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## Letter From The Portfolio Manager

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### ***The Next Great Depression?***



Rusty Vanneman

The calendar on your refrigerator door may be new, but nothing much changed in the stock market in the first month of 2009. Extreme volatility remained the order of the day and stocks continued their slide, with the S&P 500 recording its worst January ever.

Late in the month, after President Obama's inauguration, the market rallied for four consecutive days amid hopes for a quick passage of his stimulus bill. Spirits seemed to be lifting and the market appeared to have a decent chance to eke out a second consecutive monthly gain. But the good feelings didn't last as stocks fell sharply in the month's last two trading sessions. Though one out of three stocks finished higher in January, the S&P 500 Index lost over 8%, while the Russell 2000, which represents small cap stocks, lost 11%.

You don't have to look hard to find a culprit for the continued weakness in stocks as a steady flow of extremely negative economic headlines has consumers and investors in a black mood. So black, in fact, that many seem to be convinced that the global economy is headed for the "Next Great Depression." We are not members of that camp.

In this month's report, we'll detail why we believe the economy is in better shape than many think. We will also discuss the role of expectations and how they impact stock prices. Lastly, we will highlight an asset class we find particularly appealing in the current market environment, and which we believe is well positioned to generate an attractive risk-adjusted rate of return.

### **Economy Not As Bad As It Seems**

Given recent headlines such as "World Economic Growth Worst Since WWII" we may sound slightly daft to argue that the economy is not as bad as currently perceived, but there are several reasons for our view.

First, while Obama and his financial brain trust have been front and center in talking about the severity of the current economic "crisis," we have to remember that to gain enough public support for a nearly \$1 trillion stimulus package, they need to convince everyone that it is absolutely essential if the economy is to avoid collapse. In that regard, a little bit of overt pessimism (possibly over done) is deemed necessary and that's what we're getting right now.

Second, in the end, even if many observers feel the package isn't the right size, or isn't targeted enough, or will take too long to implement, the passage of a stimulus bill should be a net positive, at least in the short term.

While we think the direct economic impact of the stimulus is probably over-stated, at the very least it should have positive symbolic value. It will mean that "something is finally being done;" it will get investors out of their "wait and see" mode; and lastly, once the bill is passed, the talk from the administration will

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switch from why the package is needed (i.e., the terrible state of the economy) to why the package is working and the economy is improving!

Third, in addition to whatever effect the stimulus package may ultimately have, there are a few tangible signs that the economy may already be bottoming. Though most indicators still disappointed in January, there were some important positive surprises.

The beleaguered housing market got some good news last month as existing home sales rose 6.5% in December, when a further decline had been expected. Granted it took lower prices to spur the sales (the median price fell 15.3%), but importantly, inventories are beginning to clear, falling to a 9 month supply (from 11 the previous month). We expect that this trend will continue over the course of the year as consumer confidence improves. Also supportive for housing is that the affordability index reached a record high of 158.8 going back to 1971. This reading means that a household earning the median family income of \$61,058 would have 158.8% of the qualifying income needed to purchase a median-priced existing single-family house (\$174,700) with a 20% down payment.

Also in December, the Conference Board's Leading Economic Indicator (LEI) Index was positive for the first time in many months. The gain in the LEI was mostly driven by the "continued and very large positive contribution from real money supply." This is a direct result of the Federal Reserve's lowering of its target for short-term interest rates along with "quantitative easing," that is direct buying of debt instruments. This interest rate environment suggests a better economy ahead.

Freight traffic also seems to be improving, albeit still from depressed levels. The Baltic Freight Index, which provides a measurement of the price of moving major raw materials by sea, has been steadily improving for weeks now. In addition, North American railroad car loadings also suggest a potential rebound (again from very low levels).

Situations can obviously deteriorate, however, in our view, the question to ask here is not how much worse is it likely to get, but when does pent-up demand become so strong that a floor to economic contraction is established? Let's look at two of the hardest hit industries: housing and autos. These industries have been a major source of the economic problems of late, but it could be argued that the worst times for these two pivotal areas may be behind us.

First Trust economist Brian Wesbury (an extremely thoughtful and accessible economist) had this to say about auto sales recently:

*" Figures from the Federal Highway Administration suggest there are now about 240 million light vehicles in the US, including those owned by individuals and businesses. In December, light vehicles sold at a 10.3 million annual rate. At that pace, it would take 23.4 years to replace all the cars and trucks now on the road in the US. Normally, the replacement rate for auto sales is about 13 years, and even at the bottom of the recession in 1981-82 it was only 16.3 years."*

Wesbury takes a similar approach to housing with the following:

*“Take home building: There are about 130 million homes in the US, according to the Census Bureau. In December, the latest data available, home builders started houses at a 550,000 annual rate. In other words, at the current pace of housing starts, it would take 236 years to replace all the homes in the US. To put this in perspective, homes are normally built at a pace that would replace the existing stock of houses every 75 years. Unless you can imagine everyone living in Thomas Jefferson’s Monticello – first lived in 239 years ago – this is impossible to sustain.”*

While it’s possible for the auto and housing industries to still trend downward in the short-term, it seems highly probable that we’re at least nearing the bottom, and eventually demand – even if it remains below long-term averages – will start creating positive growth in these sectors again.

On a personal note, when my family and I went shopping this past weekend we found the customer traffic at every store we passed to be surprisingly heavy – even heavier in some cases than what we saw during the holiday season. Even our favorite family restaurant had a line out the door. Maybe it was just the respite of nice weather in what has otherwise been a tough winter, but whatever the reason, the mood (and the lack of parking!) surely did not match the gloom we have been reading about in the news.

