

The Advantage Advisor

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Market Commentary:

As I wrote in my client letter earlier this month, October was one of the worst for the financial markets - ever. And the downside that we see in the table to the right is only half of the story. The sheer volatility of the markets reached historic levels during the month as well. In one instance, the Dow actually gained more than 24% - a bull market by most definitions - in just 36 hours!! Managing this kind of volatility has required a dramatic shift in investment policy. I once heard a fighter pilot describe flying in combat to being the closest he has ever come to having no idle moments in activity. I would guess that most investment managers (myself included) would say that this market has brought us to where we can truly relate to that level of attention.

Without question, investors have thrown out any concern for the fundamental underpinnings of the marketplace and sold indiscriminately as they ran for the exits. Now that the markets seem to have plumbed the depths to which we could fall, we must take a step back and see just where we are, and where thing could head next. I know that sentiment is bad, and it seems like it will be this way forever, but that is simply not the case. Over the past couple of months some significant changes have taken place, and things are starting to pick up once again. Here is a short list of the positive developments that we are seeing:

- ◆ The overnight LIBOR lending rate has fallen from its high above 6% to below 1/2% - lower than the Fed Funds target rate of 1%.
- ◆ One year LIBOR (the rate upon which many adjustable mortgages are based) has also fallen to below 2.8% from a level of 4.5% one year ago. This means that many adjustable mortgages will reset significantly lower - reducing payments and fi-

Market Statistics for October

<u>Market Index</u>	<u>Closing Price</u>	<u>% Change</u>
Dow Jones Industrial Average	9,325	-14.1%
S&P-500 Stock Index	969	-16.9%
Russell 2000 Stock Index	538	-20.9%
Shearson Treasury Bond Index	15,456	-5.0%
Dow Jones World Stock Index	178	-20.0%
Nasdaq Composite Index	1721	-17.4%

financial stress on homeowners.

- ◆ Raw materials prices have fallen dramatically, and Crude Oil is now trading below \$55 per barrel. As a result, gasoline prices have dropped below \$2.00 per gallon and may well fall to \$1.50 before the end of the year.
- ◆ It is estimated that every \$.01 drop in the price of gasoline frees up \$1 Billion for consumers to spend each month. The decline in gasoline prices now equates to an additional \$200 Billion in the hands of consumers, which is \$50 Billion more than the tax rebates that were handed out earlier this year!

Let me first summarize my view of the markets right now, and then go into each area individually to show just where things are and where we believe they are heading. First, I believe that the financial markets, with the exception of the commodities markets, have been sold off to irrational levels. This selling is mainly due to excessive fear in the marketplace and investors pulling their money out of securities in favor of cash or very short-term US Treasury securities. Hedge funds have suffered a tremendous amount of redemptions, and in order to give the money back to investors, they are forced to sell their more liquid holdings. This forces even high quality stocks and bonds down in price in spite of (or possible because of) any positive financial performance. Because of those persistent selling pressures, any attempt at a rally is short

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The Economic Picture

One might take a look at the table to the right and notice that our economic analysis still has us in a contraction stage. This could easily lead one to wonder just what it is going to take to push us into the recession stage. As of right now, the only thing that is holding us up is the lack of a bear market in US Treasury Bonds.

As one can see in the chart below, both the stock market (S&P-500 Stock Index) and the commodities market (CRB Commodity Index) have fallen well below their 12 month averages confirming a bear market for those sectors. But thanks to massive cutting in interest rates and a global flight to safety, the Treasury market has remained above that average and avoided a bear market (thus far). What this masks, however, is the severe bear market that has been seen in both high quality corporate bonds and high yield bonds. The likely outcome of this divergence is that we will see a serious decline in US Treasury bonds once investors begin to shift their money back into other investments.

As was expected, many of the economic reports for the month of October were terrible. The worst of the group was an increase in the unemployment rate to 6.5%, with further increases in that rate expected over the next several months. GDP for the US posted a 0.3% loss for the 3rd Quarter, and further declines are expected for the fourth quarter. However, one curiosity in that report was the fact that GDP only declined because of a much larger than expected increase in headline inflation for the quarter. It is within the realm of

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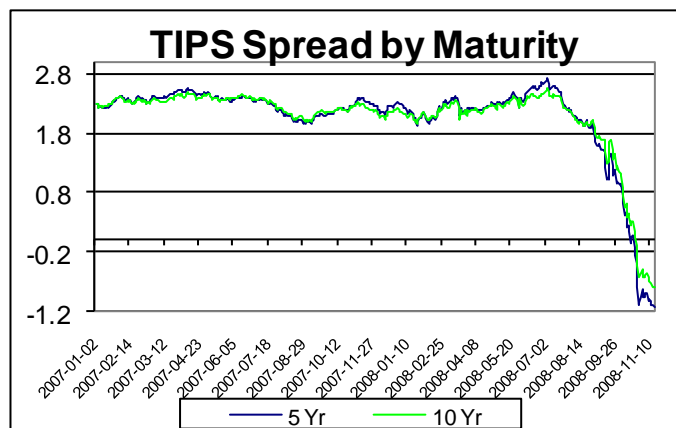
Current Economic Position:
Stage 5 - Contraction

