

## **Fourth Quarter 2008 Economic Commentary**

**James L. McCabe, Ph.D.**

**Adam B. Landau, CAIA**

In the fourth quarter of 2008 and in the 2008 calendar year, global markets for virtually all asset classes, from stocks to commodities, to real estate, to bonds susceptible to any default risk, had abnormal declines. For example, in the U.S. the S&P 500 Stock Index fell by 21.9% and 37.0%, for the quarter and the year, respectively. Non-US equity markets fared even worse with the MSCI EAFE (developed markets) index off 43.4% for the year while the MSCI Emerging Market index was down 53.3%. Even the Lehman Municipal Bond Total Return Index had negative quarterly and annual price returns, with the latter substantially offsetting the coupon.

2008 will go down in the record books as one of the worst ever for U.S. financial markets. The main reason for the pronounced weakness was the process of “deleveraging” which affected many financial institutions, indebted consumers, and strained an already slumping real estate sector. A negative feedback loop was created as declining asset prices made banks increasingly anxious, which choked off credit and promoted more asset liquidation. At the same time, an increasing number of households found it necessary to reduce, both voluntarily and involuntarily, their mortgage and installment debt because of a downward spiral in collateral values and servicing ability. Home prices in relation to personal income partly retraced the prior bubble with a negative wealth effect on overall consumer spending, employment, and economic activity which was self-reinforcing.

Issues involving the solvency of the world banking system came to a head during the week of September 15 beginning with the announcement of the Lehman bankruptcy and the breaking of the buck of one of the major U.S. money market funds. This led to a major money market fund outflow and the collapse of commercial paper demand. Within a week, the market for the highest rated U.S. commercial paper had shrunk to a two and a half year low of \$1.7 trillion. (In early September, the nationalization of two government sponsored enterprises, Fannie and Freddie, and the suspension of their preferred dividends wiped out 11% of Tier One capital of the U.S. banking system.) The margin required for credit default swaps increased by a total of about \$45 billion and monetary velocity fell to almost zero. The TED spread (the difference between the three-month bank offered rate [LIBOR] and the T-bill rate) peaked at 4.64% on October 10, a level only exceeded in 1974 after the Arab oil embargo. The spread between the three-month dollar LIBOR and the expected official policy rate over the same horizon, the Overnight Index Swap (OIS) rate, climbed to unprecedented levels, as did corporate bond spreads.

The global banking crisis did not start to come under control until mid-October when both U.S. and European governments agreed to inject substantial capital into financial entities for the purchase of preferred shares and to increase bank deposit insurance and to stand behind interbank loans.

By the end of the year, unconventional easing measures<sup>1</sup> adopted by the Fed had caused the TED spread and more broad based U.S. financial conditions indices (FCIs) to return almost to their pre-September levels after a tightening, which was one of the sharpest on record following the Lehman crisis. Although the expansion of the Fed balance sheet caused the FCIs to ease, it has not yet produced the desired level of private credit creation. For example, the spread between the LIBOR-OIS, at about 1%, is still well above the pre-Lehman level of slightly less than 0.8%. This indicates that U.S. banks are not yet entirely confident about making loans to each other. However, we can anticipate that the trend toward easing in credit markets will continue.

We do not expect the U.S. equity market to stay below its 2008 lows for a sustained period in 2009. In our opinion, the Fed's unconventional easing measures, a large and varied economic stimulus package, new initiatives to reduce the pace of foreclosure and housing price declines, and an emphasis on stabilizing financial institutions through additional TARP money should prevent another Great Depression or lost decade.

The bottom in equity markets associated with prior recessions has tended to occur close to the point of peak deterioration in the growth and labor market picture, not at the point of absolute recovery. Equity markets tend to be forward looking and thus tend to bottom well before the economy does. The same is not true of bonds or short-term interest rates – which tend to see growth revert to trend, or spot commodities – which tend to need demand to recover. While we do not see any clear signs of the pace of deterioration stabilizing yet, the broad range of policy initiatives being taken imply that this point could be reached by mid-2009. In the meantime, with heightened fear and uncertainty, a temporary decline below the November 2008 low cannot be ruled out.

The U.S. is experiencing what appears to be the deepest recession since 1973-74, but three economic positives should lead to recovery in late 2009 and more sustainable growth in subsequent years:

1. The non-financial corporate sector, which entered the downturn in good financial condition, with low debt levels.
2. Substantially lower energy prices, which should give a boost to real disposable income and eventually lift consumer confidence and corporate profits.
3. The current debt reduction will lead to a less vulnerable household and financial sector.

