



## The Road to Hell is Paved with Good Intentions

### Market Commentary

January 1<sup>st</sup> 2009

I am constantly amazed at the degree of stupidity that can be attained at almost all levels of government and the public's willingness to accept any cockeyed scheme they can dream up. In a continued effort to mitigate any financial pain or failure, the coordinated actions of the Treasury, Federal Reserve, and Congress may have the unintended consequence of extending the recession and accentuating the destruction of capital.

Just as there is a natural order or "cycle" in nature there is a natural cycle in business and the economy. As spring follows winter, periods of contraction or recession follow periods of growth or expansion. This is the natural order and when, with our well-meaning intentions, we attempt to circumvent the cycle, there can be unintended consequences.

It has been a long held belief by historians that it was President Hoover's lack of fiscal stimulus that caused a recession to morph into a depression and it was only the actions of F.D.R. that brought the country back to some semblance of economic stability.<sup>1</sup> Further study now suggests that the "New Deal" in fact extended the depression by not allowing the economy and therefore the capital markets to find a natural bottom.<sup>2</sup> It was only the advent of America's entry into World War II that the economy was able to pull itself out of the financial crisis.

We believe the failure to recognize the need for the economy to revert to the mean or the desire to avoid any financial pain can, in the long run, do more harm than good. Rather than let the markets and the economy find a natural bottom, however painful that may be, and it would be painful, we have attempted to lessen the immediate pain through government intervention. In the end we will likely revert to the mean and the cycle will proceed; the question will be one of timing. Will it occur quickly with a sharp contraction in growth followed by a period of stabilization; or will it be a long drawn out process?

At this point it's too early to tell, but let's plan for the worst and hope for the best, that way we might be pleasantly surprised or at the least not disappointed.

### **Year in Review:**

2008 will go on record as the third worst year in the history of the stock market as the S&P declined 38.5% and the Dow fell 33.8%. Only two other years suffered more significant declines: 1907 and 1931 for the Dow Industrials. Given the damage to all sectors of the equity markets, both domestically and internationally, it would be understandable for investors to believe that the worst may be behind us. In fact, if we were to follow the 1907 pattern, the markets in 1908 jumped 46.6% after declining 37.7% the previous year.<sup>3</sup>

<sup>1</sup>, "America's Great Depression" Rothbard, Murray N

<sup>2</sup> "New Deal Policies and the Persistence of the Great Depression: A General Equilibrium Analysis", Journal of Political Economy, 2004, vol. 112

<sup>3</sup> Source for current and historical Data: Dow Jones



However, in 1931, the Dow having fallen 52.7% for the worst year in history, the markets fell further in 1932 dropping an additional 23.1%.<sup>4</sup> Many strategists are predicting the bottom of the current bear market will be reached in 2009. That very well may be, but that doesn't mean the immediate resumption of a bull market or even a positive year for stocks. Much will depend on the markets ability to discount the current economic woes and focus on the future.

It doesn't require a keen intellect or an advanced degree to know that the first half of 2009 will be a continuation of the bad news on the economic front. Unemployment is forecasted to rise significantly, home prices are predicted to decline further<sup>5</sup>, and consumer spending will be pitiful at best. With those head winds, corporate profits will be hard pressed to achieve even drastically reduced forecasts; which leads us to a discussion of fair value.

**Valuations:**

Consensus estimates for S&P as reported earnings or net profits are coming in at \$42.24 for 2009, revised lower from previous forecasts. Long-term, the average price to earnings ratio for the S&P is 15.79, which encompasses a range of 5.9 in June of 1949 to 46.50 at the close of 2001. If we were to use an estimate for earnings or net profits on the S&P of \$42 a share for 2009 and calculated multiple P\|E ratios, the index could trade in the following range:<sup>6</sup>

Price to Earnings Ratio	S&P Level	Comment
29.41	1235	P\ E in March of 2000
15.79	663	Average P\ E since the depression
10.00	420	Potential P\ E for recession
8.00	336	Potential P\ E for depression

The S&P closed the year at 903.<sup>7</sup> Obviously, if corporate earnings exceed expectations and come in higher than the consensus estimate or investors are willing to accept greater levels or risk, the S&P could trade considerably higher in 2009. However, when using a top down approach to earnings, we believe the \$42 number may in actuality be slightly on the high side and would recommend erring on the side of caution.

