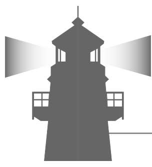

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Market Outlook

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Stock and bond markets around the world crashed last month as the weight of the financial crisis in credit markets brought global economic activity to a halt. In hindsight, the government's failure to prevent the bankruptcy of Lehman Brothers on September 15th will be viewed as the critical event which led to market capitulation. The Standard & Poor's 500 (-17%), Dow Jones Industrials (-14%) and Nasdaq Composite (-18%) all plunged in the month of October.

We have consistently maintained that the monetary and fiscal policy actions taken by the federal government, beginning with the bailout of Bear Stearns in March, would be effective in resolving the financial crisis. These actions would prevent the economy from falling into recession and avoid a bear market in stocks. We were wrong. After facilitating the bailouts and mergers of several financial institutions, the federal government changed the rules of the game by allowing Lehman Brothers to fail, and the consequences were irreversible. Its attempt to rectify this inaction was the announcement of the $700 billion rescue plan, but the intended psychological impact was negated by the extensive public debate within Congress and the media. The financial crisis on Wall Street quickly manifested itself into a global economic crisis.

> We believe we may be embarking on one of the best five-year periods for U.S. stock performance despite the dire outlook.

Despite unprecedented amounts of liquidity pumped into the financial system by central banks around the world, lending came to a standstill. Banks were unwilling to lend to other banks for fear that another institution would be allowed to fail. This fear was reflected in a surge in the London interbank offering rate, or LIBOR, which determines borrowing costs for banks, businesses and consumers around the world. Corporations were either unable to finance or afford to fund their working capital needs for weeks. As stock and bond prices began to fall, financial institutions, already faced with dwindling capital levels from the mark-to-market losses on mortgage securities, were forced to sell good assets in an attempt to deleverage. The insurmountable force of deleveraging that led to indiscriminate selling created a negative feedback loop that culminated in a 27% drop in the S&P 500 by October 10. Central banks around the world responded by cutting short-term interest rates and guaranteeing inter-bank lending and bank deposits. The LIBOR rate has since declined dramatically, leading to the recent market recovery.

A global recession is upon us. The U.S. stock market has declined 46% from peak to trough over the past year, the bond market has been dismantled, commodities posted a record 50% decline and the safe havens of money markets and Treasury bills are yielding a paltry 1%. Consumer confidence fell to a record low in October, and the unemployment rate will continue to rise in the months ahead. Home prices have yet to stabilize, and there will continue to be more mortgage delinquencies and foreclosures. Investor sentiment is at an all-time low as many are disillusioned after what has been a "lost decade" for the stock market.

Investors are now faced with the aftermath of the greatest financial crisis in modern history and, at the same time, the investment opportunity of a generation. Some may choose to listen to the day traders and naysayers who are worried about what will happen next week, next month or next quarter, but we believe long-term investors should be buying this stock market hand over fist! The most recent phase of the market decline is completely absurd and not based on fundamentals. If investors choose to liquidate the stock of profitable companies at valuations not seen since the Great Depression or the era of the 1970s, so be it. We believe they will feel disillusioned like never before when they realize that the cause of this recent meltdown was

forced deleveraging of the global financial system. We prefer to follow Warren Buffet's lead rather than listen to the pundits who spread fear at bottoms and euphoria at tops in our markets.

Prior to the bankruptcy of Lehman, there were meaningful signs of improvement in the economic outlook that received little attention. Sales of existing homes in September rose by the largest amount in five years, with sales in California up an astonishing 57% year-over-year, and the inventory of unsold existing homes fell. This tells us that mortgages are available. The plunge in oil from $146/barrel in July to $64 today has led to a decline in gas prices from more than $4/gallon to what should soon be $2. This is in effect a $200 billion tax cut for consumers. Social security recipients will be receiving a 6% cost-of-living adjustment next year that will result in an additional $35 billion in income.

The headwind of inflation that peaked in July at 5.6%, eroding stock valuations in the first half of the year, should be a tailwind in the future. The rampant speculation in commodity markets has made an about-face, and commodity prices have collapsed. We believe the rate of inflation will fall to 1% or less next year. This will allow the European Central Bank to continue lowering its short-term interest rate as a global easing cycle unfolds, which in turn will lead to further strength in the U.S. dollar. A decline in the rate of inflation coupled with a strengthening dollar has historically been very positive for the stock market.

It is very difficult to look forward when the past decade has been one of the worst periods for the stock market in history, only surpassed by the 1970's and Great Depression. What might surprise most investors is that the two best five-year periods on record for the stock market began in 1932, during the Great Depression, and in 1982, during a recession. There was a commonality between the foundations of both recoveries that we believe has significance for the election which will take place tomorrow. Both President Roosevelt and President Reagan implemented massive domestic spending initiatives that resulted in economic growth and job creation. President Roosevelt's New Deal, initiated in 1933, was largely responsible for bringing our country out of the Great Depression through banking regulations and relief programs started by the federal government. President Reagan initiated a massive increase in defense spending that led to economic growth and job creation in the early 1980's. These were two polar opposite approaches to recovery that produced phenomenal market performance.

We believe that Barack Obama will be the next President of the United States and that the Democrats will gain control of both the House and Senate. If this happens, the investment implications are significant. Obama's economic policies bear important similarities to the 1930's and 1980's in that he has proposed massive domestic infrastructure spending to create jobs and stimulate economic growth. He has also proposed strengthening the regulation of financial markets, with the intent of improving transparency and disclosure, preventing financial institutions from taking reckless risks, and restoring confidence in our markets. In addition to domestic infrastructure, he has proposed a $150 billion spending program to build an alternative energy industry in the United States. We believe these two initiatives will be critical to an economic recovery likely to unfold in the first half of 2009.

We regret not forecasting the re-intensification of the credit crisis and the decline in markets that followed. Now we must look forward. Stock valuations currently reflect a deep and long recession with no end in sight. The cash currently held by individuals in savings accounts, money market accounts and certificates of deposit now approaches $8 trillion relative to a U.S. stock market valued at just $10 trillion. We believe we may be embarking on one of the best five-year periods for U.S. stock performance despite the dire outlook. Unlike previous periods in history, we are not faced with double-digit rates of inflation, unemployment and interest. We believe America is selling at a discount to its past, present and future valuation, and we are optimistic. ■

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