

A Sense Of Emerging Stability

2009 marks the 27th year that I've been involved in the investment industry. Sometimes it feels as if those years have passed with a blink and other times, such as today with glacial speed. Having experienced the declines of 1982, 1984, 1987, 1990, 1994, 1998, 2000-02 and 2008 patterns start to emerge when watching or listening to the public and media at large. But it was my first recession that enforced the fact that economies and markets don't bottom or peak simultaneously, as markets exploded upward in the Summer of '82 despite unemployment peaking at 10.8% three months later.

- While news of the economy and accompanying announcements of layoffs are widespread, equity markets around the world become less sensitive to the shrill declarations of doom. The author of the "Black Swan" Nassim Taleb who now speaks to standing room only crowds is completely dismissive of any economic certainties. But in fact we do know that there is a general roadmap for the restoration of values in asset classes, in which the prime component is time. Just as you cannot expect a heart attack survivor – and our economy has suffered a heart attack – to immediately commence running wind sprints. Our markets need a time to heal, not very long but at least a period of months to show stability, which is where I believe we are at now
- Human nature being what it is continually forms new bubbles once confidence has been restored. Just when you reach the point of complete disbelief in a counter move you're likely closer than you realize. I can remember visiting Colorado in 1988 and was stunned to see how inexpensive real estate was as the state was mired in a real estate crisis. All you needed to show a banker back then was proof of employment and a paycheck and the home was yours. But you would have been hard pressed to find a buyer since investors had been so beaten down to the point of future disbelief.
- Teflon-investor Warren Buffet, who has been burned by recent events as much as anyone is fond of saying "I'm a buyer when others are fearful and be a seller when others are greedy". While I have been perplexed over the years at how his reputation as an investor has remained spotless in spite of several missteps, the wisdom of his expression remains largely true. At some point down the road, our economy will show signs of bottoming. Its absurd to extend our present day issues indefinitely into the future just as it was absurd to extend the real estate boom indefinitely as well.

Asset class bubbles and deflations are an ever-present fact of life in the world where a semblance of Capitalism exists. Little has been said in public circles of the current bubble in Treasury bond prices. To deny the existence of this bubble would equate to revisiting real estate in '06 or stocks in 2000. Money has come out of equities, hedge funds, commodities, and corporate bonds in tidal wave fashion driven by fear to Treasuries. Credit yield spreads are now the widest in our lifetime, assuming you don't have vivid memories of 1932.

This is a roundabout way to mention forcefully that its imperative to remain open minded that a major move in equities could happen. While I have no desire to force the issue, I'm content to remain patient for the impending signs of such a move to evolve. This would be a ludicrous statement if the stock market had continued its decent lower, but it hasn't. Treading sideways is frustrating no doubt but at this moment in time the future of earnings, earnings growth and the effects of Obama's stimulus plan remain largely in doubt, so we wait. When you consider that Treasuries now yield nil, real estate is still declining the move to holding 100% cash and earning nil is as senseless now as being 100% committed to equities, we are in a moment "in-between" a gray twilight between dark and dawn. Just remember that in late 2007 when the markets were riding high there was nary a negative blip in the media and what negativity that did exist, highlighted a shallow economic slowdown at worst. Now that financial and economic Armageddon have been priced in, Obama's economic team has tilted policy to housing revival with lowered interest rates and declining prices, combined with continued immigration and demographic shifts the question now seems more inclined to "when" as opposed to "if"

How do we know we are in the healing phase of the markets and not merely the pause before another major decline? There is no certainty yet, but there are positive hints:

- **Declining New Lows:** On October 11th when the SP500 first reached 850, the number of stocks making new lows exceeded 3000. On January 20th the SP 500 touched 804 and the number of new lows was 186. Despite the SP500 being actually lower than 10/11, the number of stocks making new lows is only a tiny fraction of previous sell-offs. This trend has been apparent since November when the index made what might be the ultimate low for this Bear Market of 740 yet the number of new lows was just 600. In addition, trading volume and the Advance-Decline line is nowhere close to levels seen in November. Is this relative? A drop-off in New Lows has been seen in every Bear Market bottom since WW2.
- **Lowry's Research** (established 1938) has noted that new bull market rallies do not coincide with peaks in selling pressure. However they do mention: "it is possible that the next time the market reaches a deeply oversold condition, we may find that Selling Pressure has remained well below its November high, setting up the possibility of a more lasting rally from the next bear market low." So far, Selling Pressure is not close to November levels but investor demand has been tepid as well.
- **Crude oil prices:** Although we all love paying less at the pump, the extraordinary losses in crude are not a positive harbinger of economic growth or stability. Aside from the fragility in developing countries reliant upon crude for national income, the decline in oil is also symptomatic of economic weakness. Stability in oil prices may mean we're reaching stability. Considering that Exxon is now the largest cap stock in the SP500 only further reinforces the need for oil price stability.



