

October 30, 2008

THE CASE FOR LONG TERM OPTIMISM

As you are aware, the capital markets and global economies are experiencing a tremendous shock. What began in the sub-prime mortgage market has spread to other areas. Naturally this has translated into low investor confidence - a phenomenon with which we can all relate.

As we move toward the end of October, I cannot remember a 30 day period when there was the amount of fear and volatility that we have experienced recently. Over this time I have met or spoken with many of you receiving this letter. I have also spent far more time than usual on conference calls and in meetings with money management firms and economists in my own effort to gather as much information and opinion, both good and bad, as I can in order to advise and counsel our clients in this very difficult time.

For those of you receiving investment account statements, whether from us or other firms, September month-end values were bad, and October will be worse for most of you.

I believe it is very important that we not let the shock of these recent months cause us to abandon long term financial plans by making short term emotional decisions. I fully understand that this is much easier said than done. We are here to help our clients through these difficult periods, and having gathered information, assessed it as best that I can, I have decided to write to you what I am calling, **THE CASE FOR LONG TERM OPTIMISM**. I am not naïve, nor do I only see good things coming. Quite the contrary, I see plenty of challenges and difficulties ahead. I have read or heard pretty much all of the potential doomsday scenarios, with the word “depression” being stated or printed more than once lately. And while a significant economic downturn appears to be in our future (equities do not drop over 20% in a month for no reason), most scenarios that I see are worst case. It seems that almost everyone is taking the most negative of the current facts and extrapolating them into the future. This would imply that events will continue under the most negative conditions, without adjustments in behavior or activity by individuals, organizations or governments.

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I realize that making an optimistic argument in the midst of the worst financial crisis in many decades can backfire on me. **I am not making predictions**, which would be folly because we have no way of knowing what will happen over the next months or years. I am basing my case on what I feel are steps and trends already in place which could begin to create a more positive economic climate.

Here are my top 10 reasons for optimism! Some of which are longer term than others:

1. The leading bankers and government officials worldwide are committed to fixing the problems. Some coordinated to fixing the problems. Some coordinated work has already been done, while the rest is coming, including considerable new regulations which should help investor confidence and stability in global banking. Many of you may have already heard that the United States will be hosting a global economic summit in November after the elections. This alone is an action that seemed impossible only months ago. I have written and spoken many times about one of the great global trends of our lifetime which is increasing political stability in the world. Every government and every leader understands that the only way to create political stability on a long term basis is to have economic stability. The participants of this meeting will no doubt have their own political agendas, but they will do whatever is necessary to maintain or restore economic stability.
2. Oil prices have fallen by over 50% in just a couple of months, and the commitment to gain energy independence is in place and will be continued in the future. Regardless of who is elected, I believe that for the first time in my life we will make a serious effort to free our country from our dependence on hostile countries for our energy. Recall that several months ago the price of oil appeared to be the biggest headwind to our economy, but today that headwind has become a tailwind and prices continue to fall at the pump. Of course, oil prices are very volatile and this may provide only temporary relief, but now we are seeing the reaction of oil prices to a global economic slowdown.
3. U.S. businesses, especially the large publically traded ones, are in very good shape in terms of debt and liquidity and many have ample (or even record) liquidity available for investment. I believe sooner or later, these funds will be used to expand, acquire other companies, and repurchase shares or even to increase dividend payouts. All of this would be positive for equity markets.
4. The recession that everyone keeps talking about will almost certainly arrive. Those of us living in Michigan know that we have been in a recession for many months already. The good news is that historically recessions do not last that long and they have an average decline (10-1/2 months on average according to the National Bureau of Economic Research). Equity markets have often done very well coming out of a recession and stock indexes generally begin rising before the recession has ended. There are no guarantees that this will happen this time, but I see no reason to think it will not happen.

As we are currently seeing, predicting when a recession begins or ends is not possible. What is possible is to determine what has happened as recessions have ended over the past 62 years (from 1945-2007). According to studies done by the Ibbotson organization, on average, stocks have appreciated as listed below:

Large Stocks: +19.1% after 1 year, +47.7% after 3 years

Small Stocks: +33.7% after 1 year, +74.0% after 3 years

Source: Ibbotson Presentation Materials, Morningstar, Inc. 2008

Since WWII, economic expansions have, on average, lasted five times longer than recessions and bull markets, twice as long as bear markets. While we cannot know how this will be in the future, studying the past is helpful in assessing the future and making decisions accordingly. **Recessions will come but they will also come to an end.**

