

2008 Year End Commentary and 2009 Outlook

In preparing this commentary, I searched long and hard for an opening statement which would accurately reflect the events and circumstances that we all experienced these past twelve months. “Ouch” seemed accurate, but a bit short. “Wow” does not quite capture it either. I finally decided to simply forego a pithy introduction and speak frankly and plainly about this historic year and share some insights for 2009 that you may find moderately encouraging.

2008 proved to be one of most challenging years for market and economic performance in several decades. Virtually every asset category - stocks, bonds, real estate, oil, etc – declined for the year. Even cash and short term US Treasuries (usually the haven of safety in uncertain times) produced negative real returns for investors after taxes and inflation. In essence, there was nowhere to hide. Here are the 2008 returns on some key benchmarks:

BENCHMARK	2008 Returns*
STOCKS	
Dow Jones Industrials	-33.8%
S&P 500	-38.5%
NASDAQ Composite	-40.5%
EAFE (International)	-45.1%
Dow Jones World Index	-42.9%
BONDS	
Barclay's US Credit Index	-3.8%
S&P National Municipal Bond Index	-2.8%
COMMODITIES	
Dow Jones/AIG Commodity Index	-36.6%

**Wall Street Journal, 1/2/09*

This was all brought on, of course, because the musical chairs game of easy credit, irresponsible lending, and poisonous leverage came to an end. When the music stopped, there weren't any chairs at all. The ripple effects saw major banks and Wall Street firms either close their doors or merge with stronger partners. While world governments were successful in averting a major global credit crisis, they were unable to avoid a recessionary environment. The US has now officially been in a recession for over a year. How much longer it has to go (and whether it will get deeper) remains the primary topic of conversation.

Where does this leave us? I received a lot of good feedback from my 3rd quarter question and answer format, so I'm going to follow it up with another series of common questions and (I hope) useful answers. Here goes:

Question: When will the recession end?

Answer: Since 1920, there have been 17 recessions. The average length is 13 months.* The current recession started in December of 2007, meaning we are about 13 months into it. Many economists project that economic growth will return in the second half of 2009. Of course, no one knows with any certainty when growth and prosperity will return. But, we all know that neither the good times nor the bad times last forever. Things will get better, as they always have. Only *one* recession has lasted more than 18 months – the Great Depression.

Question: Is this going to be as bad as the Great Depression?

Answer: During the October-November timeframe, this was an irritatingly repetitive topic for many news outlets. Thankfully, it seems to have subsided somewhat. Still, there are some folks out there who believe the current challenges will lead us into another Depression. The differences between 2008 and 1932 are too numerous to address here, but here are a couple of key ones that may give you some comfort.

- At the height of the Depression, unemployment was 25%. It currently stands at 6.7%** , and many economists expected to peak around 8% or so. Even if they are wrong by 20%, that's still less than 10% unemployment – a far cry from Hooverville. It's worth noting that historically, job cuts tend to continue even after the recovery has started.
- According to Federal Reserve Chairman Ben Bernanke, a central cause of the Depression was tight monetary policy by the Fed. The Fed wasn't lending, Banks had no access to capital, and they failed in mass numbers. Today, the Fed is injecting tens of billions of dollars into banking institutions and the economy. And, economic stimulus packages are on the way in early 2009.
- In the Depression, the stock market crashed in 1929. According to Dr. Marvin Goodfriend at Carnegie Mellon, the government did not get into the business of propping up the economy until 1933. The ensuing damage took a decade to fix.*** In the current recession, the Fed, Congress, and the White House acted with swift action to circumvent the pending crisis. We also have many more monetary and fiscal tools in our toolbelt that we had 75 years ago.

Question: Are things going to get worse before they get better?

Answer: It depends upon who you ask. There are two camps on this. One group of forecasters believe the worst has past during the 4th quarter of 2008. Another group believes that early 2009 will be the worst part of the recession. Again, no one knows for sure. But, it is broadly viewed that the investment markets have already factored in a lot of forward-looking bad news. That is, the markets have built in expectations for future bad news. As an example, the Bureau of Labor Statistics announced on December 5th that

November unemployment swelled by 553,000 – a larger than expected number. The Dow Jones was up 259 points for the day. One might suggest that the market had already priced in the bad news prior to announcement. Markets are wonderfully efficient at this. How much future bad news is built into today's stock prices is anyone's guess.

Question: Will the stock and bond markets ever recover?

