

## December 31, 2008 Market Commentary and Outlook

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*Humpty Dumpty sat on a wall.  
Humpty Dumpty had a great fall.  
All the King's horses and all the King's men  
Couldn't put Humpty back together again.*

--Children's Nursery Rhyme

If we were to equate the current financial climate to this nursery rhyme, we would have a long list of possible candidates who could be Humpty Dumpty: Bear Stearns, Lehman Brothers, Fannie Mae, Freddie Mac, AIG, Merrill Lynch, GMAC, Washington Mutual, Wachovia...the list (pathetically) goes on and on. For the purpose of this commentary, let's think of Humpty Dumpty as America's financial institutions.

Clearly, Fed Chairman Ben Bernanke is the King. Secretary of Treasury Paulson is foremost among the King's men, the rest of whom are the Federal Reserve's Board Governors and members of Congress.

And the King's horses? \$700 billion of TARP (Troubled Asset Relief Program) and a slew of Federal Reserve loan and buyback programs: (the TAF, PDCF, TSLF, ABCPF, CPFF, MMIFF, and the TABSLF!). Add it up and the sum comes to about \$2 trillion!

If we have a King, then surely there must be peasants! Those would be you, us, and the rest of the American taxpayers.

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The way the stock market has been behaving as of late, the prevailing sentiment must be that our financial Humpty will be repaired and can get back up on the wall! And we would be ecstatic were that to come about. Without a ready source of capital from our nation's financial institutions, many of America's corporations cannot function adequately, nor can consumers gain access to loans needed to purchase homes, autos and other goods.

The current consensus is that stocks bottomed on November 20, the economy will recover in the second half of 2009, corporate bonds are a steal at their current yields, and stocks have discounted all the bad news. And what is the bad news (or at least some of it)?

- Unemployment is rising while the average consumer is hugely burdened by debt.
- Tax receipts are down and state and local governments are desperate for funds.
- The debt market, except for U.S. Treasuries and Government supported issues, remain essentially closed.
- Corporate earning estimates for 2009 are down as much as 60%.
- Consumer confidence is the lowest in 41 years.
- New construction and homes sales continue to decline along with prices.
- Industrial production is declining.
- The U.S. auto industry is on the verge of bankruptcy.

There has been some good news, the most important of which is that the coordinated efforts of the G7 countries last November kept the global Humpty Dumptys from shattering into such small and numerous pieces that repair would have been impossible. Oil prices have dropped dramatically from their high of \$147 per barrel last year, resulting in welcome relief at the gas pump that has proven to be a much greater economic stimulus for the U.S. Consumer than the \$600 rebate Congress doled out last summer. And there is a heightened sense of optimism that new leadership in Washington can make important and positive changes.

The stock market usually prices in factors it forecasts to occur many months out. In the face of negative current news, it would not be unusual for the market to have turned around. In 10 of the previous 11 recessions since World War II, the accompanying bear market ended and the bull market started prior to the end of each recession.

Investors need to be aware of the pattern of market movements in bear markets. Although the long-term trend of a market's movement might be up or down, there are intervening periods during which the markets move in the opposite direction of its trend. For instance, during the 2000-2002 bear market, the market had advanced three times in excess of 20% as calculated from an intra-day low to a subsequent intra-day high, with many advances ranging from 5% to 10%. However, peak-to-trough during that period, the S&P 500 declined 49.15% on a closing basis. Since the S&P 500 peak on October 9, 2007, we've seen two intra-day rallies above 20% that occurred within 10 trading days.

Have we in fact seen the lows of this bear market? Credible arguments can be made for both a “yes” and a “no” answer. The inevitable rallies and test of lows within a bear market make it difficult to know if the worst is over.

**Given a degree of uncertainty about the direction of the stock market, what should an investor do?** We have consistently counseled investors to get their asset allocation right, meaning the mix of cash, bonds and stocks within their portfolio must be appropriate for their circumstances and tolerance for investment risk. Shorter-term investment objectives should be funded with cash and bond investments; longer-term investment objectives can be funded with stock investments.

**We remain skeptical that the bull market has started. We think the market will once again test its lows in the first half of 2009. However, we advise against market timing. Instead, an investor whose asset allocation is right for him or her must accept the inevitable, near-term volatility of the markets, remembering that today’s stock investments need to be evaluated over a 5-plus year period.** If it turns out we’re wrong about the market and it has already bottomed, great! Stock prices now are such that they should deliver acceptable returns (8-10% annually compounded) over the next 5-plus years, and perhaps even modestly higher returns. If the market does go lower from here, the probability exists that long-term returns will be even greater from that point on. Stock investments have created the recent losses you’ve experienced. Ironically, stocks are the best investment to help you recover from those losses.

Almost every investor needs to have a hedge against inflation in his or her portfolio—a role stocks historically have played well. Markets are as unforgiving when investors take risk in overvalued markets as they are when investors abandon risk in undervalued markets. When markets keep going up and up and stock valuations are rich, the gains to be had are seldom permanent. Conversely given the current, low relative market valuations should subsequent losses occur on future market weakness, such losses historically have not been permanent. Paradoxically, it’s easy to own stocks when the markets are trading at speculative highs (yet the risk is great); and it’s hard to buy or hold stocks when the market prices are falling (yet the long-term rewards are great). Investors should only fear a decline in the markets if their temperament or situation forces them to sell stocks at much lower prices.