5. The fundamental reason for owning equities remains unchanged. People still have the same goals of retirement, educating children and grandchildren and wealth accumulation for other goals, including charity. Though shaken, these goals remain and the alternatives to achieving these goals are few. People will continue to stay invested and will add to those investments (some already are) as confidence grows.
6. There are some very smart people wading in as buyers of U.S. equities. By the time this letter gets to each of you, you will most likely have heard about the editorial in the NY Times on October 17th by Warren Buffett. Mr. Buffett, who recently invested \$8 billion of his own company's money in Goldman Sachs and General Electric, wrote that in his personal savings account, which previously held on U.S. Treasuries, he is now buying U.S. stocks and will shortly have 100% of his own funds invested in those stocks. Mr. Buffett may not have picked his absolute market bottom – he has no better crystal ball than anyone else. However, this is his own personal show of confidence that the best potential returns have switched from owning bonds, which are guaranteed, to stocks with no guarantee at all. He sees opportunities in solid, growing businesses that are currently selling at low prices compared to just a few months ago. Mr. Buffett is following the philosophy which has made him one of the most successful investors ever: **“Be fearful when others are greedy and be greedy when others are fearful.”** We all know that today there is a lot more fear and pessimism than greed and optimism. Keep in mind that Mr. Buffett made these comments, in the face of the almost unprecedented amount of daily volatility we have ever been experiencing recently. As difficult as it is for all of us to accept these breathtaking daily and weekly changes, this is the price to be paid for the longer term stock market returns which have been double that of government bonds, and triple when you deduct inflation from the returns of both stocks and bonds.
7. In one of the more remarkable and honorable business dealings that I can recall, several weeks ago Mitsubishi Financial Group agreed to purchase 20% of Morgan Stanley for \$9 billion. As the day of the actual deal settlement approached, Morgan Stanley stock, along with the rest of the U.S. market, was in a free fall. In fact it had reached a point where the \$9 billion could have bought 80% of Morgan Stanley at the then current market price. The internet and financial press were declaring that Mitsubishi would walk away from the deal or demand a renegotiation for more favorable terms. Mitsubishi continued to claim that they would go through with the original arrangement, regardless of market price. In the end, that is exactly what they did, honoring (imagine that) an agreement they had negotiated in good faith and more importantly showing their faith in the American financial system in a way that all of the pundits and politicians could not credibly have done.
8. Stock markets, although they could go lower, significantly from their lowest level which for the Dow Jones Industrial Average was 7773 on October 10th. This confirms the extraordinary volatility we have been seeing, but it also illustrates the potential for significant recovery once perception turns from negative to positive. As recently as September 29th, the market was at 11,139 and the news of both the poor real estate market and impending recession were well known. The point is that, as bad as things feel right now, markets have the potential to bounce

up as fast as they fall. This does not mean we will have a V shaped recovery. I believe this is extremely unlikely. I think it could mean that the perceived “worst case” may be behind us and that some level of confidence is being restored.

As I have written, we have no way of knowing when a recovery in stock prices may begin, but I would contend that fixing an overleveraged financial system is a huge step forward. It’s also important to remember that all of the elements which helped to cause stock to rise over the past couple of years (growth of economies worldwide, especially in countries like China, India, and Brazil are still in place. At the end of the 15 bear markets since the end of WWII, the market has moved higher. In essence every bear market in the U.S. has been a temporary in values in what has historically been a permanent uptrend over many decades.

9. Real Estate has been in a multi-year decline, but there are early signs that the significant overbuilding is in the process of a slow but steady absorption. There are markets when this process will be painfully long, but nationwide, we are seeing some light. Given the annual population growth in the U.S. of about 3 million per year, we should be building 1.6 to 1.7 million new units annually. We are currently at a level of approximately 900,000, so the excess inventory is slowly being absorbed. Also, with mortgage rates still low and housing prices falling everywhere, homes are more affordable now than in several years. In fact, if you adjust the cost to buy a home today relative to average income, the cost is as low as it has been in 30 years. In fact, if you adjust the cost to buy a home today relative to average income, the cost is as low as it has been in 30 years according to David Kelly, a chief market strategist at J.P. Morgan. Of course, to keep this process moving, it’s critical that banks continue to lend money (more rationally) and for stability in credit markets.
10. There is additional stimulus and lower interest rates most likely on the way. There has been talk of another stimulus package by Congress, possibly tied to an infrastructure jobs program. This could happen as early as next year and would help to create jobs and boost confidence. In addition, by the time you receive this letter it is very likely that the Federal Reserve will have lowered interest rates once again by as much as .50%. These kinds of actions are signs that our government, while slow and at times clueless, is starting to understand the need to take action.

Conclusion

I realize that for every point I have just made, there could be a pessimistic counter point, but this is always the case with financial markets and investing. There is always someone out there in the media predicting a financial crisis that will bring down the financial markets as we have known them and that this crisis is in some way so different that we will never be able to recover economically. I truly believe that while this is a very difficult period, it will ultimately be resolved and we will resume the upward trend in financial markets across the world. In fact, let me propose one potential outcome that is getting no play in the doomsday loving media: *What if we actually come out of this current crisis stronger than before? What if due to the unprecedented global effort and collaboration brought on by this crisis, the world (global equities in particular) eventually becomes a safer, more stable and transparent place to invest? **This is anything but a certainty, but it is certainly a possibility.***

As the points above hopefully convey, we have some good occurring in what is otherwise a pretty bleak picture and one we are not very used to experiencing. It is best at times like these to avoid making rash decisions under pressure. In order to provide additional support and perspective on this recent crisis I am presenting a seminar/workshop titled: **HOW TO HANDLE BEAR MARKETS**.

This will take place on Wednesday, November 12th from 6:00 – 8:00 PM at the Assumption Cultural Center. I strongly recommend that our clients attend this presentation.

Please feel free to invite anyone, relatives, friends or associates who may need some kind of reassurance at his time. This is a frightening time for many and perhaps seeing some historical perspective, and hearing some long term optimism will be of some comfort to them.

Sincerely,

Jeffrey Brayton
Financial Advisor