

Todd's Perspective

Fall 2008

Does the 50% market drop already discount our economic misery?



Summary

I believe our economy is in the midst of an economic contraction of unknown length or depth. It is likely to be longer than average because of the strain on consumer balance sheets following the consumption excesses of the past decade. My guess is that this will last most of 2009. While we obviously do not know what the stock market will do in 2009, I believe most of the misery is already discounted.

It's Risky to Sell after a 40% Collapse

The Standard & Poor's 500 stock index is down almost 40% in 2008, including a dismal 25% decline in the fourth quarter. In the words of Hank Paulson, U.S. Treasury Secretary: "We are dealing with an historic situation that happens once or twice in a hundred years".

There have been five major bear markets over the last 83 years, 1926 - 2008. Only the four-year 64% decline in the "Great Depression" 1929-1932 was more severe than the 2008 bear market. Details are shown in Exhibit 1 below.

It is worth noting the strength in the market in the recovery year. While we caution that the past is not necessarily prologue it is risky to liquidate stocks after a 40% market collapse.

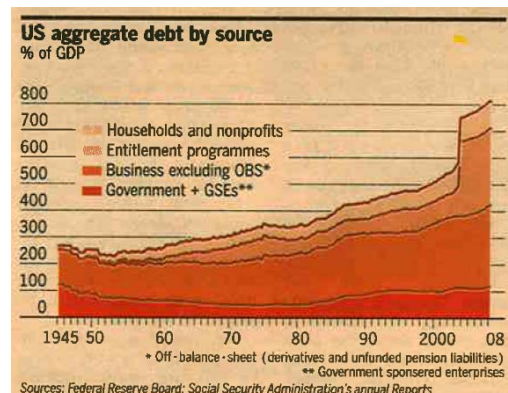
Period	Length	% of Decline	% Change Following 12 Months
1929 - 1932	33 Months	-86%	121%
1937 - 1938	13 Months	-54%	29%
1973 - 1974	21 Months	-48%	38%
2000 - 2002	31 Months	-49%	34%
11/1/2007 to 12/31/2008	14 Months	-52%	?

Source: Bloomberg

Unraveling the Credit Bubble

Never before have we been so leveraged with debt. Rob Arnott, Chairman of Research Affiliates, points out (Exhibit 2) that in the last ten years total debt in our economy, including households, companies, and government has soared from nearly five times GDP to over eight times GDP. The Federal Reserve is creating more money in less time than ever before.

Exhibit 2:



How much longer should this recession last? It is already one year old. David Rosenberg, Merrill Lynch economist, says economic history going back to the 1800s reveals recessions that involve a collapse in credit and asset deflation tend to be longer than the ones we have experienced in the post war period. That suggests to us the recession will last through most of 2009.

One Historian Questions Paper Money

Harvard historian Niall Ferguson said in the December Vanity Fair that: "it remains unclear if the monetary authorities will succeed in averting a 1930s-style "Great Contraction" of credit and output by transferring the as yet unquantifiable losses from banks to tax payers. He made the

shocking statement that we now have to question some of our deeply rooted beliefs about the benefits of paper money. It is true that over the last 3 ½ years the price of gold has doubled while the stock market has dropped 25%.

It seems to us this also makes Treasury Inflation Protected Securities (TIPS) particularly attractive at this time since they provide an interest income of 2% plus whatever the rate of inflation is. At the moment, the market seems to anticipate that it is less than 1%, which seems overly optimistic to us.

Housing Market Remains Weak

The housing market remains extremely weak. The S&P / Case-Schiller home price index declined 8% in the year ending October 31, 2008. It is hard to visualize the end of this severe recession until home prices decline to a level where the average family is able to afford one. In our opinion that means another 10-15% decline, or another 6 to 12 months.

Detroit Competes With Wall Street For Bailout Funds

The UAW President Ron Gettelfinger is a good negotiator. As a result, President Bush reversed course by his willingness to use TARP money earmarked for financial firms, to keep Detroit alive without harsh concessions sought by the Senate GOP. Thus, comprehensive bailout legislation will be left to President-elect Obama, since only \$17 billion is earmarked for the automobile industry. The Center for Automotive Research suggests that a fifty percent contraction of the U.S. big three would create massive job losses that would push the unemployment rate from the current 6.7% to 10.5%.