- **The Baltic Dry Index** of shipping rates for container ships has leveled off after a precipitous decline. The Baltic Index is a very good forward indicator of worldwide economic activity. It reflects the prices paid to hire an oceangoing freighter to haul goods or raw materials. In recent years, China has been a driver in pricing with their economic expansion.



- Monetary Policy and Credit Spreads (Chart 2):** The Fed has cut the funds rate to 0%-.25% which essentially means that banks and investors will earn virtually nothing on overnight rates or Treasuries and has publicly stated rates could remain this way for a while. The effect will be to force banks and investors out farther on the risk scale once some level of confidence returns. My guess is the trickle down effect would first be felt by increased buying interest amongst corporate bonds, mortgages and preferred stocks before reaching to equities. However the correlation of huge credit spreads and future stock performance is undeniable, when you look at the credit spread peaks you'll find correspondingly that:

June 1932: market low at 41 by August it reached 80.

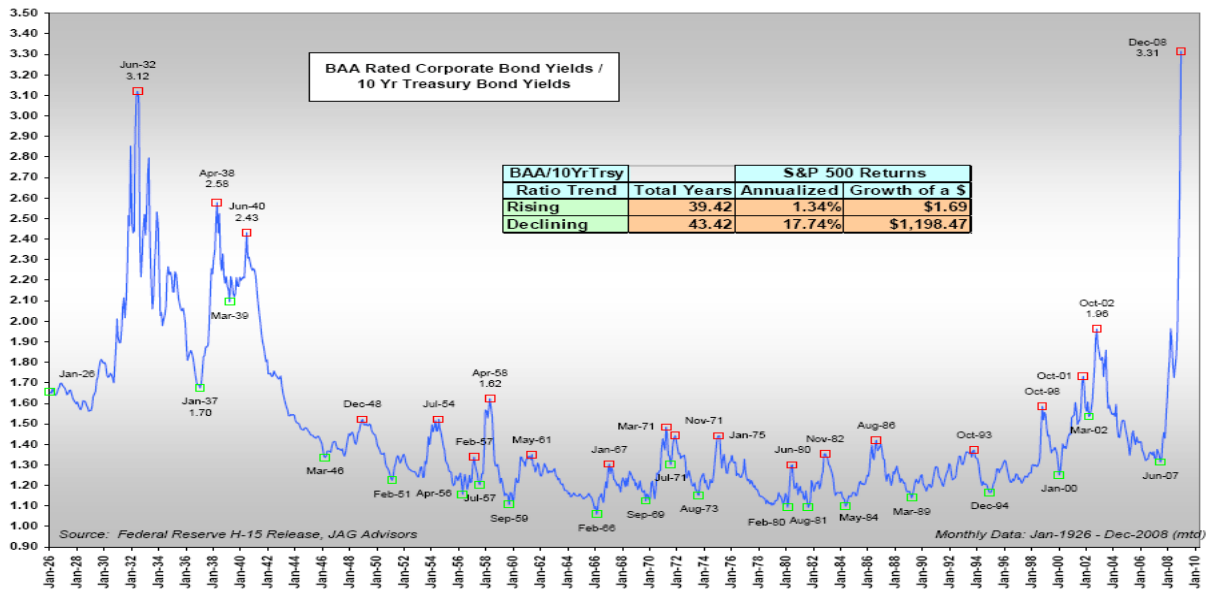
April 1938: low at 99 by November it reached 158.

June 1940: low at 111 by November it reached 137.

April 1958: the October 1957 low was 419 and by October 1958 the high was 550.

October 2002: A low of 750, retested in March '03, which peaked at 1150 by January '04.

