Market Narrative 2008 -2009

In a Perfect Storm, being half right and half wrong doesn't mean much!

In last year's Market Narrative, I suggested that 2008 would bring a slowing economy, a weakening stock market, and that defensive preparation was in order. *So far, so good*. I then postulated on the potential severity of the stock market's decline and suggested that it was not likely to be as dramatic as that which we suffered in 2001-02. *Not so good.* The worst bear market since the Great Depression proved the second half of my prediction to be very wrong.

Actually, for the first three quarters of 2008, my prediction was holding up. Then in the first 19 business days of October, the market lost 27%. Nothing was spared in this lightning fast decline except US government securities. The strongest of financial institutions were brought to their knees, a prominent money market fund "broke the buck," high quality corporate and municipal bonds lost value, and the ingredients for a perfect storm of economic destruction began to metastasize. In such a perfect storm environment, traditional diversification disciplines offer little to no protection. Even those who were hunkered down in cash were vulnerable to loss.

The resulting shock and fear drove the investor community to near panic and the government to take unprecedented action. Historians and politicians will debate for years the causes of and cures for our current malaise, yet those of us who choose to live out today's realities in undeterred hope of regaining the road to financial stability must focus on a new strategy in light of a changed world.

2009 Outlook

It is generally acknowledged that the economic outlook for 2009 will remain bleak. Although it is true that the anticipatory nature of the equity market will cause it to respond in advance of actual economic improvement, we don't expect such a recovery soon and remain very cautious about equities overall. Great uncertainty still exists in the international economies and with the state of their financial systems. It has been reasonably argued that international financial institutions are in a more difficult situation than our own, and could cause even greater turmoil in world markets. In light of this potential headwind, and with vivid memory of losses suffered last year, we shall put emphasis on the areas that are most likely to generate positive returns with less risk.

When indiscriminate selling pressures infect all asset categories as they did last year, some categories are dragged down without justification resulting in significant opportunities. The most notable example in 2008 was the decline in value of high-grade corporate bonds. The vast majority of US corporations is meeting debt obligations and will continue to do so through weakening conditions. These low risk, high quality bonds are valued at sizable discounts with attractive yields and offer stock like appreciation opportunities. Furthermore, as economic conditions improve, lower quality bonds will represent a similar opportunity; their prices and yields are already at historic levels. International and emerging markets debt will be the final phase of our bond strategy as we work back to equity dominated normal market conditions.

The new strategy I referred to above is our bond focus. Although we will not suggest a total retreat from equities, we will favor a bond emphasis until we are convinced that equities have begun a sustained recovery. It is very difficult to know how long it will take to revert to normal conditions, but the stock market is going to have to convince our skeptical eyes. Such emphasis means that the early stages of equity recovery could be missed, yet the downside risks are still too great, while bond return opportunities are too compelling to bet any other way

When an improved equity cycle does begin, history tells us it will be significant and long lasting. In the last ten years, investors have suffered through two major market corrections, which has resulted in an annualized return for the S&P 500 of -1.4%. Every ten-year period in which the annualized return for the S&P 500 was 2.5% or less, the following ten-year period averaged 13%. Although past results offer no guarantees for the future, hope springs eternal.

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