The current recession is now about 14 months old. The average recession since WWII has been 10 months and the longest has been 16 months, which happened once in the 1970s and once in the 1980s. We are surely going to surpass that length, so in that respect, this recession is going to be the worst since the 1930s. That said, it doesn’t mean it will be as *bad* as the Great Depression. Money-manager John Hussman sums up our feelings quite well:

*“This is not to minimize the prospects for a further economic downturn, but to say that this is “the worst economy since the Great Depression” is like blowing up a crate of dynamite on the Nevada Proving Grounds and saying it is the worst explosion since the detonation of the atomic bomb there. Even if the statement is accurate, the comparison is absurd.”*

The current environment does not rival the Great Depression, in fact, looking at the Conference Board’s Composite Index of Coincident Indicators, the severity of the economic weakness in the current recession doesn’t even rank in the top five since WWII. In nominal terms, during the Great Depression, the U.S. economy shrunk nearly 50% from its high in 1929 to its low in 1930. Currently, our nominal GDP has contracted *only 1%* off its all-time highs reached earlier in 2008. Today’s generation of economists grew up studying the policy mistakes made in the 1930s (Bernanke in particular is a student of the Great Depression) and we have avoided repeating them so far (such as a failure to add liquidity, backstop bank assets, or pro-actively increase counter-cyclical government spending).

### **Investor Expectations Are Certainly Depressed**

In terms of consumer and investor expectations, however, it certainly feels like a depression. Even though confidence seems to be improving mildly by some measures, it hasn't been enough to prompt any significant risk-taking as people remain hunkered down in anticipation of more economic losses. As a result, investors have dropped their equity allocations to their lowest levels in years. Cash levels meanwhile, are now at their highest levels in many years. This is true not just of individual investors, but institutional investors, such as hedge funds and private equity funds.

Markets often bottom when the consensus outlook has been extremely negative for some time. That's because under those conditions, the bulk of the selling pressure is likely exhausted. Think about the tremendous amount of negative news since the stock market's panic low in early October. Despite weakening economies worldwide, historic levels of government intervention, geopolitical tensions, the Madoff scandal and more, nearly four months later, the market is basically still at last October's level. In short, the market has taken quite a few punches in recent months and hasn't pushed to new lows.

Couple this market action with the tremendous amount of cash on the sidelines now – earning not much more than 0% - and even marginal economic improvement (from very low levels) will likely create the positive surprises that can begin to fuel a market recovery.

### **Corporate Bonds Look Especially Attractive**

Valuation measures are now suggesting above-average long-term returns for stocks for the first time in a very long time. In some respects though, there is an asset class even more attractive from a potential risk-adjusted performance perspective and that is corporate bonds.

Corporate bonds come in many varieties, but to simplify, corporate bonds could be put into two buckets: investment grade or high yield. Both are currently attractive, though each has their own distinctive risk profile.

High-yield bonds, otherwise known as “junk” bonds, tend to trade much more like stocks than bonds. High-yield bonds are high-risk, non-investment-grade bonds with low credit ratings which are much more leveraged to the economy and therefore have a much higher probability of defaulting. Junk bonds need to offer higher yields to compensate investors for taking on their higher credit risk and higher price volatility. Historically speaking, high-yield bonds have rewarded investors with attractive returns. However, last year was their worst year on record. As a result, yields were recently above 20%. While defaults are clearly on the rise, those record-high yields provide what we believe is a more than adequate margin of safety. With credit conditions starting to improve and investor interest in this asset class starting to come back, we are optimistic about its potential.

Investment-grade corporate bonds may not have the sizzle of high-yield bonds, but they too appear to be quite attractive. Recently, high quality (AA) credit spreads were trading at their widest levels

in 75 years. If stocks were pricing in a deep recession, corporate bonds were evidently priced back at Depression-era levels.

Depending on what the economy does, high quality corporate bonds might just give the stock market a run for the money, especially on a risk-adjusted basis. Over the past twenty years investment-grade corporate bonds have generated returns similar to equities, but with one third the volatility.

Corporate bonds, especially investment-grade, may also start to perform better before the stock market does. There are a number of reasons for this. First, the current credit environment should continue to motivate many corporations to emphasize improving their balance sheets over investing for growth. Second, many government policy initiatives are likely to favor bondholders before stockholders. Third, as many investors begin to warm back up to riskier assets, a good starting point may indeed be investment-grade corporate bonds.

### Reasons for Hope

In summary, we think there are several valid reasons for hope in 2009, and plenty of investment opportunities for the patient, long-term investor. Several asset classes appear to be attractively priced, with some at their most appealing valuations in decades. Many potential leading indicators have improved in recent weeks. And, once we get on the other side of the stimulus package, we think the information cycle will begin to get a bit more upbeat. That should in turn start to help lift the gloom and doom that now seems to be so entrenched. Remember, it doesn't take a lot to change expectations, even extreme ones; less than a year and a half ago, in 2007, consumer confidence was at an all-time high.

### Thank You Again

Once again we'd like to express our sincerest thanks to you for your continued support. Needless to say, it was a terrible year for the stock market in 2008 and we all suffered emotionally and financially. Many of our new clients came from referrals and I'm proud to say that at the end of 2008, we had a record number of clients. We will continue to work diligently to maintain your trust and confidence.

Sincerely,



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Portfolio Manager