% more than comparable Treasury bonds. This is the highest corporate yield spread in 46 years. The previous record yield spread occurred same week as the last major stock market bottom in 2002. The corporate yield spread reflects fear that corporations may default on their bonds. That fear is now extremely high.

While no indicator can tell you when the stock market has stopped falling and economic woes will give way to recovery, they can reveal when fear and pain have reached the high levels associated with past market bottoms. That appears to be the case today.

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The Panic of 2008

The current financial crisis is the modern version of the bank failures which produced financial 'panics' in the 19th century. Banks borrow short term money from their depositors and use the money to make long term loans to businesses and homeowners. If depositors lose confidence in the bank, they all demand their money at once, a so called 'run on the bank'. Because the money is tied up in long term loans, the bank is unable to pay all their depositors and the bank fails.

Over the years, as a result of the hard lessons from financial panics, our government learned how to control the risks associated with banking. The Federal Reserve system, Federal Deposit Insurance and the agencies which regulate bank activities are some of the more noteworthy safeguards.

But the financial system is not static. New financial technology made it possible for organizations which were not banks to assume the essential role of banks, i.e. borrowing short and lending long. We now realize that it did not matter that complex financial instruments were employed to control, diversify and insure the risk inherent in

Continued on page 2.

Panic: continued

long term lending; when enough of the loans went bad, the solvency of the system was questioned and confidence plunged. And it did not matter that the short term lenders who supplied the money for the long term loans were investors instead of depositors; when they lost confidence and stopped lending, it had the same effect as a bank run.

With this idea in mind, here are some of the players who contributed to these unfortunate developments. Some were greedy but most were well intentioned. All suffered from hubris.

The Federal Reserve: The Fed controls short term interest rates and the money supply. When the technology bubble burst they kept their foot on the monetary gas peddle for too long. They failed to realize that excess efforts to recover from the bursting of the technology bubble would help to create a new bubble in real estate .

Congress: Congress wanted to increase home ownership, particularly among less advantaged people. Rather than appropriate tax revenues to support this initiative, they passed an unfunded mandate which forced banks to make mortgage loans to people who previously did not qualify. Also, with the same good intentions, Congress protected mortgage giants Fannie Mae and Freddie Mac from efforts to rein in their unprecedented growth. They failed to see the rising risk and opposed reform which would reverse it.

Investment Banks: These institutions historically made money by helping businesses raise money in the investment markets. But as sophisticated financial tools were introduced they found new profits in the mortgage market. In the process they eventually took on the essential banking role of borrowing short and lending long. The difference was that, because they did not take in deposits, they were not subject to regulations which limit the risks a bank can take. Unlike banks which are limited to 10:1 leverage, investment banks were leveraged at 30:1.

The Securities & Exchange Commission: The SEC is the primary regulator of securities markets. They either did not appreciate the system-wide risk which was developing or failed to act to turn the tide.

Financial Engineers: Finance experts developed a whole host of new tools to model the behavior of financial markets and control risk. Otherwise sensible investment managers believed that employing these strategies allowed them to violate supposedly outdated risk standards. What they discovered is that their strategies could not work when everyone was using them. The risk had spread to the whole system.

Real Estate Speculators: Although too many people were duped into buying more home than they could afford, the real estate boom was fed by speculators. Many of them never intended to live in the home, only to ‘flip’ for a profit. Even foreigners got in on the action. Without the speculators, the boom would never have gone to such an extreme and the bust would have been a mild correction.

Rather than resulting only from the unchecked greed of a few, the current financial crisis is more like a large chain reaction collision on the highway. Rarely do such accidents have just one cause; they usually result from a number of small miscalculations which combine to create a large disaster.

Annual consumer spending by the Chinese is nearly $2 trillion and growing at 20% per year.

The Bottom Line: 9/30/2008

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1165	-22.0%
Small company stocks *(S&P Small Cap Index)*	361	-13.8%
Short term interest rates *(3 Month T-Bill Yield)*	0.9%	From 3.7%
Long term interest rates *(10 Year T-Bond Yield)*	3.8%	From 4.6%
Inflation *(Consumer Price Index)*	218.9	+5.4%
Energy *(West Texas Intermediate Crude Oil)*	$101/bbl.	+23%
The economy *(Inflation adjusted GDP)*	14.3 trillion	2.0%

QUOTABLE

“You never know who is swimming naked until the tide goes out.”
Warren Buffet

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