Paul Ingrassia, former Detroit Bureau Chief of the Wall Street Journal, advocates a federal restructuring trustee, with the same powers as a bankruptcy trustee as part of any bailout plan. Such a person would have the power to cut through various contractual obligations so that the automakers can emerge with a viable business model. Surveys cited by Advisor Perspectives suggest up to 90% of consumers

would not buy from a bankrupt automaker. Congress can address that specific problem rather than by writing an open-ended check. Not since the early 1950s with Truman and the Steel Industry, have we come this close to nationalizing an industry. (Maybe the financials in 2008 is close).

Our auto industry has been in a decline for a number of years. Today, nearly 60% of the vehicles we buy are made by foreign transplants, according to Merrill Lynch economist David Rosenberg.

Madoff With Ya Money

“If something sounds too good to be true, it probably is”. This was the response of one of my business associates to a friend who many months ago asked if he should invest in Bernie Madoff’s hedge fund. Unfortunately his friend ignored this warning, lured by the promise of a steady 10% return.

Madoff was actually turned in to the authorities last week by his two sons upon learning their father was running the biggest Ponzi scheme of all times, \$50 billion. His downfall came when some investors actually asked for their money back. Sophisticated investors are guilty of naivety, and litigators will thrive.

Make Quantitative Experts Accountable

It is ironic that much of our economic woe today reflects the failure of subprime mortgages in 2007 whose risks were downplayed by the same quantitative methods that caused the collapse of Long Term Capital Management in 1998. Nassim Taleb, author of “The Black Swan: The Impact of the Highly Improbable” complained that risk methods that failed dramatically in the real world continue to be taught to students in business schools. Lehman Brothers and Morgan Stanley used the model, called Value at Risk, citing that it is used on CFA exams. Nassim says these quantitative methods were used to create complex derivatives. They did not work and could provide undue comfort by hiding risks. He urged removal of Value-at-Risk books from the shelves of academia.

Quantitative Easing

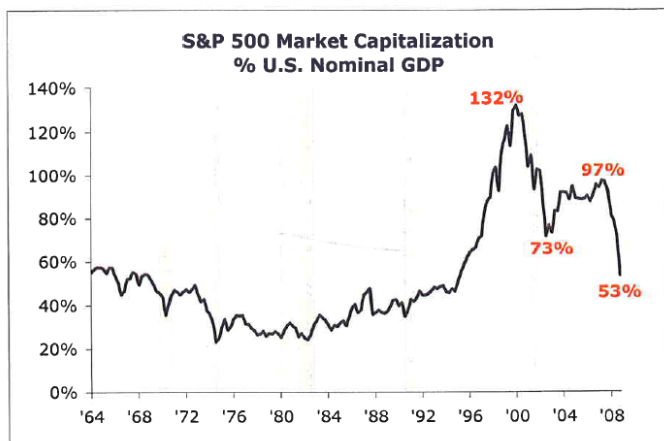
Quantitative easing is a high-risk option taken by the Fed to prevent the much feared deflation. Since interest rates have already reached near zero, the only way the government can get more money into the system is to pump it in by other means. For example, it can create money and give it to the government to spend, forcing up the demand for goods and services and preventing prices from falling. Bernanke is saying he will do whatever it takes to push money into the economy. What are the risks? The risk is prices start rising at a rapid pace accompanied by a collapse of the dollar. It was just such hyperinflation that plagued Germany in the 1920's and some Latin American countries in recent years.

In our opinion that is one reason to hedge in a small way with gold.

Stock Market Back To a Normal Level

On a more cheerful note, Steve Leuthold, of the Leuthold Group reminds us that we have had a "lost decade" in the stock market. The S&P 500 has produced an annual total return of -0.9% for the ten years ended November 30th. He comments this does set the stage for a strong performance going forward. The Strategas Research Investment Group observes that the market capitalization of the S&P 500 in relation to nominal GDP, has already completely retraced from the 1994-2000 boom years (as noted in Exhibit 3 below).

