

The Oarsman Outlook

Third Quarter 2008

In the face of rising financial-market tensions and flagging global economic growth, the July-September period was difficult for most investment categories. Large-company U.S. stocks suffered their fourth consecutive quarterly decline; small-company stocks fared considerably better, but most non-U.S. markets lagged. Among U.S. stocks, there was a wide range of results, with solid performances coming from the Health Care, Consumer Staple, Consumer Cyclical and, surprisingly, Financial Service sectors; the Energy and Basic Materials sectors, however, were extremely weak. In the fixed-income realm, near-panic conditions proved difficult for all but the highest-quality securities, resulting in modest, albeit generally positive, returns.

Benchmark Performance – Equities

	<u>Third Quarter 2008</u>	<u>Last Twelve Months</u>
S&P 500 Index	-8.4%	-22.0%
Dow Jones Industrial Avg.	-3.7%	-19.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-9.4%	-22.0%
Small-Cap Stocks (Russell 2000)	-1.1%	-14.5%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-21.6%	-30.2%

Benchmark Performance – Fixed Income

	<u>Third Quarter 2008</u>	<u>Last Twelve Months</u>
Lehman Aggregate Bond Index (taxable)	-0.5%	+3.7%
Lehman Municipal Bond Index (tax-exempt)	-3.2%	-1.9%

Review

September and October 2008 will long be remembered as a time of nearly unprecedented volatility in global financial markets. By now, the milestones of the crisis are numbingly familiar: ongoing deterioration in the real estate market continued to exert pressures on financial institutions that owned (or had insured via credit-default swaps) large quantities of mortgage-related securities. One of the firms most acutely affected was Lehman Brothers, which, in early September, saw its stock price plummet as it was shunned in the markets. Over the weekend of September 13-14, when no buyer could be found, Treasury and Federal Reserve officials decided to let Lehman Brothers fail, judging that the global financial system had had sufficient time (six months since the managed-collapse of Bear Stearns and more than a year since the mortgage-related crisis emerged) to prepare itself for this fateful event.

That judgment proved spectacularly wrong. Over the next several days, the world's financial machinery effectively ceased to function. Rampant fear of domino-like failures among banks and brokerage firms caused stock market values to plunge; supposedly safe money-market funds with exposure to financial-firm debt teetered (with one "breaking the buck") before the Federal Reserve announced an emergency insurance plan; mortgage giants Fannie Mae and Freddy Mac, as well as American International Group (one of the world's largest insurance companies) were in effect nationalized; Washington Mutual (the country's largest savings and loan) collapsed; Merrill Lynch arranged a hasty combination with Bank of America; Morgan Stanley and Goldman Sachs sought to re-charter themselves as commercial bank-holding companies – all in a desperate effort to stave off calamity. Most ominous for the world beyond Wall Street, short-term inter-bank and corporate lending essentially froze, depriving the global economy of vital credit and liquidity.

Amid the chaos, U.S. officials began to cobble together a massive rescue plan. Stock markets rallied strongly on September 18-19 on rumors and leaked details. But in their understandable haste to put a plan in place, officials neglected essential communication/political groundwork, with the result that the original plan bogged down and was eventually defeated in Congress. Markets plunged in despair. A second, compromise plan was drafted and finally passed, but market participants seemed unimpressed. Notably, there seemed to be no improvement in the inter-bank and short-term corporate lending market – banks had ceased to trust one another and their best customers. As the gravity of the situation set in, global stock markets plunged some 25% in eight trading sessions between the 1st and 10th of October.

Finally, over the weekend of October 11-12, European officials, led by U.K. Prime Minister Gordon Brown, announced a sweeping set of coordinated measures aimed at restoring confidence in the financial sector, guaranteeing deposits and bank debt, making available essentially unlimited quantities of short-term loans, as well as taking substantial equity stakes in many of the Continent's largest financial firms. Central banks around the world bolstered these announcements with the first coordinated interest-rate cut since the aftermath of the September 2001 terror attacks. Markets were buoyed, rising nearly 20% from their October 10 lows, with the rally gaining momentum as it emerged that the U.S. rescue plan, too, was morphing into one that would include substantial government capital injections into the nation's banks.

Since the mid-October climax, indicators of credit-market stress have gradually eased and volatility, while still unusually high, has diminished slightly. Nevertheless, as investors have turned their attention to the likelihood of a relatively deep and possibly long recession, they have continued to push stock prices lower. In addition to reflecting rational pessimism concerning the likelihood of recession and substantially lower corporate profits, the nearly unprecedented level of volatility suggests substantial forced selling has been undertaken by leveraged entities like hedge funds in an effort to meet margin calls and fund redemptions.