Credit Spreads

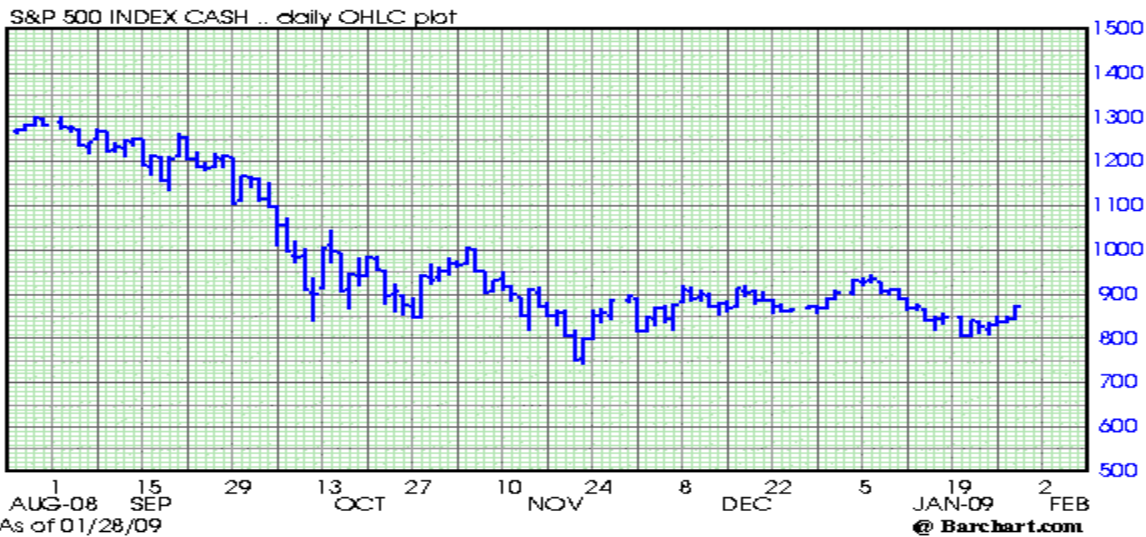
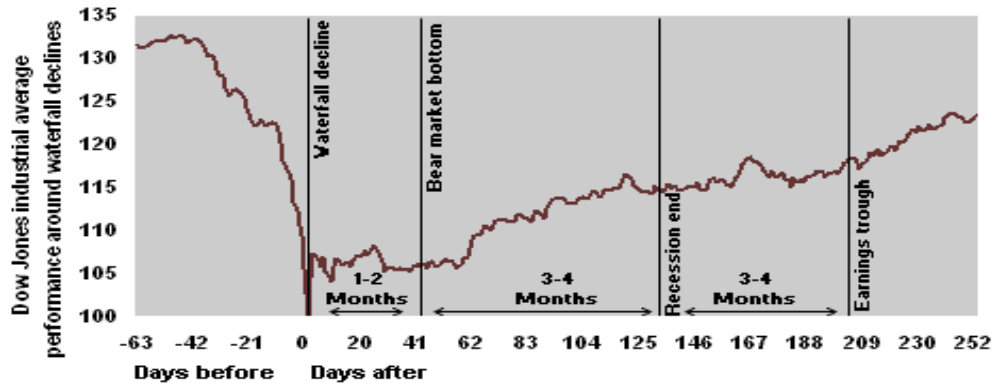


Market Mirrors: The 1938 and 1974 market decline that most closely resembles our current Bear in several aspects:

	3/31/38 bottom	12/6/74 bottom	11/20/08 bottom
Preceding Cyclical Bear Market			
Dow Jones Average % decline	-49%	-45%	-47%
Years	1.1	1.9	1.1
Concurrent Secular Bear Market			
Years from start	9	9	9
Years to end	4	8	?
Concurrent Recession			
Months from start	10	12	11
Months to end	3	4	?
Subsequent advance to high			
Percent Gain %	60%	51%	?
Months	7.5	7.5	?
Source: Ned Davis Research			

A roadmap of composite (1929-2002) post-crash DJIA performance. Ned Davis Research has done a fascinating study of post crash declines in excess of 20%. Although the “crash” phase was not the actual end of the Bear Market, the declines were not exceeded either. Retests of the market lows were very common and generally occurred within 90 days of the waterfall selloff. In our case, October 11 would be the 0 date while November 20, 2008 remains the ultimate low of this Bear decline, which perfectly parallels the composite roadmap of this chart.

Other points of merit: The waterfall selloff occurred on average of 130 days before the end of the recession, but the markets started to make progress approximately 70 days before the end of the Recession. Based on analyst estimates for the Standard and Poors 500, the approximate end of the recession could be in the 2nd or 3rd quarter of 2009, which coincidentally matches Davis’s chart.



My guess is that we're in the gray area which would correspond with Day 41 to roughly Day 70 where there is little progress made but there should be concerted effort given to analysis of industries and sectors plus investor styles which will do best in the coming months. It was also the Davis composite chart, which made me question the idea of raising cash to substantial levels after the crash in October.

But how do we invest once markets start to anticipate an economic bottom?

Keep in mind that just as our current bear market started its decent when the news was rosy, the move up will commence even though the news will probably remain bleak. On average major rallies have started 7 months before the trough in unemployment so if you wait until the headlines show improvement, it will be too late.

