

Dr. Krosby

A LONG, HOT SUMMER

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The second half of 2008 arrived amid a torrent of headline-grabbing news: concerns over General Motors, Middle East saber-rattling, the collapse of IndyMac Bancorp, the Fannie Mae and Freddie Mac non-demise demise, and near-daily food riots somewhere around the world. Add in worries over inflation and deflation—not to mention continuing evidence of a global economic slowdown—and it's a small wonder that the official arrival of the bear market was officially acknowledged for the S&P 500, the Dow Jones Industrial Average, and Nasdaq. Global indexes, too, are either in bear territory or getting dangerously closer. Indeed, this is fast becoming the summer of our collective discontent.

In a vulnerable market, rumors quickly take precedence over fact, and denials are treated with skepticism. CEOs, CFOs, and high-level government officials have been subjected to intense analyst and media cross-examination. Ultimately, the motto becomes “Sell first—ask questions later.”

Certainly, there has been good news, and even dollops of “less bad” news have been mildly therapeutic. Exports remain solid, and the unemployment rate—although on a rising trajectory—hasn't reached recessionary levels. Deals and mega deals are still being announced, proving that there's plenty of money looking for investments. But with confidence wanting, the exhilaration is fleeting.

Credit worries, housing declines, and escalating oil prices remain the dominant theme. It will take a decisive paradigm shift, a transformational event, to bring back investor confidence and the nearly \$3.5 trillion sitting in money market accounts.

According to the most recent Gallup poll, 81 percent of Americans hold negative views of the economy, while other surveys indicate that consumer confidence stands at a 30-year low. With layoff announcements beginning to pick up and consumer net worth declining, the scene of depositors trying to get their money out of IndyMac Bancorp branches splashed across the evening news did little to inspire confidence. The seemingly endless

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game of “which bank is next?” has moved from the confines of Wall Street clear onto Main Street.

Still, in the midst of the endless drizzle of bad news, the sage words of Sir John Templeton, one of the world’s leading investors who passed away in early July, should offer some much needed solace: “Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell.”

The tug-of-war is intensifying, however, on precisely how much more pessimism we have to endure before optimism returns.

Chairman Bernanke Assesses the Situation

Appearing on Capitol Hill to testify on the economy before the U.S. Senate Banking Committee about his semi-annual report, Chairman Ben Bernanke of the Federal Reserve described a U.S. economy that faces significant challenges from a weak housing market, tight credit conditions, high energy prices, and inflationary pressures that “seem likely to move temporarily higher in the near term.” He stressed the importance of bringing the financial markets back to health, as “healthy economic growth depends on well-functioning financial markets.” This will continue to be a top priority for the Federal Reserve.

As for why investors are nervous, Bernanke cited the vicious cycle of an uncertain economic outlook and fragile credit conditions. “Many financial markets and institutions remain under considerable stress, in part because the outlook for the economy, and thus for credit quality, remains uncertain.”

The Federal Reserve’s new economic projections were released, and a best-case scenario forecasts sluggish growth of 1.6 percent and an unemployment rate that could reach 5.7 percent. The Chairman qualified the outlook by warning that there still remain “significant downside risks to the outlook for growth, and upside risks to the inflation outlook have intensified.”

While it’s been a popular game to guess which bank is “next,” Bernanke assured the committee that the banking system is “well capitalized.” His concerns, however, have “turned less on the solvency of these institutions and more on their ability to extend the credit that our economy needs to keep growing.”

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The Chairman’s testimony, coupled with perceived Fannie Mae/Freddie Mac machinations, have only fueled investor concern that the Federal Reserve—and the government, in general—is following events just like the proverbial man-in-the-street. And if, as it is said, investors need clarity, the bureaucratic environment certainly doesn’t offer much in the way of guidance or confidence.

Glimmers of Hope

- a) Bear markets are nasty, but significant rallies of 20 percent, and sometimes even 30 percent, punctuate the bear’s grip. But more importantly, opportunities arise for long-term investors. That is why the likes of Warren Buffett, Kirk Kerkorian, Wilbur Ross, and Carl Icahn, “whale investors” in Wall Street lingo, often appear on the financial pages, as they seek value amid the ruins. When others are forced to sell, or fear pushes them to sell, these icons go against the trend to take advantage of the downturn.

b) A July 14, 2008 *Barron's* cover story, "Home Prices Are About to Bottom," suggests the unthinkable: that a turnaround may be gathering momentum. According to the article, recent data point to home prices rising very slightly in eight of the 20 markets analyzed by the S&P/Case-Shiller index, while the rate of the monthly price decline is beginning to ease in many of the markets with negative readings.

c) Oil prices may be on a sustainable climb-down as traders assess the impact of a global economic slowdown on demand, and a possibility that the U.S. may be inching closer to an agreement on offshore drilling. The Organization of Petroleum Exporting Countries (OPEC), supplier of nearly 40 percent of global oil, announced that it expects demand to slow in 2009 as the economic slowdown unfolds. Meanwhile, President Bush lifted the executive branch moratorium on offshore drilling and urged Congress to consider oil and gas drilling on the U.S. outer-continental shelf. The President warned that there will continue to be "upward pressure on price" until more supply is brought on the market. This is a seemingly intractable problem for the consumer, as higher prices deplete disposable income. Anything that can be done to reduce energy costs will help propel domestic economic growth.

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d) Despite the ensuing slowdown, U.S. companies, with help from the weaker dollar, continue to boost sales overseas. Even though growth is projected to slow in emerging markets, a report from Global Insight, based on a survey of 54 developing economies, indicates a 6.7 percent rise in GDP for 2008, down from 7.5 percent in 2007. As the second quarter earnings season continues, companies such as General Electric, Johnson & Johnson, and Intel all report solid second-quarter earnings despite a challenging environment. Business in the developing markets may slow, but those markets will continue to provide an important source of revenue as companies diversify their client base.

History tells us that bear markets, on average, last about 18 months (based on the last 19 bear markets) and, at their low point, reach about a 37 percent decline. This suggests that there's more pain in store for investors. Not all bear markets are alike in terms of duration and depth, but their common denominator is time-tested: Money is made even during bear markets, but you just don't know it at the time. It's a pity we don't have Sir John Templeton with us now to help us through these dark days. We do, however, have his enduring words of wisdom.

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Always Thinking Ahead



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