Outlook

Although the scene in the rear-view mirror is ugly, the view of the road ahead is actually somewhat clearer than it has been in some time. The U.S. economy was on the verge

of recession *before* the financial-market meltdown. Events of the past several weeks are certain to make the downturn deeper and also probably longer than previously anticipated, as individuals and institutions alike suffer from a reduced flow of credit and undergo a long-postponed process of reducing debt. Unlike the 2001-2002 recession, the present downturn will be focused in the consumer sector of the economy, whose finances have been dealt twin blows by the real estate and stock markets. The corporate sector will not be immune, and earnings expectations surely have far to fall. The interconnectedness of global financial and traded-goods markets will spread the pain world-wide, although we suspect the better-positioned emerging markets (in particular China, which has enormous foreign reserves, a massive budget surplus and a banking system that is relatively non-integrated with the rest of the world) will remain relatively resilient.

While it is certainly early, we believe that prompt, massive and coordinated government interventions into the financial sector will prevent a repeat of Japan's "lost decade" of the 1990s or, even worse, the worldwide Great Depression of the 1930s. In Japan, bank executives and government officials dithered for more than a few *years* before owning up to the severity of the problem. Similarly, effective policies to combat the Depression didn't come into force until well after Roosevelt's inauguration in March 1933 – three and a half years after the stock market crash. In the current crisis, the response time of governments, though excruciating to experience in real-time, was measured in weeks. Moreover, many officials charged with drafting and executing the current response, in particular Federal Reserve Chairman Bernanke, have spent years analyzing the causes and cures of both previous crises (in addition to numerous less famous ones); they have most assuredly learned from history and will do everything in their power to avoid repeating it.

We believe most of the ingredients are now in place for a gradual return to stability. The most important elements are a recapitalization of the banking system, the numerous programs/efforts to restore the inter-bank lending market, coordinated interest-rate cuts and currency-market interventions, and the willingness of the International Monetary Fund to provide a safety net for vulnerable second- and third-tier economies (e.g., Iceland, Ukraine, Hungary). Still on the horizon, but being actively discussed, are additional fiscal stimulus measures and efforts to slow the pace of foreclosures by modifying problem mortgages, which would put a floor under real estate prices, the downward spiral of which is the root cause of most of the carnage.

Worth noting amidst all the gloomy headlines are a number of positive developments. Interest rates tied to Fed Funds/Prime are falling and likely to stay near all-time lows for some time; mortgage rates have yet to decline meaningfully, but we suspect they will before long. Inflation fears are evaporating as commodity prices plummet and businesses gird themselves for recession. The recent 35% decline in gasoline and heating oil prices will put more dollars in consumers' pockets than did the mid-2008 economic-stimulus tax rebates. Finally, the U.S. dollar has staged a substantial rally versus most other currencies.

So, is it a good time to invest? Certainly, many stocks appear cheap – or, at a minimum, cheaper than they have been in years. The price/earnings (P/E) ratio on the S&P 500 index has fallen to less than 13 times current earnings, and the dividend yield is above 3% – both figures not seen since the early 1990s. Investing luminaries including Warren Buffett

and John Bogle are buyers. Buffett notes that great American (and, we would add, non-U.S.) companies (e.g., Procter & Gamble, Johnson & Johnson, Microsoft) are certain to be attaining new earnings records 10 and 20 years from now; long-term investors who want to own a piece of those future earnings can do so today at marked-down prices. Bogle (founder of the Vanguard mutual group) has said he believes stocks are now priced for prospective returns equal to the historical average of around 10% per year; he had held for more than a decade that future returns would be lower as a consequence of what he viewed as an over-valued market. Even away from the equity markets, forced de-leveraging and extreme risk aversion have also created unusual value in many high-quality corporate (taxable) and municipal (tax-exempt) bonds. So, it may be possible to benefit from the current turmoil without stepping beyond your comfort zone in terms of risk.

As for timing, markets almost always begin to recover months or even quarters before the economic news brightens; with most economic forecasts calling for the downturn to reach its nadir this quarter or next, the market lows could be near at hand (or even past). But it seems a fair bet that volatility will be with us for a time, as earnings projections come down and de-leveraging continues. This argues for a cautious, but constructive, approach to stocks (as well as non-government bonds), with greater-than-usual focus on financial strength, sustainable competitive advantage, and secure and preferably growing dividends.

In treacherous markets, all investors can take solace in history, which has shown repeatedly that amidst uncertainty and fear lies opportunity. While we can't promise a quick return to new market highs, we are confident that prudently balanced investments made at today's levels will prove rewarding for investors whose time horizon is longer than a few years.