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Market Outlook

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Markets probed for a bottom in November as investors expressed their disdain for Treasury Secretary Paulson's indecision and ineptitude at resolving the financial crisis in credit markets. Yet stocks posted their strongest weekly performance since 1932 following the announcement that Timothy Geithner, president of the Federal Reserve Bank of New York, would be his replacement. The Standard & Poor's 500 (-7.2%), Dow Jones Industrials (-5.4%) and Nasdaq Composite (-10.8%) all finished down, but well above the lows established earlier in the month.

We are in the midst of a synchronized global recession due primarily to an unprecedented contraction in credit availability, which was precipitated by the bankruptcy of Lehman Brothers in September. Credit is the life's blood of our economy. If you own a profitable and growing business, but you abruptly lose the line of credit you depend on to fund your day-to-day operations, you are out of business. This credit crisis has become an epidemic, and until it is resolved, the recession in economic activity will only deepen.

> Despite our expectation for continued volatility in the weeks to come as the bottoming process continues, we believe we are embarking on a period of significant outperformance for the stock market in the months and years ahead.

Treasury Secretary Paulson proposed, and Congress passed, the $700 billion Troubled Asset Relief Program (TARP) in October with the stated intent of purchasing "troubled assets" from lending institutions. These assets are debt securities comprised of a variety of consumer loans (mortgage, auto, credit card). It is the decline in value of these securities held by lending institutions that has led to the contraction in credit. The value of these securities has plummeted during the course of the year, in contrast to the performance of the loans they hold. Forced liquidations of these securities by leveraged institutions in an illiquid market, combined with irrational ratings downgrades and bearish speculation in derivatives markets, has divorced market prices from their intrinsic value. Mark-to-market accounting rules have forced lending institutions to take unrealized losses on these troubled assets, eroding the capital base on which they lend, further restricting credit availability.

In mid-November, Paulson announced he no longer intended to purchase troubled assets with the TARP funds, but instead would employ the same broken, free market ideology that led to the credit crunch in the first place. The Troubled Asset Relief Program morphed into a Troubled Bank Relief Program when Paulson decided to inject $250 billion into our largest bank holding companies behind the façade that taxpayers were taking equity stakes in these banks. In reality, these funds are 5-year loans to the banks at 5% interest with the option of repayment that would nullify any equity stake. The sales pitch was that banks would use the capital infusion to lend to businesses and consumers, but instead they have hoarded it to protect their capital bases or to acquire weaker institutions. In response to this "bait and switch," troubled asset values resumed their decline and credit spreads widened, further raising the cost for businesses and consumers to borrow and deepening the contraction in credit.

Paulson let his ideology take precedence over common sense. Free markets are a cornerstone of our economy, but in their current form they are absent the regulations and oversight required to provide transparency and confidence in the system. Our free market system is broken, and the only resolution to this crisis we find ourselves in is government intervention in an effort to restore confidence.

We do not need more government or less government, we need smart government. We do not need onerous regulations and oversight that stifle innovation and growth, but we do need logical boundaries that prevent the mistakes of a few from destroying our system as a whole. The announcement of Paulson's replacement as Treasury Secretary was a step in the right direction, and the clear rationale behind the best weekly performance in the stock market in decades. Timothy Geithner is highly respected, apolitical, and free of any ideology that will prevent him from taking the steps necessary to restore confidence and credit availability.

We believe Geithner will employ a more interventionist policy by using the remaining TARP funds to purchase troubled assets of all kinds, including corporate debt. This will support and raise the prices of the assets owned by banks, attract private investment capital and reduce borrowing costs, while improving credit availability. We also believe the new Congress will guarantee the debt of Fannie Mae and Freddie Mac, already in conservatorship, which should lower mortgage rates to 5%, leading to a tsunami of refinancing.

Abraham Lincoln said, "Public sentiment is everything. With public sentiment, nothing can fail. Without it, nothing can succeed." The pessimism that persists today is staggering. This pessimism is a repudiation of our current leadership and the broken free market ideology they embrace, but we are on the cusp of a change in direction. Stock prices are distorting the economic value of the companies they represent. Fixed-income prices imply massive losses on consumer and corporate loans that simply don't exist. Following the bailout of Bear Stearns in March, the government guaranteed $30 billion of toxic mortgage-backed securities acquired by JP Morgan. In a recent report, these securities had lost a mere 10% of their value, and the cash flows generated to date indicate they are not as toxic as originally thought. Loan delinquency rates for businesses are at near record lows, and despite the steady rise in consumer loan delinquency rates to 3.8%, this is still well below the levels of 4-6% that persisted throughout the late 1980's and early 1990's. This is not to say that loan losses will not rise in the months ahead, but they do not support the Depression-era valuations we see in the markets today. This is not an overly optimistic estimation on the part of a delusional asset manager—it is fact.

We see an improvement in credit markets and investor confidence in the months ahead that will restore rationality in market prices and narrow the disparity between negative perception and reality. The fourth quarter of this year will likely be the largest contraction in growth for this recession. The first quarter of next year should result in some improvement, considering the monetary and fiscal policy stimulus already in the system, the inevitability of another reduction in short-term interest rates by the Federal Reserve and the new policy initiatives that will be implemented by the Obama administration..

The dividend yield on the Standard & Poor's 500 has now surpassed the yield on 10-year Treasuries for the first time since 1958. When stocks provide more income than bonds, it is an indication to us that the stock market is an extraordinary value. Despite our expectation for continued volatility in the weeks to come as the bottoming process continues, we believe we are embarking on a period of significant outperformance for the stock market in the months and years ahead. If history repeats itself, the markets will look forward to the economic recovery, despite the expected rise in unemployment and loan losses in the near term. Restoring confidence and improving credit availability is the first step in this process. ■

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