Answer: I must qualify this response. In time such as these, I tend to become a market historian; since history is pretty much all we have to go on. As such, I will root my answer in historical facts:

In *every past instance* of recession, the stock and bond markets have recovered to new highs. And here's the surprising news: Typically, the stock market begins to recover and advance *before* a recession is over. The problem is, nobody rings a bell at the bottom and says, "Come on in, the water's fine." This is the reason for staying invested. In addition, the recoveries tend to be fairly robust when the declines have been significant. The current situation certainly qualifies. So, if we're 13 months into the recession, and the average recession lasts 13 months, and the stock market historically leads out of a recession before it's over, history might suggest there's reason to hope that a recovery for our portfolios might be on the horizon. No one knows for certain when that might be, but history can be a good teacher if we are willing to listen. That's not to say we won't continue to experience fluctuations in the near term - we probably will. But ultimately, a focus on the longer term should pay dividends if history is any guide.

Question: Wouldn't it be safer to be on the sidelines right now?

Answer: Here's a great analogy I've shared with some of you. Assume you own a beach house in Galveston, and Hurricane Ike is upon you. You decide to sell your house. What's it worth? Its worth whatever someone will pay you for a beach house in a hurricane. So you sell it at a rock bottom price. Then, like all storms in recorded history, Ike moves on. The sun comes back out. Real estate prices for beachfront property go back up. But, you don't own your beachhouse anymore. You sold it in the middle of a hurricane. As I noted earlier, no one rings a bell at the bottom and let's everyone know it's time to invest. The only way to ensure you experience the highs is to experience the lows as well. If you're properly allocated in line with your time horizon and your tolerance for risk, I advise you to stay put.

Question: What will it take to turn things around?

Answer: A great question. There are seeds of recovery already sown. (It's just hard to see them when gloom and doom are all the media seems to relay to us.) For instance:

- **Mortgage interest rates continue to fall**

The housing market needs to stabilize for widespread economic growth to take place. Lower mortgage rates will help in many ways. Buyers can afford to purchase homes, and those with higher mortgage rates can refinance into more affordable payments. This may take some time, but it's headed in the right direction.

- **Inflation is all but dead – for now**

In fact, we've seen consumer prices actually fall for the past few months. While continued deflation isn't desirable, it isn't currently seen as a genuine concern. For the time being, inflation should moderate and give us all some breathing room. \$1.60 gas is a welcome sight.

- **A new stimulus package in on the way**

The Obama administration has stated that its first order of business will be the passage of a massive stimulus bill aimed at job creation and infrastructure development. This is good for people and for companies. It creates jobs and profits.

- **The stock market is undervalued**

As of November 19th, 2007, 101 of the S&P 500 stocks – the largest, most well capitalized companies in the US - were trading at under \$10 per share. Companies with strong balance sheets will benefit from economic recovery. Arguably, the markets offer some great values at today's prices. Smart money managers are positioning their portfolios to take advantage of this.

- **There's cash on the sidelines**

Contrary to popular belief, investor savings didn't simply evaporate. According to the St. Louis Federal Reserve, there is a record \$8.8 *trillion* dollars of "MZM" (that's money with a zero maturity) currently parked in savings accounts, money markets, and CD's. Much of it is earning a *negative real rate of return*. Sooner or later, a good portion of this money will need to go back to work for its owners.

Question: What should I do now?

Answer: Remember what I've said countless times. "The key determinant of investment results over time isn't returns, its investor behavior." Ask yourself these five simple questions:

1. Are my long term objectives the same as they have been?
2. Do I own a diversified portfolio of quality stuff?
3. Am I willing to use history to help make rational decisions about what I should do now?
4. If I am in retirement, am I willing to take less income off my retirement investments than originally planned?
5. If I am close to retirement, am I willing to put it off until things improve?

If you need any help answering these questions, please call me. That's what I'm here for.

In closing, I hope this rather long commentary helps put things in perspective. I want to thank you for the confidence and faith you've shown in our firm through this very difficult time. We're investors too and, like you, we experience the same feelings and emotions. But we are confident that discipline, quality, and diversification will win out for us all, as they always have in the past.

Rest assured we are here to serve you, so don't hesitate to call or stop by for a visit.

See you next quarter,

* Curian Capital, Capital Markets Briefing, 12/08

** Bloomberg News, 12/23/08

***NPR, 9/22/08