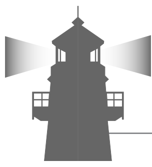

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Market Outlook

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Managing Director and Portfolio Manager

The stock market surged more than 20% last month following a public relations blitzkrieg by Ben Bernanke, Timothy Geithner and President Obama. The Dow Jones Industrials (+7.7%), Standard & Poor's 500 (+8.5%) and Nasdaq Composite (+11%) all finished the month with impressive gains, and the financial sector (+17%) led the charge. (source:Yahoo finance). We have witnessed five stock market rallies of 10% or more since last November, including the most recent, but each of the previous four left investors empty-handed. We see two key developments underlying the latest upswing that sets it apart from the others, leading us to believe it has much further to go, and could mark the birth of a new bull market.

Yet most investors still can't see the forest through the trees. The amount of misleading and inaccurate fear-driven noise disseminated on a daily basis by politicians, market pundits and journalists is overwhelming for the average investor. Most are unable to digest this stew of one-part fact, one-part fiction and lots of opinion in an effort to think clearly about events past and present. It is even more challenging to predict the future.

The Congressional outrage over AIG bonuses is a prime example of the political deflection practiced by lawmakers in their effort to divert the public's attention away from the root cause of the current crisis. They know that the dog-and-pony show some call the main-stream media will cover the bonus issue relentlessly at the expense of everything else. We are as disgusted as everyone with the $165 million in bonus payments to AIG executives, but we are more enraged over the billions in bailouts required to allow this company to make good on its legally binding contracts to other firms that were speculating on credit default insurance, and thus avert a catastrophic meltdown. If the public wants answers, then they should read the Commodity Futures Modernization Act passed by Congress in 2000 and hold lawmakers accountable.

There is no doubt in our minds that the significant discount placed on market valuations to date can be attributed to a lack of confidence, transparency and trust in the financial system itself.

This legislation was authored by Phil Gramm, endorsed by the likes of Alan Greenspan, Robert Rubin and Larry Summers, passed by members of Congress and signed into law by Bill Clinton. It paved the way for financial institutions to trade derivatives (credit default swaps) without any regulatory oversight. These are the very same derivatives, sold by AIG with reckless abandon to Wall Street firms, for which taxpayers are now paying the price. We hold these financial institutions accountable, despite the legality of their actions, but we place equal blame on lawmakers for building the framework for this disaster. Focusing myopically on an issue like bonuses, in an effort to instigate a populist tirade, is akin to fretting over a hangnail while you are having a heart attack. It has also served to sour investor sentiment and divert attention away from important developments that we believe underpin the current rise in stock prices.

There is no doubt in our minds that the significant discount placed on market valuations to date can be attributed to a lack of confidence, transparency and trust in the financial system itself. Yet we sense a renewed level of confidence contributing to the recent rise in stock prices. The SEC has announced it will reinstate the up-tick rule, which will make it more difficult for short-sellers to pursue bear raids on stocks. Lawmakers are finally addressing the need to regu-

late the credit default swap market. The Financial Accounting Standards Board will soon be announcing modifications to the mark-to-market accounting rules that have devastated bank balance sheets. These are the desperately needed changes we have been discussing for months, and they are happening!

In concert with this renewed confidence comes a bank plan announced by Treasury Secretary Geithner that we think will be successful. The irony of this plan is its similarity to the first plan introduced by Henry Paulson last October, one that we wholeheartedly endorsed, which intended to purchase toxic assets. The Public-Private Investment Program (PPIP) will partner private institutions with the Treasury to purchase the troubled assets that are eroding bank balance sheets. The Treasury will provide low-cost financing to these institutions, using up to $100 billion from the TARP, to enable them to leverage their initial investment and bid on debt securities that are trading at depressed valuations. This will create a market for these securities that has not existed for months. We also believe it will lead to significant price recovery that will benefit all parties involved. The taxpayer, represented by the Treasury, and the private institutions will realize positive returns from these investments over time. The banks that sell these assets will improve their regulatory capital position, and those that don't will realize higher market values for similar debt securities they continue to hold. We are not surprised that lawmakers and the media have defined this latest effort as "cash for trash." Based on that commentary, it is bound to work.

Sustaining the current uptrend will require more than just confidence and a viable plan to fix the banking system. It will require a gradual recovery in economic activity, and we see reasons to be encouraged about this recovery that most do not. It comes as no surprise that the recent market lows coincided with the deepest point of contraction in economic activity, but the rate of decline is moderating. Retail sales are on track to increase in the first quarter of the year, and bank lending to consumers is improving. The decline in home prices and mortgage rates has led to record levels of affordability, and we believe we are on the cusp of a surge in refinancing activity. It is likely that the economy will be growing again before year-end. Focusing on lagging indicators like unemployment and home prices is a recipe for missing a significant percentage of the market recovery. These statistics have historically never improved until well after the economy has rebounded.

Despite what appears to be a trough in the economy, investors continue to pour money into the safe havens of U.S. Treasuries and money market funds with virtually no yield. We believe this could prove very costly in the months ahead. If investors keep looking in the rear view mirror for direction, they will be run over by an oncoming train in the form of $4-5 trillion of cash earning less than 1%. Investments viewed as safe havens today could be disasters in the not too distant future, as Treasury yields rise and asset prices inflate.

We believe we are near the end of an unprecedented period of fear and uncertainty – a period during which at one point General Electric was considered to be a greater credit risk than the country of Vietnam. We must concede that we were unable to anticipate the rapid decline in stock prices that ensued from mid-September through November, but we have refused to capitulate to the doomsday scenario, and thankfully so, as March was the best performing month for the stock market in more than six years. We remain focused on the underlying value of the businesses we own, rather than on the irrational stock price declines that have occurred in recent months. In fact, we welcome the opportunity to buy more shares in these businesses at lower prices in anticipation of increasing future returns. We still see tremendous long-term value in common stocks and virtually all segments of the bond market, with the exception of Treasuries, and remain fully invested with respect to our allocations. ■

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