



The Bottom 2009

November 28, 2008

By Peter Scholtz

The market decline has accelerated since September, and I thought it therefore made sense to give you a mid-quarter update. This has been one of the hardest market periods to anticipate and position for since the nature and extent of the problems has become apparent only slowly over time. It was known a year ago that high oil prices and the inflated housing market, combined with previous Fed tightening, would create a severe slowdown or mild recession. The surprise is how its impact was aggravated by the aggressive lending and leverage in the global capital markets that built up over the past few years. This has now ensured a severe recession and clearly has made the financial carnage much worse. Anyone who says they saw this coming to this extent is disingenuous. Like peeling back the onion, it became clearer only one layer at a time, one institution at a time. One financial firm after another has choked on the toxic losses in mortgages that ultimately are worth far less than one hundred cents on the dollar. Bear Stearns is gone, Lehman is gone, and the remaining institutions have been put on capital "life support." When Iceland claims they own too many sub-prime U.S. mortgages and Latvia admits to borrowing too much in the rapidly appreciating yen, you wonder when this will all end. For a year it has appeared to be "a few more months" of problems and then the markets can recover. Our reaction over the past year has been to get incrementally more defensive with each new report of negative developments. As I write this I have the lowest percent of stock ownership in my accounts that I have had in my career. This is partially due to our defensiveness, and partially due to the attractiveness of viable fixed-income alternatives. In spite of our low equity exposure, I believe we are in the final hour of this bear market, especially in terms of price, but that the new bull market will not begin until the first quarter of next year. Let me explain.

Many of the negative conditions that started this decline are reversing. The initial drags of high energy and food prices, along with higher interest rates, have all sharply declined. Low fuel costs and low food prices help revive a consumer much like a large tax cut, because they increase disposable income. Although lower interest rates have not permeated the entire credit market, it is slowly happening. Inflation is gone, period. The threat is deflation and the solution is to grow the money supply and make borrowing cheaper. There are still some banks that will surface with problems, but this credit crisis in financial institutions is well on its way to resolution. The housing market is also beginning to repair. Housing starts are at such a low level that unsold inventory has declined a good deal. Housing prices have declined to the point where the affordability index has fully normalized. The government has come out with some supportive measures directly aimed at the housing market, which should help to strengthen this very recent change in momentum. The overall stimulus package early next year might clearly mark the turning point.

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Although the financial system repair and cost breaks to the consumer are well under way, the deepening recession remains the final unresolved problem. The decline in the stock market since September has been eighty percent related to the rapid deterioration in economic expectations by economists and market participants. This was the result of the financial turmoil which has made this downturn go far beyond what the housing market alone would have done. Current expectations are for the fastest pace of the decline to occur in the fourth quarter, with less in the first quarter and a bottom in the second quarter. This is a very recent negative change from the expectation of a bottom in the first quarter.

The stock market always (at least as far back as the 1920's) recovers before the economy. The shape of the market recovery tends to mirror the shape of the economic recovery as well. Stocks typically start up three to five months ahead of the economy. I am therefore looking for the economy to give me a time frame for the market recovery. If GDP bottoms in the second quarter of 2009, the stock market should start up during the first quarter. If the economy doesn't bottom until the fall, this market turn could be pushed well into the second quarter. In addition, the deeply oversold panic levels we are at make me think that although we will bounce off these levels, we will revisit them in the first quarter for the ultimate low. From the recent 800 level on the S&P 500, the market should advance 100% over three or four years. As was the case in 2003, the most dramatic part of the move will be up front.

To protect our accounts while staying invested in securities that will participate in the coming recovery we have emphasized high yield convertible bonds with short durations. Our bonds mature in one to three years and give us twenty percent plus yearly returns. These are big opportunities and a symptom of the credit market stress; normally these bonds yield far less. Because they mature in a short time, the price should steadily progress to 100, even as the stock market may linger. If the credit markets calm and the stock market rises rapidly, these bonds' prices should quickly rise to give a normal eight percent yield to maturity instead of twenty, enabling us to keep up with the stock market to some extent. In this way, we can keep our stock exposure much lower than normal. The bonds do bounce around short term in reaction to the stock market, but they will quickly recover as they approach maturity due to their high yield. Keep in mind that a discount bond increases in yield as it gets closer to maturity if the price remains the same. This is because you get the same return (\$60 to \$100 for instance) in a shorter period of time. For this reason time is on your side with discount bonds.

As I write this, I can't help but feel that we are very close to a major bottom, probably because the world is so defensive. In any case, we probably have a few more months before the big new bull market begins, and then, hopefully, it is off to the races.