

Capital Markets Outlook
March 2009

In the twenty recessions since 1900, U. S. equity markets reached their nadir on average ten months following the start of the recession. In the nine recessions since 1950, stocks reached their low point on average six months following the start of the recession. On the basis of these historical patterns, and since we are currently fifteen months into the current recession, some analysts anticipate that stocks will reach their low point in the very near future and stage a recovery later this year. We think this view is mistaken and that the experience of 2009 is not likely to mimic the typical recession and recovery of the twentieth century. We should be cautioned by the experience of 1929 through 1933, during which time, stocks declined an additional 59% after falling 44% in the first fourteen months of the downturn. While we do not believe we will replicate the experience of the Great Depression, we believe stock returns in all developed countries are likely to suffer further declines before any recovery begins.

How much further do the equity markets have to fall? Looking at the graphs of the S&P 500 index since 1950 (see figures CMO.1 and CMO.2 below) is enough to convince some that the markets must be near a bottom. "How much lower can stocks go?" some investors ask, believing that since the market has declined so far already, it cannot go much farther. In fact, as of the market close on Friday, March 6th, the S&P 500 index had declined 56.4% from its October 2007 peak before subsequently retracing some of that loss.

Investors should not take comfort in the uncritical belief that stocks cannot fall any further because they have already fallen so far. Stock prices can fall further and are likely to do so. In the nine recessions since 1950, the stock market has bottomed five months before the end of the recession on average. The timing has ranged from just over two months to over eight months before the recession's end. For the stock market to be at or near its trough today, we should be looking for an end to the recession around Labor Day, give or take a few months, based on the past fifty-seven years. Although this timing fits in with the Fed's "reasonable prospect," it is much too early in our view. If the recession lasts 36 months and ends in December 2010, we are likely to be at least one year from the bottom of the stock market.

In trying to project the market's trough we are faced with multiple and compounding uncertainties that

make the task extraordinarily perilous. How long will the recession last? Will bailout fatigue or partisan politics impede government action to stimulate the economy? How large of a decline in economic output will the U. S. and the world suffer? How much will corporate earnings decline? When will earnings begin to recover, and how rapidly will they recover? When will investor sentiment turn positive and valuations increase?

As the economy contracts, corporate earnings decline, and stock prices fall, valuation levels have reached a level not seen since December 1984 (see figure CMO.3). As of the end of February, the S&P 500 was priced at 10.3 times trailing twelve months earnings (from continuing operations), the lowest level since December of 1984. Again, though, we find little comfort in this statistic, as we see no fundamental reason for valuations to increase for the foreseeable future in the face of the daunting uncertainties. It is an indication of the degree of uncertainty about the future that the last time stock valuations were as low as they are now is when the target Fed Funds rate was 8.25% and ten year Treasuries were yielding more than 11%.

It is entirely plausible that the S&P 500 index will decline to 450 before recovering. We derive this level from two different approaches to forecasting a trough for the market. In the first method, we look at how far the recent downward momentum could take the market. In the second approach we project a 50% peak to trough decline in earnings and value those earnings at today's valuation level.

Figure CMO.4 charts the actual daily close on the S&P 500 from 2007 through 6 March 2009 and projected levels through year-end 2011. The dotted blue line shows the results of extrapolating the average daily price decline of the index (based on the period from 1 May 2008 through 6 March 2009) through June 15th. This extrapolation declines to a level of 450 at June 15th. The dotted red line shows the results of extrapolating the average daily percentage decline of the index (based on the period from 1 October 2008 through 6 March 2009) through September 30th. This extrapolation declines to a level of approximately 398 at September 30th.

Neither of the extrapolations in figure CMO.4 are predictions per se. They do indicate the levels the market could reach, however, in the absence of any

fundamental support or a change in market sentiment. We do not see either occurring on a sustained basis, despite the strong performance of the market in March following the news of Citigroup's internal memo from the CEO saying the company had a profit in the first two months of 2009 and the Treasury's release of details of the toxic asset purchase plan.

