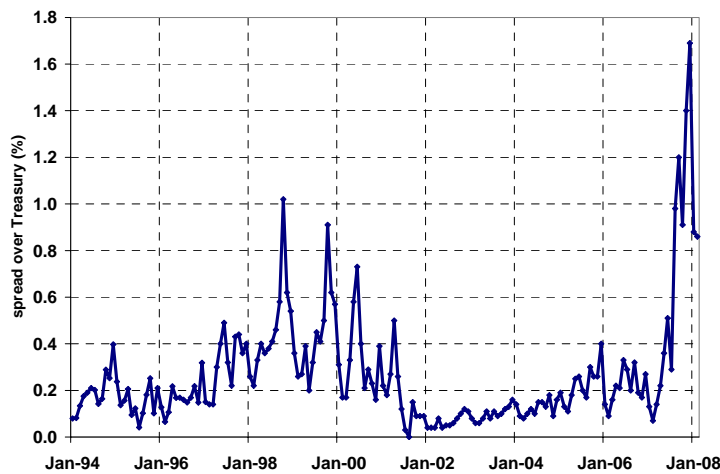


Coping with the Recession – Staying the Course March 2008

It's not fun to be wrong, even when you're wrong with the Fed. Late last summer, we shared the Federal Reserve's mistaken outlook about the impact of the sub-prime mortgage problem and its likely repercussions on the economy. At that time, we believed the sub-prime mortgage problem was localized and would affect just one segment of the credit markets; and we believed that strength throughout the broader economy would enable growth to continue despite the slow down in the housing market after the boom fueled by sub-prime lending. Both views were wrong.

The sub-prime mortgage problem has not been a localized problem, and largely on account of its broader impact, its repercussions have brought about a recession. Note that we choose our words carefully here. The United States is now in a recession. Although that may appear to be bad news for investors and endowment managers and fiduciaries, it is not. The sooner the recession started, the sooner it will end, and the sooner capital markets will enjoy the strong returns typical of post recession periods. More about this shortly.

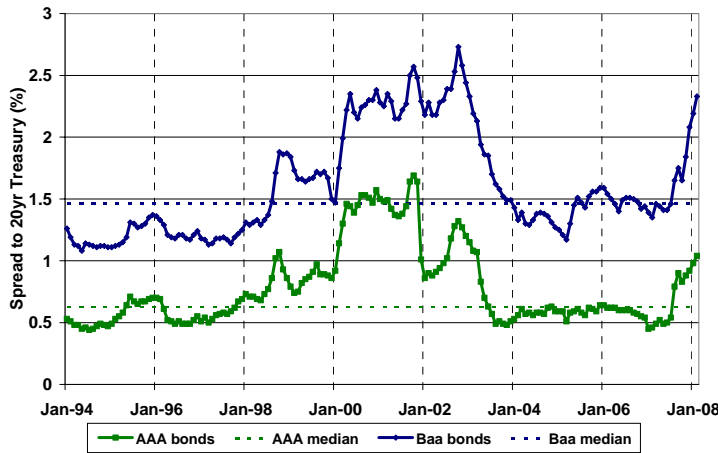
Problems with sub-prime mortgages have had wide repercussions throughout the credit markets. Unanticipated default rates on the underlying mortgages have severely eroded the value of the securities that were built with the mortgages as the underlying source of cash flow. Financial engineering of the securities made it difficult to understand their risk. Securities with investment grade ratings were tainted, if not directly, then indirectly on account of the potential losses faced by bond insurers that guaranteed them. Lenders refused to accept the securities as collateral for financing or only at deeply discounted values. Institutions that relied on the securities for collateral for financing (some hedge funds and SIVs – Structured Investment Vehicles) found they could not borrow. Liquidity dried up. What was available was very expensive. The credit spread on financial commercial paper, the premium borrowers pay over Treasuries, soared to the highest it had ever been – a level nearly six standard deviations above the historic norm (see figure CR.1). The Federal Reserve Bank and foreign central banks were forced to step in and offer term financing arrangements to provide liquidity.



