

December 8, 2008

As of this writing, the S&P 500 is down about 39% year to date. As frustrating as that number is, the market is up almost 10% from the low on October 10th. Some of the major uncertainties facing us are finally seeing some resolution. The election is behind us, energy prices are dropping like a rock and even the credit crisis seems to be abating. Short term borrowing rates are dropping rapidly, to the point where the banks overnight lending rate (LIBOR) is at its lowest point all year. We're still waiting for the market to settle down, but the requirements for a more lasting stability are slowly falling into place.

Quality stocks are discounting an economic disaster that we think is unlikely to occur. The world's finance leaders have agreed to a coordinated plan of attack that should eventually lead to greater confidence in the global banking system.

The recent market decline accelerated from a typical bear market to something that more resembles a panic. In nine trading days the S&P 500 dropped 25%. That's only happened twice in S&P data history... during the crash periods of 1987 and 1929. In both instances, the stock market was higher at one week, one month, three months, and six months later. In fact, the six-month gains were 15% and 21% respectively. We seem to be on pace for a similar recovery rally.

What the heck is going on?

In a nutshell, a bad situation got a lot worse when Lehman Brothers failed. They owed a lot to money market funds and the failure to pay off these loans led to a run on the money markets. Money market funds provide the short-term funding to operate many global businesses. Short-term money is the oxygen of capitalism, and that oxygen was cut off. The only functioning market where these companies could sell assets to fund their operations is the stock market. That has caused the breathtaking declines that we have seen recently.

At its worst, the S&P 500 was down 46% from its highs from October 2007. In comparison, the Banking Panic of 1907 saw declines of 37%; the WWII bear market from 1939-1942 (including the attack on Pearl Harbor), drove markets down 39%; The 2000-02 tech stock crash led to losses of roughly 50%, similar to the losses suffered in 1974-75. Empirically, this is about as bad as it gets. I find that to be a reason for optimism.

The bottom line is that we are much closer to the end of this than the beginning. My best guess is that the market crash will run its course; the margin call on hedge funds will cause many funds to liquidate, leaving prices at almost unheard of levels below intrinsic value. The market will stabilize, and the ten or so new Federal Reserve programs will begin to kick in, leading to a super sharp and fast rally that could be as great as 50-60%.

In this kind of market, investors with a long time frame and a low leverage are in a position of strength. We have the ability to take advantage of hedge funds that are receiving margin calls. Leveraged investors are forced to sell their shares at whatever price exists in the market. They are in foreclosure. Investors with cash and an eye for value can pick up some of the best values that we'll ever see.

According to Longleaf Advisers (highly respected value investors), there have been five instances of value stocks dropping two years in a row, the depression, world war II, the early '70s oil embargo, the aftermath of the tech stock bubble, and now the credit crisis. The average twelve month return after each of these periods is 60%. According to Longleaf, price to intrinsic value ratios are the most attractive they've been in 40 years.

The market is trading at valuations that suggest a very severe economic contraction. A CNN poll suggested that 60% of the population thinks a depression is likely. Marketwatch's Chief Economist Irwin Kellner suggests that this crisis does not compare to the Great Depression:

- The jobless rate jumped to 25% by 1933; it is 6.8% today.
- The gross domestic product shrank by 25% during the early 1930s; it is up over 3% during the past year.
- Consumer prices fell by about 30% from 1929 to 1933; and the last time I looked they were still rising.
- Home prices dropped more than 30% during the Depression vs. about 16% today.
- Some 40% of all mortgages were delinquent by 1934 compared with 7% today.
- In the 1930s, more than 9,000 banks failed compared with fewer than 20 over the past couple of years.

Remember also it was policy errors, not the stock market crash, that caused the Great Depression:

- Instead of increasing the money supply, the Federal Reserve of that era reduced it by one-third.
- Instead of lowering taxes, Herbert Hoover raised them.
- And to channel whatever demand was left into U.S.-made goods, the government enacted the Smoot-Hawley Tariff Act to keep out foreign products; this only provoked our trading partners to do the same.

Add to this today's automatic stabilizers such as unemployment insurance and Social Security, the FDIC to insure bank deposits and circuit breakers to keep stocks from falling too quickly, and you can see why this is not a depression in any way shape or form.