Figure CMO.5 is a version of the chart in CMO.3 with index earnings and prices projected through 2011. The projection is based on a fifty percent decline in corporate earnings from its peak of approximately \$90.00 per share in August 2007 (based on trailing twelve month earnings from continuing operations). This decline would mimic the decline in earnings suffered by Japanese corporations in the three years following the bursting of its real estate bubble in 1989. A fifty percent decline would be larger than in any recession since 1970 and larger than the 38% decline experienced in the 1990-1991 recession.¹ Given the likely severity and length of the current recession, however, a fifty percent decline in corporate earnings may prove to be optimistic, especially if widespread price deflation occurs.

The projected index level of 490 for 30 June 2009 and following in CMO.5 is based on a valuation multiple of ten times earnings – the approximate level as of the end of February. Price/earnings (P/E) multiples typically bottom out before earnings as investor sentiment becomes positive in anticipation of improved economic conditions and corporate earnings. In fact, in every recession since 1970, valuation multiples were increasing even as trailing earnings were falling to their trough as investors bid up stock prices in anticipation of recovery. Were the current recession to be in any way similar to recent recessions, we might expect a repeat of this occurrence, in which case stock prices will reverse momentum, and P/E valuations will increase before earnings reach their low point. In this case, it would be appropriate to project the index level using a higher P/E multiple than the current 10x level. However, we do not believe the current recession has any similarity to post World War II recessions. Recovery is most likely to be long and slow in occurring. And under this scenario, we see little reason

¹ Alternative data would indicate that U. S. corporate earnings may have suffered a larger decline in the 2001 recession. A data series (index earnings before extraordinary items) provided previously by Bloomberg showed a decline of 64% from peak to trough around the 2001 recession. This data series has been replaced by the alternative series, earning from continuing operations. The previous data series is currently being regenerated by Bloomberg.

for investor sentiment to turn before earnings reach their nadir.

What might the recovery look like? Figure CMO.6 shows two different recovery scenarios of the many that might be imagined. The first scenario, indicated by the dotted blue line, is a strong economic recovery that begins to take hold in mid-2010 and is anticipated by investors beginning at the start of 2010. The second scenario, indicated by the dotted red line is a slow and weak recovery with only a grudging acceptance by investors. The first scenario results in a major market rally akin to the recovery in a V-shaped recession – even though the projection has a period of more than two quarters before investors become convinced that an economic recovery is in the works – and could bring the S&P 500 index above 1200 before the end of 2010. The second scenario results in a slow recovery in market values with the market languishing below 800 for the next three years. As much as we hope for a recovery like the first scenario, we think it very likely that the actual recovery will look more like the second scenario.

On a local currency basis, therefore, and with the conviction that economic circumstances are no better in other major developed market areas, we believe equity investors will be fortunate to break even over the next three years in any major developed market including the U. S., the euro area, Japan, and the UK. Some emerging markets may offer some upside potential, since countries like China have the potential to maintain growth – or at least limit economic contraction – through increased local demand supported by ample savings, liquidity, and government stimulus. Other emerging markets, particularly in eastern Europe, face severe economic contraction as they face reduced demand for their products or commodities and burdensome debt loads.

We conclude by offering some thoughts on other assets class returns, which will be studied in more depth in upcoming articles.

We believe returns on U. S. equity REITs are likely to mimic U. S. equity returns throughout the recession, as they have since the start. Although current valuations are moderate by historical standards, positive returns will depend on maintaining occupancy and cash flow and the potential for property value appreciation, all of which are highly uncertain at this point. In fact, anecdotal information from financial institutions and property managers indicate that the commercial property sector is likely to experience considerable stress as a result of over leveraging and declining property values.

Commodity returns through the fully-collateralized, passively-managed index funds are likely to return to positive territory with prices stabilizing even at lower levels than in 2007 and early 2008. Returns are likely to be very modest, however, since the cash component of the funds is earning a nominal rate of less than 0.50%.

