

The Oarsman Outlook

Fourth Quarter 2008

The year 2008 will be remembered as one of the most difficult in decades for investors in nearly all financial assets. Following five consecutive years of steady, low-volatility gains, the abrupt collapse in values (a good portion of the year's decline occurred over a span of just a few weeks) could not have been more jarring. Though a minor consolation, we can take some comfort in the fact that equity markets were essentially unchanged from mid-October – and had gained around 20% from late-November lows – through the early days of January.

Among U.S. stocks, those in the Consumer Staples, Health Care and Utilities sectors showed the most resilience in 2008. Lagging were stocks in the Basic Materials, Capital Goods, Energy, and Financial Services areas. Smaller-company stocks slightly bested Blue Chips; “growth” and “value” stocks were essentially neck-and-neck. Outside the U.S., many equity markets performed even worse than their domestic counterparts, with the greatest declines seen among previously high-flying emerging markets. Commercial real-estate and commodity-related investments both languished. Fixed-income investments, as a whole, provided flat-to-modestly-positive returns, but there was tremendous disparity depending on perceived credit quality: “plain-vanilla” (i.e., non-inflation-indexed) U.S. Treasury notes and bonds, seen as the ultimate “safe haven,” posted double-digit gains, high-quality municipal and corporate bonds were up or down a couple of percentage points (depending on maturity and issuer), while most lesser-quality securities declined substantially in price as credit spreads soared.

Benchmark Performance – Equities

	<u>Fourth Quarter 2008</u>	<u>Last Twelve Months</u>
S&P 500 Index	-21.9%	-37.0%
Dow Jones Industrial Avg.	-18.4%	-31.9%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-22.0%	-37.2%
Small-Cap Stocks (Russell 2000)	-26.1%	-33.8%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-21.6%	-44.4%

Benchmark Performance – Fixed Income

	<u>Fourth Quarter 2008</u>	<u>Last Twelve Months</u>
Intermediate-Term Taxable Fund Avg. (Lipper)	-0.8%	-0.1%
Intermediate-Term Muni Fund Avg. (Lipper)	+0.5%	-1.3%

Review of 2008

We won't be the first to suggest that perhaps the less said about 2008 the better. In hindsight, the market collapse seems surprisingly easy to comprehend: the U.S. economy had been flirting with a housing-led recession and financial markets had been fretting about mortgage-finance excesses since mid-2007. These worries abruptly mushroomed with the sudden collapse of numerous financial institutions, the resulting seizure of the credit markets, and plunging stock market prices that occurred in rapid succession between July and November.

The period from mid-September through mid-November was characterized by an unprecedented degree of stock-market volatility, with 5- and 6- and even 8- and 9-percent daily swings – in both directions – becoming almost the norm. At the same time, huge swaths of the private credit markets essentially ceased to function, starving the economy of its life's blood. These market dislocations coincided with a paralyzing degree of economic (and political) uncertainty, as government policy seemed a frustrating combination of indecisive and ineffective, and the fate of a number of giant economic players – not least Citigroup and General Motors – hung in the balance.

With the late-November decision to rescue both Citi and the auto-makers, followed in December by the Federal Reserve's extraordinary rate-cutting and market-intervention ("quantitative easing") announcement, financial markets calmed noticeably. Between November 20 and early January, private-sector borrowing costs (from residential mortgage rates to corporate bond yields) fell dramatically as benchmark Treasury rates plunged and credit spreads narrowed (although the *availability* of credit remained constrained), stock-market volatility plummeted, and the prices of most financial securities and a number of industrial commodities (e.g., oil, copper) rallied. Notably, these market improvements came even as the news flow highlighted the depth of the economy's woes, the \$50-billion Madoff fraud came to light, and geopolitical tensions flared anew first in South Asia and then in the Middle East. While certainly early to declare an end to the carnage, as we write, the market environment seems clearly to have entered a new, less panic-stricken phase.