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While the near-term direction of the stock market is uncertain, we have a little more clarity about the bond market.

As the credit markets seized up in the 3<sup>rd</sup> and 4<sup>th</sup> Quarters of 2008 and the stock market experienced its precipitous decline, there was a “flight to quality.” Investors snatched

up U.S. Treasury Securities, driving yields to historic lows. In fact, the rate on short-term U.S. Treasuries is now close to 0%. Yes, some investors will accept no rate of return so long as they do not lose principal!

On December 16—the date of the last Federal Open Market Committee (FOMC) meeting—the Federal Reserve set its target for the federal funds rate<sup>1</sup> as a range between 0% and 0.25%. In doing so, the FOMC stated its anticipation that “weak economic conditions are likely to warrant exceptionally low levels of the federal funds rate for some time.” The Fed stated it is “also evaluating the potential benefits of purchasing longer-term Treasury securities” on the open market. Clearly, the Fed was signaling its intent to hold down interest rates as low as possible for as long as possible.

Buying a longer-term maturity of a U.S. Treasury bond investment will not meaningfully increase your investment yield. The yields for 10-year Treasuries are hovering around 2%. No hedge against inflation with this trade!

There’s a plus to lower, long-term interest rates. Mortgage rates generally are tied to such rates, and lower Treasury yields translate into lower mortgage costs. Lower mortgage rates can only help the housing market—something we need desperately to get Humpty back together again. But can the Federal Reserve keep interest rates low long enough to help Humpty Dumpty?

We think it will be quite a challenge, and **we believe investments in intermediate and longer-term bonds pose significant risk to investors.** We suggest much shorter-term bond investments, if not money market funds. Even if the Fed can hold interest rates down, what other challenge does the Federal Reserve have? It needs to sell trillions of dollars of U.S. securities to help finance the “overhead” of the King’s horses helping to put Humpty Dumpty back together again. It will need to sell U.S. securities to help fund the deficit in 2009, estimated to be in excess of \$1.2 trillion dollars (and greater depending on President-elect Obama’s economic stimulus package). And the Treasury will need to sell U.S. securities to “refinance” trillions of dollars of previously issued debt coming due within the next two years.

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<sup>1</sup>The federal funds rate is the interest rate at which private depository institutions (mostly banks) lend balances (federal funds) at the Federal Reserve to other depository institutions, usually overnight. U.S. banks and thrift institutions are obligated by law to maintain certain levels of reserves, either as reserves with the Fed or as vault cash.

Who will buy these U.S. securities? As in the past, upwards of 40% of those buyers the Fed hopes will be foreign investors. Will foreigners be willing to purchase these bonds?

Think for a minute as if you're a foreign investor. Will you be excited about buying a long-term security paying you 2%? Can these rates go lower and create capital gains for you? (In our opinion, we think there's a small chance of this unless we experience Financial Armageddon.)

As a foreign investor, are you confident the Fed can hold rates low for the duration of your investment? If it can't and rates rise, the value of your security will drop and you'll suffer a loss of principal. (Remember, as rates increase, the value of bond securities decline.)

The U.S. Dollar for several years has depreciated in value against most foreign currencies—probably your currency—until recently. The flight to quality that drove down bond yields also increased the bid on the value of the U.S. Dollar. What if the value of the U.S. Dollar begins to weaken again (due perhaps to low interest rates, falling demand for US exports and assets, or other reasons)? As a foreigner, your investment in U.S. Dollars when exchanged back into your local currency translates into a loss.

In other words, you as a foreign investor suffer an investment loss whether interest rates rise and the U.S. Dollar maintains its strength against your currency, or if interest rates stay low but the value of the U.S. Dollar declines. There's a high probability one or the other of these scenarios will unfold.

There's a plus to a lower U.S. Dollar. U.S. goods are cheaper to buy by foreigners and foreign goods are more expensive to the U.S. consumer. Both of these factors can help the U.S. economy.

If the King's efforts to help out Humpty forces him to make a choice between keeping interest rates low or supporting the U.S. Dollar, we think the Fed will attempt to keep interest rates low and let the Dollar fall. After all, if foreigners won't buy our bonds, there's always the printing press!

Accordingly, an investment in foreign bonds offers the U.S. investor an opportunity for capital gains. As the value of the dollar falls, bonds denominated in foreign securities will exchange back into a greater amount of U.S. Dollars.

Unfortunately, very low yields on "safe" investments across the entire range of maturities only punish savers, forcing a difficult choice for them: suffer the loss of purchasing power due to inflation with low investment returns; or accept higher investment risk in an effort to increase investment yield. Buying foreign bonds is not without its risk. But it's a risk we think acceptable for longer-term investors.

Investors are driven by fear or greed. Greed feeds their appetite to take on investment risk. Fear forces them to sell investments indiscriminately to curtail losses.

In moderation, greed and fear can be useful to long-term investing success. Rightly so, fear drove the markets for the second half of 2008. We are encouraged by the market's performance since November 20. However, we would not be surprised to see the markets succumb to another round or two of fear during 2009. Investors with an appropriate investment horizon may benefit by viewing the next wave(s) of fear as *long-term* investment opportunities.

For the record: All the King's horses and all the King's men are still attempting to put Humpty back together again. The last verse is yet to be written in this modern day retelling. Let's hope for a happier ending!

Northwest Capital Management, Inc.  
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