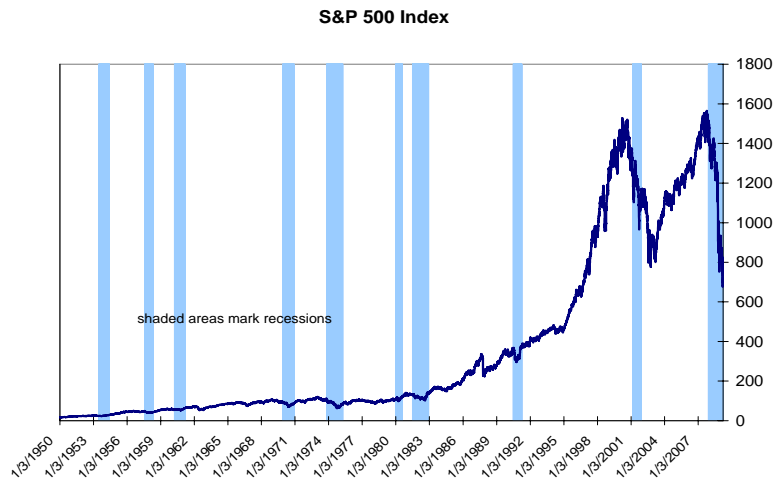
Bond market returns are also likely to remain lower than historic norms throughout the recession. Interest rates across the yield curve are at historic low levels. Any increase in rates will reduce returns, although we

do not expect any significant increases in rates for the foreseeable future. Although credit spreads on corporate bonds are at near historic highs and offer the potential for above average returns, such returns are likely to be reduced by future credit losses. Spreads on high-yield bonds, in particular, are at extraordinary levels (see figure CMO.12). But even at these levels, investors are not adequately compensated for the credit risk – readers are advised to look at the comments on high-yield bond defaults during a recession in the September 2008 Bond Market Outlook at www.aametrics.com.

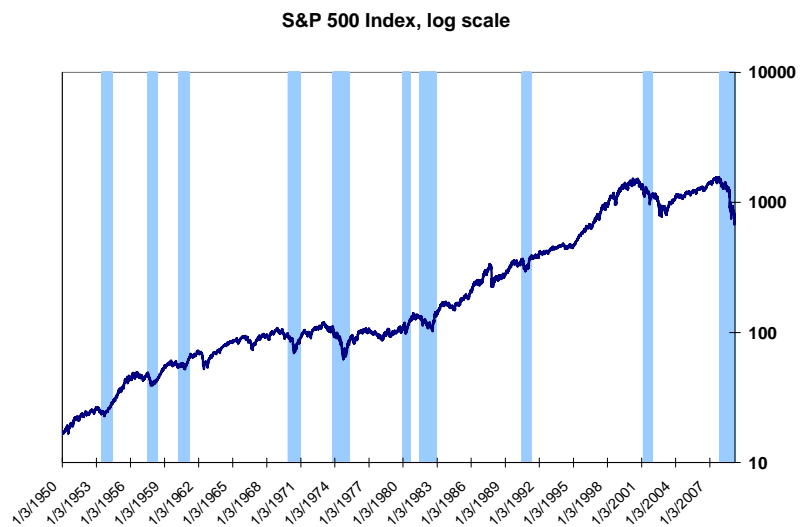
The following charts address some of the valuation factors affecting projected returns.

Figure CMO.1 (top)
S&P 500 Index, Daily Closing
Price thru 23 March 2009

Figure CMO.2 (bottom)
S&P 500 Index, Daily Closing
Price log scale
(Source: Yahoo Finance)



Although the decline in the S&P 500 index through early March appears precipitous, the log scale chart provides a better comparison to previous recession experiences. In eight of the nine complete recessions since 1950, the index has rebounded before the end of the recession. This was notably not the case, however in the 2001 recession.