Economic Indicators

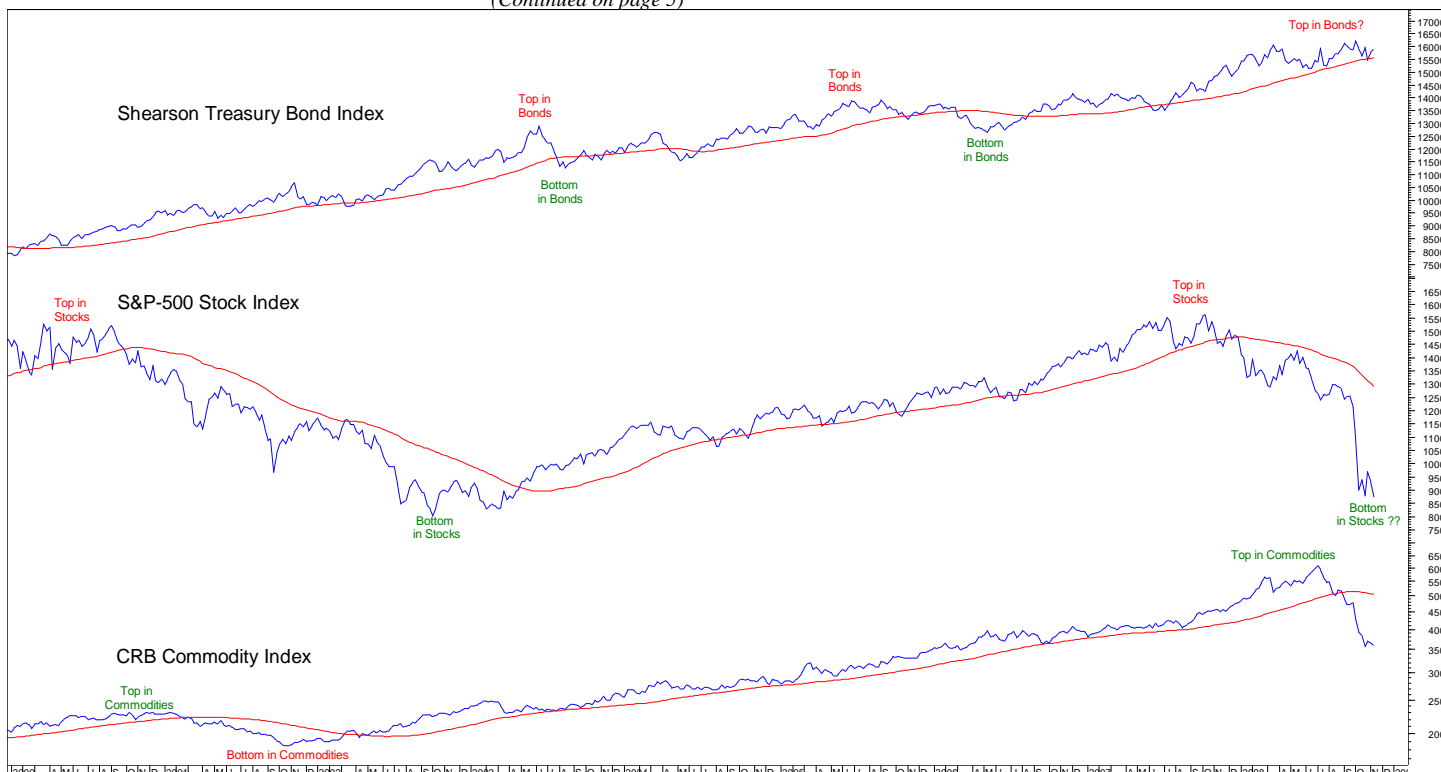
	Latest	Prior
Growth		
GDP	- 0.3%	+2.8%↓
Productivity	+1.1%	+3.6%↓
Employment Cost Index	+0.7%	+0.7%
Capacity Utilization	76.4%	75.5%
Inflation		
Consumer Price Index	- 1.0%	+0.0%
PCE Deflator (Personal Inc)	+0.1%	+0.0%
Implicit Price Deflator (GDP)	+4.1%	+1.3%
Sentiment		
Consumer Confidence Index	38.0	61.4
Unemployment Rate	+6.5%	+6.1%
Personal Income	+0.2%	+0.4%

↑=revised up, ↓=revised down

Source: Moody's Economy.com



Source for data: US Federal Reserve



Source for data: Investor's FastTrack

(Market Commentary, continued from page 1)

lived as the next round of selling pushes prices back down to their low levels.