3 Month Financial Commercial Paper,
Spread to 3 month T-bill yield (monthly
averages)

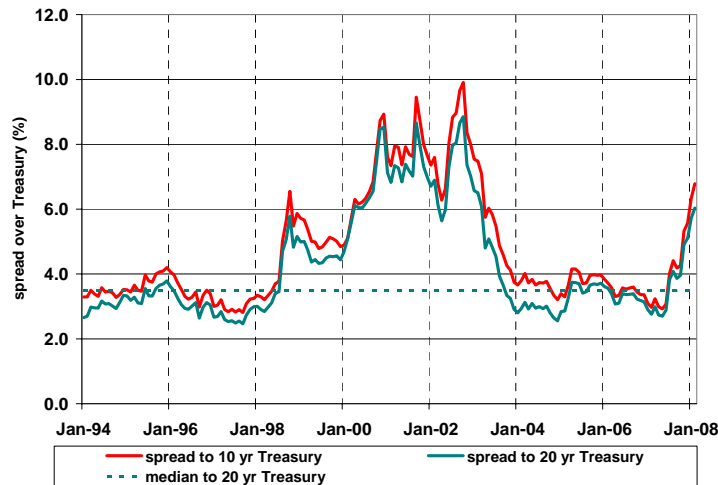
Figure CR.1
Source: Federal Reserve Board

The broad impact of the sub-prime mortgage mess has been on the market's appetite for risk, or to be more precise, its pricing of risk. As readers of this journal know, in recent years, investors had to come to accept smaller and smaller premiums for credit risk throughout all credit markets, from emerging market sovereign debt to investment grade corporate bonds to high-yield corporate bonds. Not any longer. Uncertainty about the magnitude and location of the risks associated with sub-prime mortgage lending and the fact that the risks were so poorly anticipated by the agencies whose job is to understand risk have raised investors' expectations about what they should be paid to accept credit risk. As a consequence, credit spreads have widened across virtually all segments of the credit market (see figures CR.2 and CR.3)



Investment Grade Corporate Bonds Spreads (monthly averages)

Figure CR.2
Source: Federal Reserve Board & Advisor calculations



High-yield Bond Spreads (monthly averages)

Figure CR.3
Source: Merrill Lynch, Federal Reserve Board, and Advisor calculations

All other things being the same, higher credit spreads translate into higher credit costs, a reduction in borrowing, and a slow down in economic activity – either a deceleration in the growth rate or an actual decrease in demand, output, and employment. Of course, all other things are not the same; and the Fed is trying to ameliorate the impact of higher credit spreads by

reducing the base level of rates, so that borrowers won't feel as much of the pain. Borrowing at 1.0% over the three month treasury rate is better when the rate is 3.3% rather than 4.7%, even if your company could borrow at 0.6% over the Treasury rate when it was at 4.7% (as was the case with the commercial paper market comparing January 2008 with June 2007).

Although the Fed is doing its best to maintain liquidity and ease the impact of higher credit premiums, bankers are tightening credit standards partly in anticipation of an economic slowdown and partly in reaction to the perceived need to be more vigilant in credit underwriting. Although we do not think the banking industry generally is at fault for the sub-prime mortgage mess, the tightening of lending standards is an understandable and almost predictable behavior at this time in the economic cycle, even if it is an overly harsh tonic for the economy in its present condition.

And just what is the economy's present condition?

Although economic forecasting is a perilous business and not our standard occupation, we are convinced that the United States will enter a recession as a consequence of the sub-prime mortgage mess and its repercussions and believe it has already started. Economic data to confirm this will not be available for months; however, the unemployment rate spike in December was consistent with the increases that have marked the start of the last ten recessions – a fact noted by Andrew Tilton, a senior economist at Goldman Sachs in a recent address on the economic outlook to the Hartford Society of Financial Analysts.

Although we are more interested in how best to cope with the recession in terms of portfolio management and asset allocation, we take a moment to make its case. Several factors are combining to reduce total economic output: a dramatic reduction in new home construction due to the large oversupply of new homes (approximately 3 years by our calculations at the current rate of new home construction), tighter credit conditions for consumers, a sharp reduction in the home-equity cash outs that fueled a good portion of recent consumer spending, slow growth in business capital spending, and low consumer and business confidence. The only bright spot for the domestic economy is the growth in exports due to the weaker dollar. Export growth, however, will not save the economy from a recession. In fact, the weaker dollar is likely to make consumers feel even more pinched than they already feel due to high fuel and food costs as foreign producers find themselves unable to maintain dollar prices in the face of rising input costs and a weaker dollar. The inflation data for December and January show price increases appearing in traditionally low-cost imported goods.