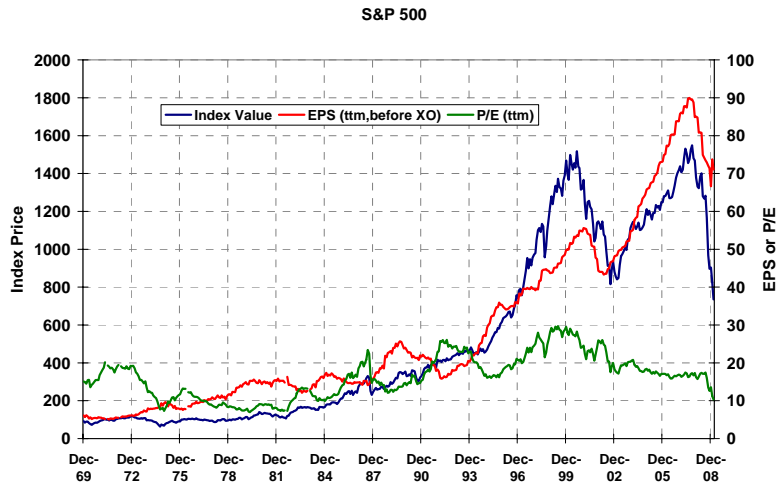


Figure CMO.3
S&P 500 Large-cap Index: Price, Earnings, and P/E Ratios, January 1970 through March 6, 2009
(Source: Bloomberg and *Advisor* calculations)

The P/E valuation level at the end of February was the lowest level since December 1984. Although stock prices rose more slowly than earnings from 2003 through 2007, prices have led the decline in earnings since the market peak in October 2007.

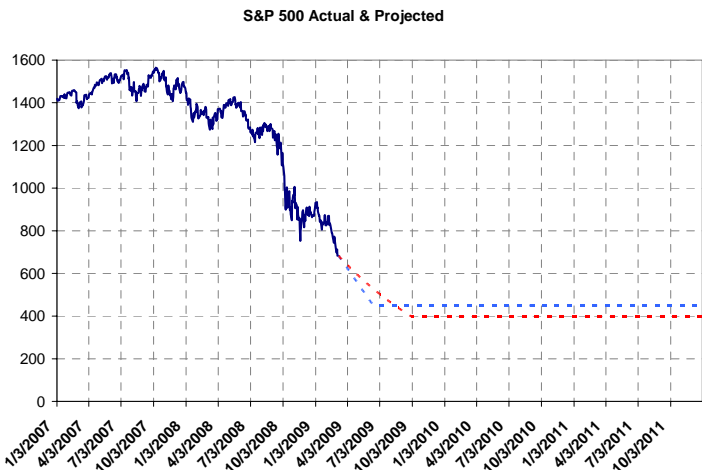


Figure CMO.4
S&P 500 Index, Actual and Projected Price Levels
Source: Yahoo Finance and *Advisor* projections

Extrapolating market momentum (from March 6th) results in significant further declines in the index. Since investor confidence typically changes before trailing earnings reach their trough, predicting a market bottom is perilously difficult. We are not sanguine about the prospects for a broad change in investor confidence, especially once the full magnitude of the change in the economy and the difficulty of achieving a recovery become evident.

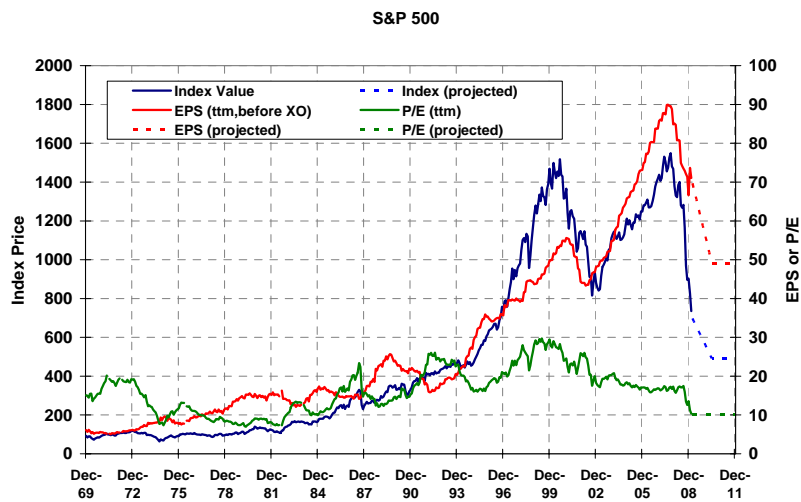


Figure CMO.5
S&P 500 Index, Actual and Projected Price, Earnings, and Valuation Levels
(Source: Yahoo Finance and *Advisor* projections)

A fifty percent decline in earnings to just under the equivalent of \$50.00 per share would reduce the index to just under 500 using a P/E valuation of 10 times trailing earnings. Valuation levels are likely to increase once the prospects for a recovery become evident, however, we do not expect those prospects to become evident soon. Should deflation set in and the U.S. get stuck in a liquidity trap, valuation levels could continue to drop.