Exhibit 3:



Oil Price Collapse Cushions Economic Decline

Oil has fallen below \$36 a barrel, its lowest level since July 2004 in response to reduced global demand for energy. Oil companies and traders are storing at least 50 million barrels of oil in supertankers. The surge in floating storage is a clear sign the OPEC cartel is losing its battle to cut supplies more quickly than demand falls, according to the Financial Times, 12/16/08. This is a welcome relief to the debt-burdened consumer. Stratfor Research, in a 12/18/08 piece said: "Prices are likely to remain low for some time. Large production cuts are needed to prevent massive oversupply. Oil prices fall far faster than it rises when the fundamentals are out of whack."

Few of us ever expected to see gasoline below \$1.50 per gallon again.

The Lehman Fiasco

Ben Bernanke and Hank Paulson did the right thing in bailing out Bear Stearns in March. However, with hindsight, they should not have let Lehman Brothers go bankrupt in September. Notice in Exhibit 4 (page 4) how the stock market and several other market measures of risk aversion spiked dramatically after that moment. As the Bank Credit Analyst pointed out in the year end review, "The sudden loss of trust in the financial system pushed the economy past the tipping point."

Thankfully our policy makers stepped up efforts to stem the economic slide. So far, from the stock market view point, it is working. The Dow is now at 8,500. It first fell below that level about ten weeks ago, on October 10th. It has since traded in a wide range between 9,600 in early November and 7,500 on November 20th.

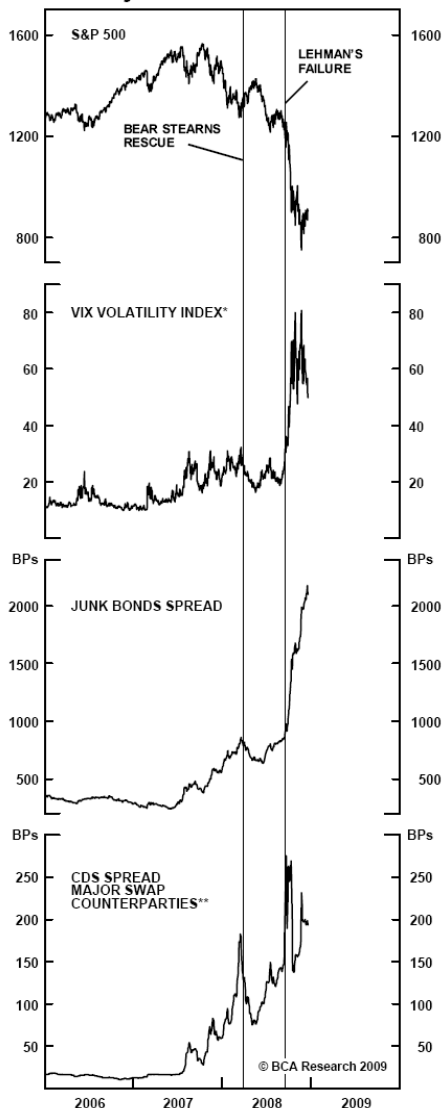
Conclusion

There seems to be little logic in the bond world which is now dominated by fear. For example, 10-year Treasury bonds now yield only 2.1%. By contrast, investment grade corporate bonds yield about 7.0%, a spread of approximately 500 basis points.

Massive fiscal and monetary inflation should prevent the U.S. from slowing into a 1930s type depression. Nonetheless, our recession has now become global and could drag on through most of 2009. We will experience a dramatic increase in the role of government in our economy. Inflation will remain low for the next several years. While aggressive government action might create the potential for higher inflation, that danger, in our opinion, is several years away.

Stock market valuations are cheap. The dividend yield on the Dow Jones average is now 3.7%. The market should be able to sustain an advance once the credit system starts to function in a more normal pattern.

Exhibit 4:



* SOURCE: CBOE
 **UNWEIGHTED AVERAGE 5-YEAR CDS SPREAD: JPM, BAC, C, WB, WFC

Sources for this article include:

- Wall Street Journal, June 2, 2007, Interview with Boone Pickens
- Energy Outlook, November 27, 2007
- Vanity Fair, December 2008,
- Bank Credit Analyst, Year End 2008
- Advisor Perspectives, December 2008
- Leuthold Group, December 2008
- Paulson quote: Fox News November 25, 2008
- Financial Times, December 8, 2008
- Merrill Lynch, December 16, 2008

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