Interested readers looking for a more extensive and well articulated case for the recession should read the address by Nouriel Roubini at last September's International Monetary Fund seminar on the risk of a hard landing in the U. S. Mr Roubini is a professor of economics and international finance at the Stern School of Business at New York University.

Our primary concern is how best to manage an investment portfolio through a recession, especially when faced with the regrets of hindsight and the temptation to adjust allocations to reduce losses.

If we were blessed with perfect foresight and were able to know in advance when a recession would start, three to six months before the recession started, we would sell all domestic equities, real estate, and positions in commodities index funds and shift the allocations to government bonds. Even if we missed the start of the recession, we would still follow the same strategy in the

first few months of the recession. By shifting to bonds, we would avoid the typical losses that equities and real estate suffer at the start of a recession.

Figure CR.4 shows the median total return on selected domestic asset classes leading up to and following the start of a recession for the ten recessions since 1947. The returns for real estate and commodities are for the five recessions since 1973.

Asset Class Total Returns for Periods Preceding and Following Start of Recession					
	Prior 6 months	Prior 3 months	3 months after	6 months after	12 months after
Large-cap stocks	-3.6%	-0.9%	-0.6%	-3.6%	11.3%
Small-cap stocks	-2.6%	-2.9%	-5.7%	-4.2%	15.1%
Intermediate Treasuries	0.0%	1.9%	3.3%	5.6%	6.0%
Long Treasuries	-0.9%	1.0%	3.1%	6.3%	7.1%
Corporate bonds	-0.1%	2.4%	2.9%	4.4%	7.4%
Real Estate	4.1%	0.7%	-5.5%	-1.3%	12.0%
Commodities	5.1%	-1.6%	-3.1%	1.9%	-1.6%

Figure CR.4: Asset Class Returns Preceding and Following the Start of a Recession
 Source: Bloomberg, Morningstar/Ibbotson, National Bureau of Economic Research and *Advisor* calculations

Domestic equities on average have produced negative total returns leading up to a recession and for the six months following the start of a recession. In six of the ten recessions since 1947, both large-cap and small-cap stocks had negative total returns in the six months leading up to a recession. In eight of the ten recessions, they had negative returns for the six months following the recession's start. By contrast, in nine out of the ten post World War II recessions, bonds produced positive returns for the six months following the start of the recession. If only we knew!

But we don't know when recessions start, and often times, we don't know that they've started until months after the fact. We should take comfort, however, in the longer term median total returns. Twelve months after the start of a recession, a portfolio that remained in equities would have a higher total return than one that shifted into bonds three or six months before, or at the start of the recession. The only strategy that would have produced superior returns on average would be one in which allocations were shifted out of equities and into bonds at or before the start of the recession and then shifted back into equities six months following the start of the recession. To do this, however, we have to get the timing right not once but twice.

Market timing is not a strategy we advocate and believe investors, managers, and fiduciaries should avoid all temptations to time the market. Studies have well documented the risk of trying to time the stock market. Portfolio returns are more greatly reduced by missing just several of the upside movements in the market than they are enhanced by avoiding downside movements. For the investors who were lucky enough to reduce their domestic equity positions last October, the real test is whether they move back into the market at the right time to catch the upside. If they don't, their portfolios are likely to have lower returns than those who maintained their long-term equity allocations.

In the last analysis, the best way to cope with the recession is to look forward and not backward, maintain asset allocations, and remind ourselves of the following lessons from history. Declines in the stock market are to be expected at the onset of a recession. Standard correlations among returns are likely to breakdown at the start of a recession with more classes producing negative returns than would normally be the case. Bonds will outperform stocks at the start of a recession, but within twelve months of the start of a recession, risky assets such as stocks and real estate will produce returns substantially in excess of bonds and reward investors for staying the course.