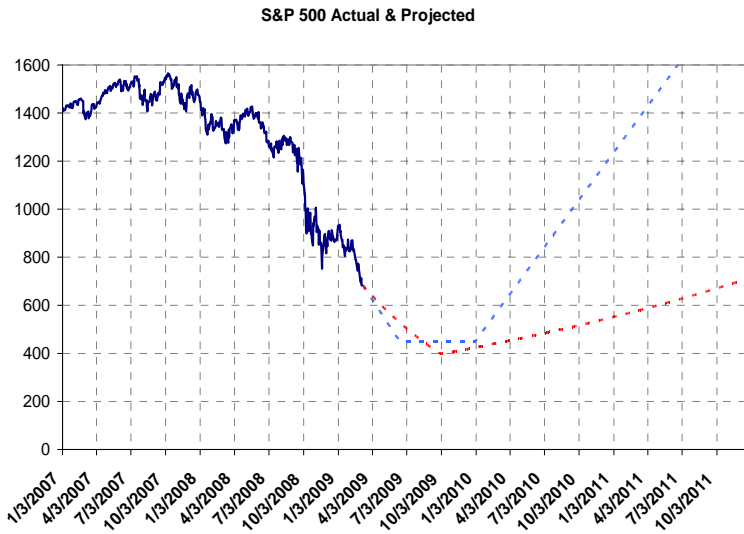


Figure CMO.6
S&P 500 Index, Actual and Projected Price Levels
(Source: Yahoo Finance and *Advisor* projections)

Much discussion in the press has been about the shape of the recovery. Will it be a V-shaped or a U-shaped recovery? Or, worse yet, will it be an L-shaped non-recovery like Japan? The two projections here are hybrids. If the prospects for a sustained and meaningful recovery in 2010 become evident, the market could rebound above 1,000 by the end of 2010 – or earlier if the prospects become evident earlier. If the prospects for a recovery are uncertain and/or the pace of the recovery appears slow and questionable, the market could take three years to get back to 800.

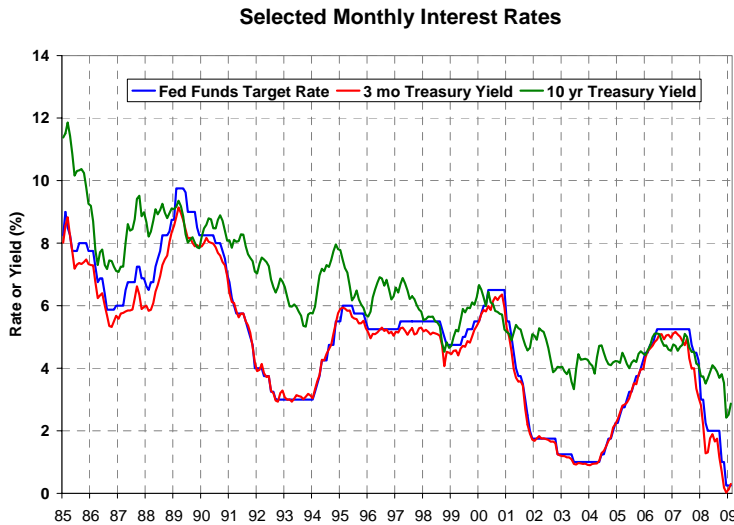


Figure CMO.7
Selected Monthly Interest Rates
(Source: Federal Reserve Board)

Interest rates are at historic low points on account of Federal Reserve action to reduce short-term rates and investor demand for the security of U. S. Treasury bonds.