Academics have been studying the causes and policy mistakes that led to the Great Depression for more than 60 years. Chairman Ben Bernanke is a leader in this field of research. If the main question is whether we are heading into a Great Depression like disaster, it's only fair that we describe the tools that the good guys have to keep us out of it. As of today, we have the following:

- \$700 billion purchase of distressed illiquid securities, to be managed by outside asset managers (like a typical pension)
- Extraordinary pace of financial industry restructuring
- Central Banks are acting as lender of last resort for short-term money markets
- Government guarantee of deposits

- Emerging markets have vast dollar reserves
- Oil price stabilization
- Coordinated interest rate cuts
- Direct purchase of banks in order to ensure adequate capitalization

Right now, we have two choices. We can bet on recovery, or we can bet on financial debacle. The government agencies are not sitting on their hands. This increases the likelihood that we will not suffer to the same extent as in the Depression. According to the Wall Street Journal,

Eugene White, an economics professor at Rutgers University who is an expert on the crash of 1929 and its aftermath, thinks that the only real similarity between today's climate and the Great Depression is that, once again, "the market is moving on fear, not facts." As bumbling as its response so far may seem, the government's actions in 2008 are "way different" from the hands-off mentality of the Hoover administration and the rigid detachment of the Federal Reserve in 1929 through 1932. "Policymakers are making much wiser decisions," says Prof. White, "and we are moving in the right direction."

The economy will definitely stay weak for a while. The new consensus is four more quarters of negative growth and unemployment pushing 8% from 6.5% today. Sentiment and valuations seem to be discounting a much worse slowdown than that.

From an investment standpoint, it's probably too late to seek the safe haven of cash. Safety currently pays .07%. I could write pages of valuation analysis that point to valuations being absurdly attractive today. The money is out there, but it is confidence that is lacking. But, as interest rates decrease, the profitability of lending increases. Banks with capital to lend will benefit from higher profit margins and earnings will turn dramatically higher. I am convinced that we are approaching one of the best buying opportunities this decade.

These are terrifying times. But I am convinced that it is these times when we are most rewarded for investing with our heads.

We've been through difficult times before. James Stack at Investech provided the following headlines for comparison:

Recession Starts Taking Toll: Will it lead to another crash? "Worries are building that today's sagging economy may be on the brink of collapse."

U.S. News & World Report

Running Short of Cash

"The United States and its allies scramble to head off a global financial disaster... finance ministers from the United States, Britain, France, Japan and West Germany met last week near Frankfurt to find a way to avert a global economic collapse."

Newsweek

These headlines are not from today, but from November 1974 and December 1982...at the very depths of their respective bear markets. In each of those past fearful periods, the financial world did not come to an end – not in 1974, or in 1982, or after the 1987 Crash when everyone believed another depression was imminent. Even though it's not entirely clear how we're going to muddle through this mess, history suggests that we always find a way to do so.

Times are tough for everyone right now. The following is a list of past recipients of Morningstar's Manager of the Year award. These are the titans of the industry. What jumps out is how universally awful everyone's performance numbers are. This has been an external "uncertainty crisis" that has taken no prisoners.

Price Change of Morningstar's Managers of the Year as of December 7th, 2008

COMPANY NAME	Price % Change Year to Date
FIDELITY CONTRAFUND	-39.90%
FIDELITY ADV INSIGHT	-40.30%
OAKMARK SELECT FUND	-40.90%
FIDELITY LOW-PRICED	-41.50%
SELECTED AMER FUND	-41.60%
DAVIS NY VENTURE A	-42.00%
TWEEDY BROWNE GBL VL	-42.10%
THIRD AVE VALUE	-42.20%
VANGUARD CAP OPP	-43.10%
J BAER INT'L EQUITY	-43.50%
MARSICO GROWTH	-43.80%
OAKMARK INT'L FUND	-44.90%
MAINSTAY ICAP INTL I	-45.40%
THORNBURG INT'L VL A	-45.80%
DODGE & COX INT'L ST	-46.80%
HARBOR FUNDS: INT'L	-49.50%
LONGLEAF PARTNERS FD	-55.50%
LEGG MASON VALUE TR	-58.10%

Data according to Google Finance