The timing is tricky and I don't expect to use the calendar chart as my guide, I'd prefer to allow market action to dictate when the time is right: Its better to be a little bit late than too early. Over the past months I've realized that there are better market timers than myself. So, in December I employed the most respected market timing service available to assist with major investment allocation decisions: Lowry's. Lowry's is a very old school (1938) market timing service that I believe will be invaluable in the coming years. When we're in a secular bull market, market timing will usually leave you frustrated with money on the table. But in a secular Bear market, it's a much different story.

The current Secular Bear Market probably as a few years to run. In the 1938/1974 chart, you'll notice that in their respective cases the Bear lasted from 4 to 8 more years. This would imply that although the odds are high that we're likely to see a very strong 2009 and perhaps the first half of 2010, the outer years remain in serious question. A timer such as Lowry's, which went to an "Intermediate term sell" in May 2008 will be invaluable.

The Bottom Line – Equity markets around the world have been dysfunctional and broken for going on five months, an extraordinary length of time. Fundamental relationships between valuations and trading were discarded, fear was the primary driver of decision-making. No one can be faulted for being fearful, factoring in a recession is one thing even as deep as our

present, but to also factor in the deliberate abandonment of Lehman Brothers is another matter altogether. Slowly but surely as I've tried to highlight in this letter to you, order is slowly coming back to all markets.

Great chaos should also bring great potential for those that can keep their head. Past periods of great chaos have typically rebounded with periods of extraordinary gains and to be in proper position for those gains is the focus of my efforts at this time. It's possible that we see another big bout of selling, one that could return us to the November 20 lows but my guess is it would take an extraordinary event or issuance of even bleaker new news. Considering what we've witnessed along with the mass hedge fund and mutual fund liquidations, I would not say the odds are very high, perhaps 30%. But markets do have a lovely tradition of overshooting themselves both in the upside and downside. But so far, neither the sellers nor the buyers have been able to muster any real momentum since November. Perhaps today's news of the "Good Bank / Bad Bank" plan from the government will do the trick to the upside? But for the time being the markets are more stable, but stable in a way that would resemble two heavyweight fighters in the 15th round, exhausted and unable to muster any lasting momentum.

While an endless amount of studies and evidence continue to suggest the next major move will be to the upside, but by no means am I suggesting all is rosy and sunny forevermore. Odds are any forthcoming rally will be measured in terms of months rather than years, although any selloff would likely be a pittance to last quarter. A move to 1200 on the SP500 is very possible and that would be roughly 50%, which would fall easily in line with the 1938 and 1974 scenarios.

Small Caps over Large Caps: What could make the balance of '09 especially rewarding is that Small Cap stocks could do much better than Large Cap stocks for a few reasons:

- The Small Cap over Large Cap performance gain is only in month 7. Since 1926 the average cycle where Small trumps Large has lasted 71 months. Back in 1933 Small trumped Large by a gain of 143% to 54%.
- Since Small Caps are generally US based companies they'll see greater gain from the Fiscal Stimulus Package over Large Cap multinationals.
- Since Small Caps are also U.S. dollar based, any decline in the dollar will be a mute point for Small Caps since there is no foreign currency to dollar conversion risk.

The SP 500 is exclusively Large Cap Multinational companies, a portfolio of Small Caps should sharply exceed that of the SP 500. Hence a 30% return by the SP 500 could be dwarfed by Small Cap performance in 2009. A great example of this was 2003 when the US emerged from recession and while the SP 500 returned a terrific +21.94%, the following Small Cap Russell index's returned as follows:

- Russell Microcap +66.36%
- Russell 2000 +47.25%
- Russell 2500 +45.51
- Russell Midcap +40.06%

Data from Ibbotson Assoc. Credit Suisse and Frank Russell Co.

Interest rates as governed by the Fed are likely to stay at 0% for years. The banks are in a morass of trouble, but if they can avoid nationalization then Meredith Whitney and the other bank Bears may end up overstaying their welcome and face a giant short covering rally. One day the era of write-offs will end. Banks and financials are critical to the survival of our country; they will survive in one manner or another. If the "bad bank" scenario is actualized, bad assets can be shifted to the government who can hold them for as long as it takes. Why should a bank loan money given to it by the TARP if they believe they'll need it for future losses? Ideally, if the government takes any losses from the toxic debt the banks with equity can make the taxpayers whole. Going forward, with short-term rates at zero, bank lending could once again be an extremely profitable business once the risk of toxic debt is abated. This period will eventually end and write-offs will segue into write-ups.

Sincerely,
Brad Pappas