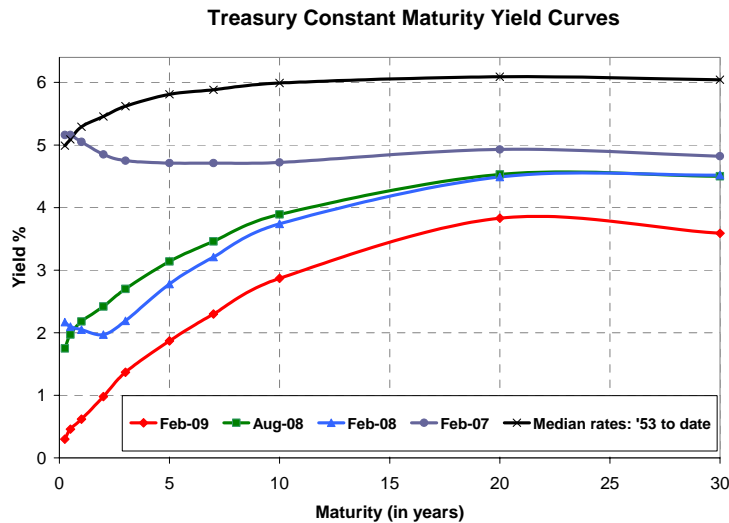


Figure CMO.8
Treasury Constant Maturity Yield Curves
(Source: Federal Reserve Board)

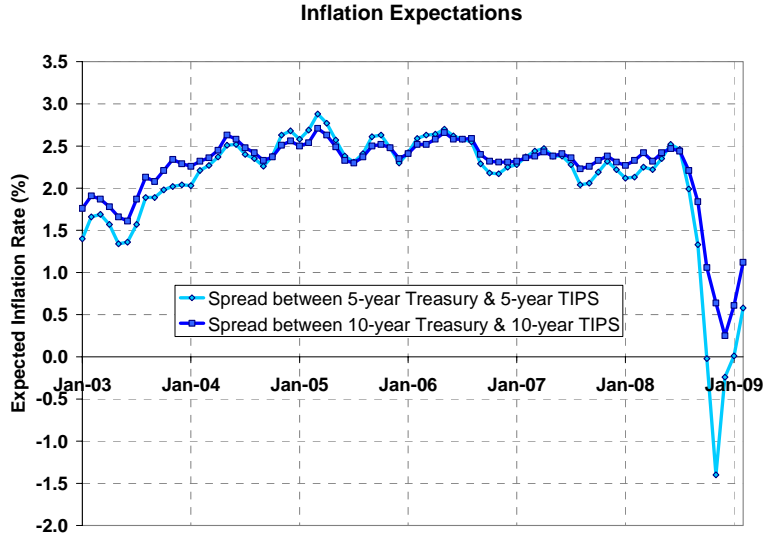
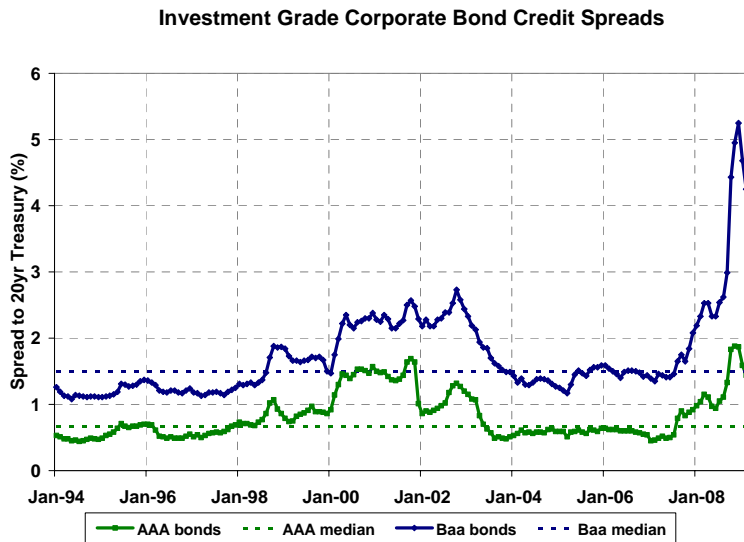


