

The Oarsman Outlook

First Quarter 2008

As credit markets reeled amidst the worst financial dislocation in a generation, and the economy slowed to a crawl under the weight of a deflating real-estate bubble, U.S. stocks suffered their worst three-month beating since the final throes of the 2000-2002 bear market. Flying in the face of the ballyhooed “decoupling” theory of global finance, most overseas markets saw declines that matched or exceeded those of domestic shares. Among fixed-income investments, all but the highest-quality issues also struggled in the severely risk-averse climate; U.S. Treasury securities, and particularly Treasury Inflation-Protected notes (TIPS), had a banner quarter, however. Commodity- and precious-metal linked investments also soared, serving as a useful hedge against the damage to most other asset classes.

Among U.S. stocks, the best-performing sectors were Transportation, Basic Materials, Consumer Staples and Consumer Cyclical; lagging sectors included Communication Services, Technology, Financials and Utilities.

Benchmark Performance – Equities

	<u>First Quarter 2008</u>	<u>Last Twelve Months</u>
S&P 500 Index	-9.4%	-5.1%
Dow Jones Industrial Avg.	-7.0%	+1.6%
NASDAQ Composite	-14.1%	-5.8%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-10.2%	-5.6%
Small-Cap Stocks (Russell 2000)	-9.9%	-13.0%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-8.2%	+0.7%

Benchmark Performance – Fixed Income

	<u>First Quarter 2008</u>	<u>Last Twelve Months</u>
Lehman Aggregate Bond Index (taxable)	+2.2%	+7.7%
Lehman Municipal Bond Index (tax-exempt)	-0.6%	+1.9%

Review

Two familiar themes dominated the first quarter: the deflating real-estate bubble and credit markets wracked by a crisis of liquidity and confidence. Both of these problems seemed to deepen during the period and were joined by a third worry: that housing- and finance-sector troubles would spill over into the broader economy, resulting in recession. This angst-laden climate unsurprisingly took its toll on most financial investments: the S&P 500 index fell a full 20% from its October 2007 peak to an intraday low on March 17th before rallying nearly ten percentage points into early April. Measures of stock market volatility reached multi-decade highs, indicating extreme uncertainty among investors. (Recall that prior to spiking in February 2007, volatility had held persistently near multi-decade lows – as economist Hyman Minsky might have observed, *stability begat instability*.) Benchmark bond

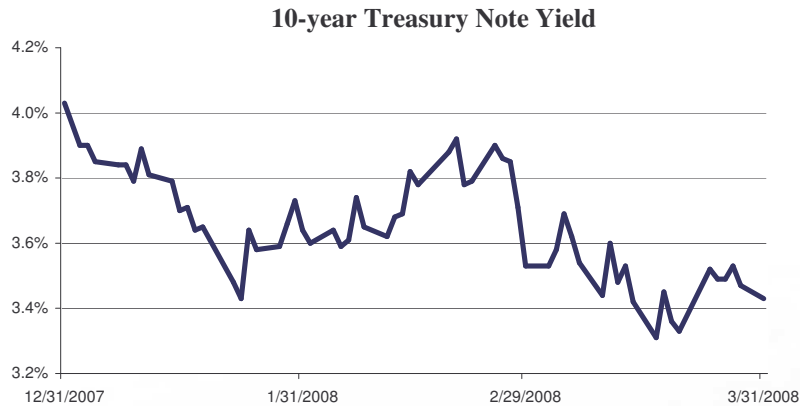
yields fell to levels not seen since mid-2003 (the 10-year Treasury yield ended the period at 3.43%), although, as noted, only the highest-quality issues benefited from the flight to safety.

House-price statistics showed accelerating declines in most parts of the country during the quarter, with the average cumulative drop exceeding 10% in major markets. Mortgage delinquencies and foreclosures continued their alarming rise. As the woeful statistics mounted, even optimistic observers concluded that the nation was in the midst of an epochal episode of wealth destruction.

In financial markets, the flight from complex and risky investments and the rush to de-lever balance sheets continued, causing liquidity problems to spread beyond sub-prime mortgage securities. Bond-rating agencies downgraded their assessments of financial guarantors, and a number of financial entities were afflicted by severe liquidity constraints as traditional funding sources evaporated. This process reached a climax with the mid-March demise of Bear Stearns, a venerable Wall Street investment house that had successfully negotiated 85 years of market and economic vagaries, including the 1929 stock-market Crash and Great Depression.

As the quarter progressed, evidence began to accumulate that real-estate and financial-market turmoil was taking a toll on the broader economy. Although export-oriented sectors continued to be buoyed by still-strong overseas demand and the salutary effects of a weakening dollar, business sentiment seemed to be eroding, and consumer confidence plunged to levels previously associated with recessions. Aggregate economic growth slowed from an annual rate over 4% in the third quarter of 2007 to less than 1% in the final three months of the year. Most forecasters – including Federal Reserve chairman Bernanke – predicted that the change in real (i.e., inflation-adjusted) economic activity will be approximately flat to slightly negative during the first half of 2008. Employment and income statistics remained a relative bright spot, however: although monthly payroll reports turned negative, job losses had not reached recessionary levels, while real income growth remained positive. These hopeful signs seemed to indicate that businesses did not (yet) feel a need for aggressive retrenchment, and may augur a relatively shallow, albeit not necessarily brief, downturn.