Although it is unclear when a sustained upward move in equity prices will occur, there are still many opportunities for managers to exploit. Our active equity managers are armed with lower share prices for well-positioned companies that can navigate difficult economic times. In a normal recession there are a large number of companies whose share price is low in relation to the present value of future excess cash flow, even with material earning declines. Unfortunately, this may be the deepest and longest recession since the 1970s. For this reason, we are not rebalancing back into equities as aggressively as we might normally, and in some cases are looking for a more secure way to participate in a market recovery by buying or increasing our

---

<sup>1</sup> These include unorthodox policies that bypass the banking system, such as buying mortgage-related and asset-backed securities, highly rated commercial paper, and providing back-up funding for non-bank financial institutions. The Fed owned almost \$2 trillion in private sector assets as of 12-10-2008, according to balance sheet data released on that date. The mid-December FOMC Meeting indicated a willingness to keep expanding the Fed's balance sheet aggressively and take further steps to ease credit conditions (e.g. directly targeting long-term Treasury yields to pull down corporate bond yields).

exposure to corporate bonds or convertibles. We will attempt to earn back last year's losses by taking only calculated risks.

We would overweight U.S. relative to non-U.S. equities for three reasons:

- 1) Economic recovery should take place in the U.S. first. Being at the heart of the global financial market crisis, it has made more progress at employing monetary and fiscal stimulus and substituting public for private sector debt than other countries (which is essential if the destructive effect of private sector deleveraging on aggregated demand is to be countered).
- 2) The U.S. banking system is far less over levered than the European and UK banking systems.
- 3) U.S. equities, in relation to trend earnings and cash flow, are at least as undervalued as international markets.

As to fixed income, we take the view that credit in various forms is clearly distressed and thus represents value. Equity may also represent value, but it appears less certain, at least at the moment since it is very hard to estimate "new normal" earnings in a different economy without debt-enabled excess growth.

In view of the fact that credit spreads are probably excessively high due to technical factors, we are taking long positions in U.S. convertibles and corporate bonds in 2009. The yield on corporate investment grade bonds is close to the historic average return on equities despite their seniority in the capital structure and a negligible probability of default. For this reason, these issues probably have higher risk-adjusted returns than do stocks issued by the same company. This is particularly true of Baa bonds that are trading like high yield issues with a spread over Treasuries of 550 basis points. Risk reduction and hedge fund redemptions have pushed many U.S. convertible bonds below the value of straight bonds notwithstanding their option value.

Municipal bonds are also priced very attractively relative to Treasuries. Historically, municipal default rates have been low, even in deep recessions. However, we would stick to high quality issues and focus only on underlying ratings in the case of insured bonds. The one- to ten-year maturity range is most attractive, since bonds of longer duration are exposed to more risk in the event that interest rates back up from current abnormally low levels.

There are two compelling reasons to potentially increase exposures to alternative asset classes. First, capital market dislocations have created opportunities for well-capitalized, conservatively managed hedge funds in certain areas, such as managed futures and debt related strategies. Second, despite large hedge fund redemptions in late 2008 and early 2009, hedge funds outperformed in aggregate most asset class indices in 2008, although there was a wide dispersion of return. Large, well diversified portfolios should have at least a 5% hedge fund exposure. As to private equity, many investors are trying to liquidate their interests in this asset class, in which they are presently overweighed. This has created some compelling opportunities in the secondary market and vintage funds, which can take advantage of the substantial discounts at which primary fund holders are willing to sell their interests.

The forecasts and opinions in this piece may not actually come to pass. Information in this report does not pertain to any MCM product and is not a solicitation for any product. They should not be construed as recommendations, but as illustrations of broader economic themes. The views and opinions expressed above are those of the portfolio management team at the time of writing and are subject to change based on market, economic and other conditions. They should not be construed as recommendations, but as illustrations of broader economic themes. All information is subject to change.

Equity securities are more volatile than bonds and subject to greater risks. Small and mid-sized company stocks involve greater risks than those customarily associated with larger companies. Bonds are subject to interest rate, price and credit risks. Prices tend to be inversely affected by changes in interest rates. Unlike stocks and bonds, U.S. Treasury securities are guaranteed as to payment of principal and interest if held to maturity. Note that it is not possible to invest in a market index.

This material may not be reproduced, shown or quoted to members of the general public or used in written form as sales literature.