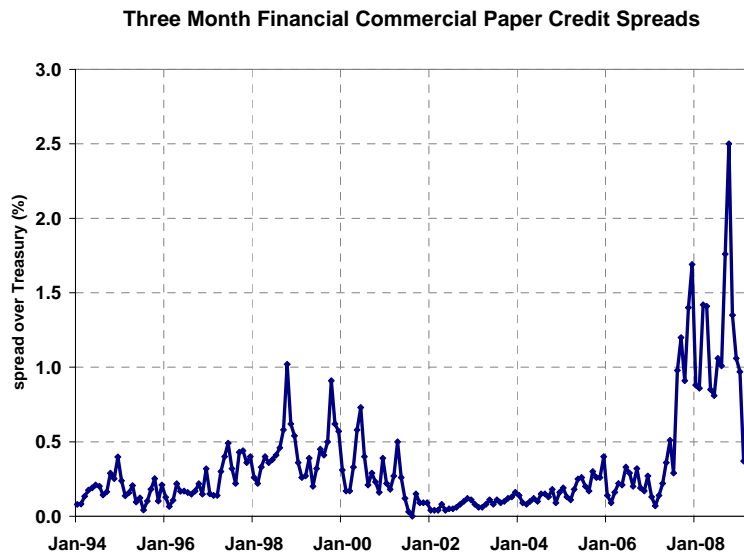
Figure CMO.9
Inflation Expectations
(Source: Federal Reserve Board)

The turmoil in the financial markets in the last quarter of 2008 is reflected in the market's expectation that prices would fall over the next five years. As of February, the fear of deflation has abated and investors now expect low inflation.



CMO.10: Investment Grade
Corporate Bond Credit Spreads
(Source: Federal Reserve Board)

Lower interest rates have not benefited corporate borrowers as the credit premium demanded by investors has increased substantially – with some relief coming in February, as spreads declined from their January peak. Nevertheless, investment grades borrowers with a Baa rating paid a higher premium to borrow in February than non-investment grades borrowers paid as recently as October of 2007.



CMO.11: 3 Month Financial
Commercial Paper Credit Spreads
(Source: Federal Reserve Board)

February finally saw financial commercial paper credit spreads return to some semblance of normalcy thanks to the Fed taking an active role in the market as a purchaser.

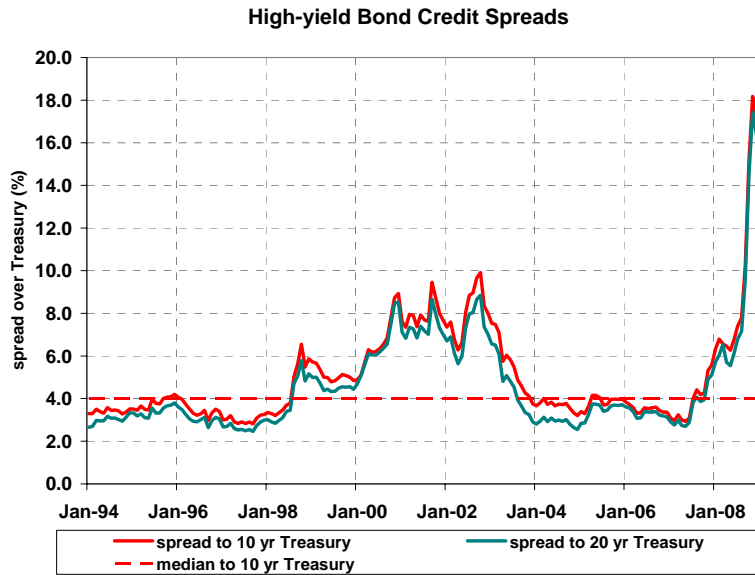


Figure CMO.12
High-yield Bond Credit Spreads
(Source: Bloomberg and Merrill Lynch)

High-yield, or junk-bond credit spreads spiked to over 17% in January before declining very moderately in February. Default rates on non-investment grade corporate debt have exceeded 10% in the past two recessions, and investors are demanding ample returns for protection against the possibility of future defaults.