The good news is that we held above a support level of around 8,000 on the Dow for some time now. Because of this, I believe it to be likely that we will move mostly sideways in a trading range type of environment for at least the next several months. This range is very broad (around 19% from top to bottom), and as such will provide opportunities for profits through more active trading strategies. Overall, our goal is to maintain a mainly defensive posture in all of our client portfolios, and take advantage of any lower risk trading opportunities that might present themselves. By implementing this type of policy in October, our average client experienced declines of only 1/3 that of the S&P-500 Stock Index.

The stock market is known as a forward looking mechanism. In other words, the market sees what may happen in the near term and then adjusts prices to suit. However, it is also an incredibly emotional place where investors invariably overshoot on both the upside and the downside. The only way to smooth out that volatility is to watch the fundamental underpinnings of the market to see where a reasonable price level should be. Then we can compare that level to the current market to get a gauge of where prices are likely to move once cooler heads prevail. We can use several different tools to determine reasonable price levels for the broad market, specifically focusing on the S&P-500 Stock Index. Most of those models are based upon projected earnings for stocks, because earnings are the basis upon which stocks are given value.

One of the best known measures of the relative value of stock prices is the price to earnings ratio, known as the P/E ratio. To get an idea of where the market's P/E ratio should be at present, we can look at where it has been in the past, based upon different levels of inflation. For example, during periods when inflation averaged between 4.5% and 5.5%, the average P/E for the S&P-500 stock index was around 14.2. During periods when inflation measured less than 2.5% (such as at present), the average P/E ratio was 18.6. This means that the S&P-500 should trade at a value that is around 18.6 times projected earnings. Based upon 2008 earnings, the S&P-500 is cur-

rently trading at a P/E level of around 9.

For 2009 there is quite a range of earnings projections, from \$90 per share to as low as \$60. A good conservative estimate is that of both JP Morgan/Chase and Goldman Sachs, which is \$75 per share. If we use the \$75 per share figure, and multiply it by 18.6, we get a projected value for the S&P-500 of 1,395 – more than 66% higher than it stands at present. Even if we use the low estimate of \$60 per share, it projects a value of 1,116 which is still 33% higher than current levels!

Another way to look at the current valuation of the marketplace is to see just what kind of earnings it would take to reach current prices. Using another, slightly more sophisticated model of the markets, I factored in the current price level for the S&P-500 (around 840), and the consensus forecast for interest rates of 4.75%. Based on those figures, the market is forecasting corporate profits (earnings) to decline by more than 41% over the next twelve months! To put that into perspective, over the past 60 years the worst 12 month period for corporate profits was a decline of just under 21% back in 1953 (the market then rose by 33.3% over the next 12 months). Our current market is priced at a

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level which assumes earnings will decline at a pace which is nearly double that rate! Finally, if I use that same model and assume 0% profit growth and a 4.5% interest rate, I get

a level for the S&P-500 of 1,618 which is 93% higher than present levels.

Do I believe that the market will rise by 93% or even 66% over the next 12 months? Not realistically, no. But I do believe this shows just how far we have pushed prices to the downside, and also that the upside potential is extremely significant. I believe now is the time for us to be actively looking for and snapping up bargains that will bring us back to well above our previous highs in the next two to three years as the market cycle moves forward.

Investment Strategy Focus

Stocks:

Our stock strategy is managed according to in-

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(Market Commentary, continued from page 3)

vestment style, such as large cap, small cap, growth, value, etc. Currently, we are holding 47% in large cap growth stocks, 25% in small cap value stocks, and 25% in cash. Our strategic allocation strategy is managed according to economic sectors such as technology, energy, financial, etc. Currently that strategy holds 17% in large cap growth stocks, 17% in small cap value stocks, 16% in industrial financial stocks, 33% in technology stocks, and 17% in cash.

In both of these strategies we are focusing on small cap value stocks for their high growth potential, and large cap growth stocks for a more defensive posture. The cash positions in both strategies will be used both for defensive purposes as well as potential trading opportunities that may present themselves. For example, in October we used our cash holdings to enter into hedging positions that actually rose while the markets fell in price. This is part of what helped us to outperform the market so well. We are also avoiding any additional exposure to international markets because we believe the US will begin to recover well in advance of other markets – most especially emerging markets.