The housing debacle, a stalling economy and, in particular, an air of genuine panic on Wall Street spurred policymakers into a frenzy of activity that, although on balance seems at once bold and prudent, smacked at times of desperation. In addition to aggressively lowering its target rate for overnight lending (the Fed Funds rate), the Federal Reserve introduced a phalanx of novel initiatives designed to ease strained credit markets, dramatically expanding its role as the U.S. financial system's lender of last resort. While at the time of writing the jury was still out, market reactions suggested that these policy responses had significantly reduced the risks to the financial system, which is a necessary precursor to mending the housing market and broader economy.

Outlook

After a year and a half of falling house prices, eight months of financial-market distress, six quarters of below-potential economic growth and a 20% decline in stock benchmarks, it is appropriate to wonder where we stand – third, fifth or eighth inning – in this mess. Although too early to sound the “all-clear,” encouraging signs suggest the worst of the financial-market crisis may be behind us: stocks have rallied, led by financial shares; prices of favored safe-havens of the risk-averse, like Treasury notes and gold, have fallen; and the near-collapse of Bear Stearns did not set off a chain-reaction of failures. In fact, on April 1st, Lehman Brothers, which had been rumored to be particularly vulnerable, secured \$4 billion of new capital on what seemed to be relatively attractive terms; stock markets surged on the news.

However, even if fear ebbs on Wall Street, the de-leveraging process, which amounts to a wholesale dismantling of the “shadow-banking system” developed over the last two decades, will continue. This process will decimate financial-sector earnings, which have grown to a disproportionate share of total corporate profits. It also seems likely to impact negatively both the price and availability of credit to many (non-financial) parts of the economy. How long the de-leveraging drags on depends in no small part on developments in the real-estate markets, which, as they continue to deflate, cause further erosion in the value of mortgage- and other asset-backed securities held by the trillions on the books of banks and non-banks alike.

Unfortunately, the outlook for real estate remains grim. Nationwide, some 10% of mortgages now have principal balances that exceed the market value of the property against which they were lent. Worse, numerous analyses suggest that homes remain overvalued in

many markets, dramatically so in those that saw the most speculative activity in 2003-2006 (e.g., Las Vegas, Arizona, southern Florida). As prices continue to fall, more mortgages will be “upside down,” giving homeowners financial incentive to default. More defaults (and foreclosures) will put further downward pressure on prices.

The self-reinforcing nature of this phenomenon – known by economists as a debt-deflation – suggests that non-market (i.e., government) intervention may be called for, perhaps including the purchase or guarantee of at-risk mortgages after reducing their principal value to below current market prices. (Policy initiatives along these lines were being debated in Congress at the time of writing.) Although such a solution would force mortgage-securities holders to take substantial losses (and would expose the government – i.e., taxpayers – to future losses should property values continue to decline), total losses would likely be less than those eventually realized via mass foreclosures. More important, intervention would swiftly remove much of the uncertainty surrounding the size and timing of mortgage-related losses – and it is this uncertainty, more than losses *per se*, that is causing the greatest anxiety in financial markets.

The broader economy seems likely to mirror the housing market in the period ahead. Until housing (and, to a lesser extent, financial markets) stabilizes, consumer confidence will be depressed, which is likely to hold spending in check. Likewise, business sentiment will remain cautious until consumer confidence improves and, importantly, financial-market turmoil abates sufficiently to improve credit conditions. We expect the bottoming of the real estate market to be quite gradual, although government intervention holds the potential for a positive surprise in this regard. In any case, however, the damage to consumer balance sheets could lead to a protracted period of increased saving, which would subtract from future growth. Accordingly, even if the downturn remains fairly shallow, the recovery could be quite drawn out. Although the weak dollar and sky-high commodity prices will pressure the Fed to begin raising rates again as soon as it seems safe to do so, we expect the magnitude of the housing problem to keep interest rates abnormally low at least through 2008.

Given the above, the stock market outlook is more uncertain than usual. However, that uncertainty seems largely reflected in currently depressed prices and elevated volatility. Stock markets are, of course, forward-looking, discounting to a present value the likely *future* course of economic developments. Accordingly, much of the damage to stock prices occurs *before* economic dislocations like recessions. And by the same logic, *prospective* (i.e., expected future) returns are generally above average at such times of heightened uncertainty (and after prices have declined).

Historically, the average stock-market decline around recessions is just over 20% – almost exactly what occurred between October 2007 and March 2008 – with most of the drop occurring *before* the official onset of recession. And, measured from points when stock prices stood 15% below a recent peak (about where we ended the quarter), prospective twelve-month returns were positive more than 85% of the time (versus an overall figure of around 70%). Moreover, the *average* twelve-month return from these depressed points was nearly twice the long-term average. In other words, much more often than not, crisis and panic have begotten value and opportunity, and it has been rewarding to be a buyer when others are fearful. While there has been variability around the above figures (for example, the market declined 45% around the recession of 2000-2001, and the prospective twelve-month return

when the market had fallen 15% in early 2001 was negative), and the magnitude of current challenges certainly warrants continued caution, history suggests the odds favor reasonable – or better – returns in the period ahead.