No one knows how or where the markets will trade on a day to day basis as evidenced by the series of failed attempts to call a market bottom in 2008 by the pundits. However, we can analyze the data and reach some broad conclusions as to the general state of the economy and the potential behavior of the capital markets over the next year.

**Outlook:**

We would not be surprised if the markets rallied prior to the inauguration of President-elect Obama. The country desperately desires some type of change and is hoping the new administration will be able to provide strong leadership and a renewed sense of hope and confidence. As confidence is sorely lacking at the moment in the investor community, this could provide a relief rally.

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<sup>4</sup> Source for current and historical Data: Dow Jones  
<sup>5</sup> Source: Goldman Sachs  
<sup>6</sup> Source for current and historical Data: Standard and Poors  
<sup>7</sup> Source: Standard and Poors



Unfortunately, we believe this rally will be short-lived as investors recognize that there is no magic wand that the new president can wave to fix our economic problems. As that reality settles in, we would expect the markets to roll over and continue to decline until at least a retest of the November lows, as the economic news grows progressively worse.

Unemployment should increase as companies accelerate the number of lay offs in fear of a prolonged recession, and the housing market is expected to continue to deteriorate as bankruptcies and foreclosures hit new highs in the first half of 2009. Consumer spending, as evidenced by the holiday retail numbers, will falter bringing a new wave of deflationary fears.

If the level of fear and concern increases even in the face of government intervention we could, by the end of the 2<sup>nd</sup> or 3<sup>rd</sup> quarter of 2009, experience a broad based capitulation in the capital markets on a global scale. If this were to occur, we could begin forming the base for the next bull market. As you know markets are anticipatory in nature, but there have been a number of false starts over the past several months. Given the degree of uncertainty, any redeployment of capital into the markets should be considered and measured.

Bearing in mind each individual's financial position, the first tranche could be allocated to well-capitalized companies with strong balance sheets and substantial dividends that are reasonably secure. High quality corporate debt could also be instituted at this juncture, but again only focusing on financially stable companies where the chance of default is minimal.

As the markets pulled back from the first rally off the bottom, we would look for the indices to hold well above the lows and stabilize. In this situation, we would be more comfortable selectively building out the portfolios, focusing on companies that could provide inflationary hedges and long-term growth where income is a secondary consideration. The final allocation, were it to transpire, would be to more speculative or long-term holdings such as emerging markets.

In the interim we continue to recommend where appropriate, short-term, high credit quality municipal bonds and TIPS<sup>8</sup> in order to potentially protect principal and generate an income stream. For instance the Gold Index, if given the opportunity, could represent a hedge against currency risk for some clients, but we would like to purchase it at levels below where it is currently trading in order to reduce the potential down side.

In short, while we believe there may be an opportunity in the coming months to take advantage of a very attractive entry point for long-term investors, we are still early in the game and need to be patient. For the moment protecting capital for the majority of our clients and potentially generating a stable income stream should take precedence over capital appreciation.

When appropriate we will need to adjust our behavior from defensive to opportunistic and hope that we successfully identify the indicators that trigger that change. But for now, we believe the cycle has not completed its journey and only more time, not intervention, will get us to the other side.

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<sup>8</sup> **TIPS:** Treasury Inflation-Protected Security. A security which is identical to a treasury bond except that principal and coupon payments are adjusted to eliminate the effects of inflation



It has been a difficult year for everyone. While we anticipated the down turn in the markets and the underlying causes, we did not accurately forecast the level of damage the markets were to experience, especially in October and November. Where we anticipated a decline of twenty to twenty-five percent for the equity markets, the reality was starker with the indexes falling at various points over forty percent.

In light of failures such as Lehman Brothers, Washington Mutual, and Bear Stearns, we feel fortunate to have avoided the worst and helped to position our clients to take advantage of what will be one of the greatest potential buying opportunities in history.

We are thankful for the privilege we enjoy working with our clients each day; for it is the relationships that we have built over the years that we most value and look forward to continuing that process in the coming year.

Sincerely,

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Managing Partner

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Partner

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