Bonds:

Our bond strategy spent most of September and October in a very defensive posture. This served us well as the high yield bond market declined more than 22% during that timeframe. Because of the absolute fear in the credit markets over the past months, bond prices have been pushed down to historically low levels. High yield bonds are trading with yields in the 16% to 17% range and even high quality corporate bonds are trading with prices **in the 70's. Let me try to put this into perspective. When** a company defaults on its bonds and goes into bankruptcy, debt holders typically recover around 60% to 70% of the value of the bond. That is exactly where the market is trading now, so we could say that virtually every bond in the marketplace would have to go into default for prices to maintain this level!

The flip side of this marketplace is that of US Treasury securities, which have been snapped up at unprecedented levels as investors have run for safety. The current yield on the 3 month T-Bill is a tiny 0.08%. Yes – that is less than 1/10 of 1% per year! These markets are

stretched to levels beyond what was ever thought possible, and the Treasury markets are setting up for massive declines once the selling does start.

The Bond strategy currently holds 25% in high quality corporate bonds, and 75% in high yield bonds. Our focus is on the high yield bonds for their potential explosive growth, and the high quality corporate bonds for a more defensive posture. The upside potential in the high yield market is greater than we have ever seen before. At the same time, we are looking to avoid any further exposure to US Treasury securities because they are so overpriced at these levels.

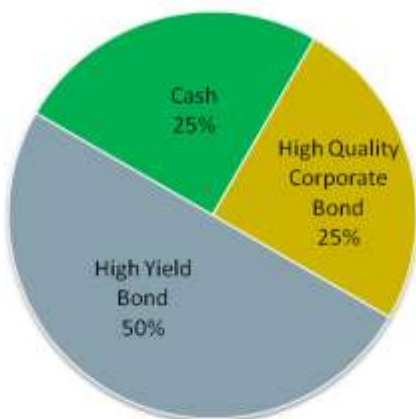
Current Income:

The Current Income Strategy remains focused on maintaining a high level of income. While that strategy has taken more than its share of punishment over the past year, the income stream that it produces has maintained its level quite well. This strategy currently yields above 7% even while the 10 Year Treasury bond is yielding less than half that amount. We are watching all of the positions in this strategy for any indication of a diminished ability to maintain their current income levels. If that deteriorates, the holding will be replaced with another, stronger position. At present, we are holding almost 25% of the assets in utility stocks which should continue to provide a good defensive anchor. We believe the bond positions in this strategy will provide returns similar to those we are watching for within our bond strategy.

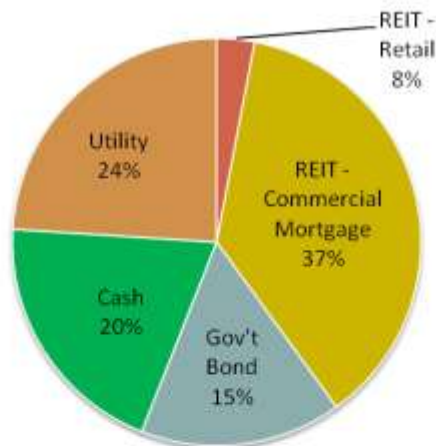
To summarize, our overall posture is defensive, but watching for opportunities to capture profits whenever it is reasonable to do so. This continues to be a difficult environment in which to invest, and one in which the benefits of our active portfolio management techniques have provided a clear advantage over the broad market. It is difficult to resist the temptation to follow the crowd, turn tail, and run. But through patient and steady work we should all make it through this bear market just as we have those in the past.

Current Investment Management Strategy Allocations

Bond Strategy



Current Income Strategy



Stock Strategy



Strategic Allocation Strategy



(Economic Picture, continued from page 2)

possibility that this number could be revised back into the positive if the inflation numbers pull back to be in line with trend of the last 5 quarters.

Economic growth is certainly on the minds of the Fed, and expectations are for yet another 1/2% rate cut before the end of the year. Inflation is no longer of concern to the central bank, and rightly so. The report for the Consumer Price Index for October posted the biggest decline in history, falling by a full 1.0% for the month. For another perspective, we like to use the TIPS Spread as a market based measure of inflation expectations. As you can see in the chart on page 2, that measure has also turned negative for both the 5 and 10 year periods. The market is now forecasting a turn into a disinflationary environment, which allows the Fed full leeway to lower rates without fear of increasing prices.

In spite of the positives, the economy is clearly in trouble. This is most evident in the increasing unemployment figures. When jobs are no longer secure, consumer spending is cut back, and that has a massive chilling effect on the economy as a whole. The timing for this could not be worse - right as we head into the holiday retail season. As a result, we are not likely to see marked improvement in the economy until we see some recovery on the jobs front. That may not happen until mid 2009. The good news is that the financial markets appear to have priced in the worst recession since the great depression (**worse even than the 1970's**), but the data simply do not confirm that level of decline.

We are indeed in uncharted waters here, but the fact remains that the US economy is the most resilient in the world. It is our economy that will turn the corner first and we will be the one to lead the world out of the current global downturn.