Outlook for 2009

Despite the gloom, the way forward is in some ways clearer than it has been in a while. There is no question that the U.S. economy is in a deep recession (though uncertainty remains regarding the likely length of the slump – see below). Few now doubt that growth in nearly all overseas economies will be severely curtailed in 2009, although some, like China and Brazil, will likely see fairly decent gains relative to the developed economies' shrinkage. With the unprecedented series of market interventions that have already occurred, and the advent of a new, Democratic presidential administration and Congress, there is likewise little mystery as to the near-term course of government policy regarding the economy. In fact, the resolution of a large number of uncertainties over the past six weeks is probably behind the recent gains in most markets.

Nevertheless, important questions clearly remain; among the most salient: how long will the economy remain in recession (which is key to predicting the damage to corporate profits and the appropriate level for stock prices)? Most market observers seem quick to

conclude that the downturn will be prolonged, probably lasting through 2009. We are less certain (not to say overtly optimistic!). Unlike most recent U.S. recessions, which have generally been caused by swings in business investment, this is a consumer-led downturn, whose driving forces are 1) wealth destruction via declining real-estate and financial-investment values; 2) constrained credit availability; and 3) income/job insecurity. These forces peaked in October/November 2008; since late November, both wealth-destruction and credit-availability conditions have improved (the former rather markedly, the latter more tentatively), while job worries have arguably worsened.

Though the American consumer has been dealt a series of blows, the prediction of a protracted slump hinges on a major *and sustained* change in consumer behavior away from consumption and toward saving. Of course, most important economic changes occur “at the margin,” and clearly recent developments will act, at the margin, to curtail spending in favor of saving. However, if real-estate and financial-market values were to stabilize, and credit conditions continued to ease (granted, these are important ifs), the future path of consumer behavior would be unlikely to resemble an extrapolation of the past two or three months, but rather something much less malign. More than 95% of Americans are not at real risk of losing their homes or jobs; as that reality sinks in, and financial-market gyrations ease, we believe many will resume something close to their previous spending patterns, despite all the media hype about a “new era of thrift.” A similar argument could be made with respect to American businesses, which seem to have reacted rapidly and aggressively to the suddenly changed (and uncertain) environment by curtailing investment and hiring, despite having entered the current milieu with relatively solid finances (outside the financial industry). If the consumer/business downshift moderates during the first half of the New Year, it is plausible that a large part of the remaining aggregate-demand deficit will be offset by the massive government stimulus (and the stimulative effects of dramatically lower energy prices) that will be hitting the economy, resulting in growing GDP in the second half of the year.

Regardless of the near-term course of economic growth, there are legitimate concerns regarding the longer-term implications of governments’ emergency responses to the current crisis. These concerns begin with the new, higher level of government deficits, and how those may eventually affect the level of market-determined interest rates/bond yields and the foreign-exchange value of the U.S. currency. It may also prove difficult (or at least complicated) for the government to remove its financial backing from some of the areas of the economy that have been, in effect, nationalized since September. These issues, while necessarily “back burner” for now, are likely to have important implications for financial investments, and we will be devoting increased attention to them in the months ahead.

As we have noted before, financial markets generally anticipate economic developments; historically, market “bottoms” occur well before noticeable improvement in economic fundamentals. If one expects a somewhat better-than-consensus economic picture, with the worst of the recession behind us and a resumption of growth before the end of 2009, the market lows reached in November seem likely to hold. A key to realizing this outcome will be the reaction of stock (and credit) markets to the imminent earnings-reporting season, which promises to be ugly. But regardless of how markets react in coming weeks, investors whose time horizon stretches 10 years or more seem likely to be rewarded by accumulating growth-oriented assets when fear and uncertainty are widespread. It seems to us that markets

at least as likely to be *underpriced* during such periods as they are to be *overpriced* during periods of “irrational exuberance.” That noted, remaining uncertainties about the economy, corporate profits and interest rates suggest it is prudent to maintain a balanced investment posture that is not too reliant on anticipated capital appreciation from stocks.

