

# The Fairlead Quarterly

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## Quarterly Overview

The collapse and consolidation that took place in the financial sector in September led to a broad market collapse in early October that was the worst we have witnessed in our lifetimes. The collapse was broad, (effecting virtually every sector of the markets), deep and precipitous (the intraday low for the quarter occurred on October 10<sup>th</sup> – the 8<sup>th</sup> trading day of the quarter). At the end of the quarter, when most values were well off their lows – most major equity indexes were off between 20 and 30 percent – and that was just for the three month period! These results were not limited to the US. During the past year some had suggested that there might be a “decoupling” that would allow the emerging markets to continue to flourish and help offset and contain any recession in the developed consumer nations. The hope that this might occur withered when all of the overseas markets were crushed, with the EAFE (Developed Markets Index) racking up a 19% decline and Emerging Markets down over 27%. The most unsettling aspect of this downdraft was that, because the problems started in the bond/mortgage market, many segments of the bond market also deteriorated significantly. Typically, bonds in a portfolio act as a stabilizing factor, often increasing in value when stocks lose value. This is because the stock sellers are using the proceeds to buy bonds – but not this time! The only segment to really benefit was Treasury bonds, bills and notes. Perhaps

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the most distressing aspect of all this is that many segments of the US equities markets are now showing 10 year returns that are negative.

By now the reality of the correction is old news and the real questions on everyone’s mind are:

- 1) Will it get worse?
- 2) How much longer will it last?
- 3) What should we do?

Let’s take a moment to look at where we are now and what’s being done.

## The Backdrop

**Bond Credit Spreads:** The huge selloff of stocks and bonds in the Fall, exacerbated by huge hedge fund liquidations, caused investors to shun all risk and buy only those assets backed by the Federal Government.

**REMEMBER:** In any market where there are more buyers than sellers prices go up, and with bonds that means yield (the interest rate you receive) goes down.

Today a 5 year treasury yields 1.43% – so buyers of these instruments are willing to accept a 1.43% per year return for the next five years to have the security of something backed by the US Treasury. In order to attract risk averse buyers to purchase other types of bonds sellers have had to reduce price (increase yield) significantly. The bottom line is the “credit spreads” – the amount investors are paid to buy classes of bonds other than Treasuries – has widened to historic levels.

**The US Dollar:** This flight to Treasuries and the global spread of the recession has also caused the dollar to strengthen considerably against other currencies. While the dollar may continue to stay strong during 2009, I would expect both the dollar and the Treasury market to weaken considerably in the wake of the enormous Government stimulus packages as the markets recover.

**Bailouts, Stimulus Packages and Investor Psychology:** The failure of Lehman Bros. dealt a cruel blow to investor confidence. Cruel enough, that it would now appear that between Monetary Policy (controlled by the Fed) and Fiscal Policy (controlled by Congress) the Government is prepared to take “whatever steps necessary” to prevent another blow of that magnitude. So we have massive stimulus packages unprecedented in size, on the way; and any firm, in any industry, that is “too big to fail” is a potential candidate to receive these funds.

**Housing, Unemployment & The Adverse Feedback Loop:** The housing market will continue to be a critical issue as we struggle to break the cycle of the *Adverse Feedback Loop* – weak Housing leads to a weaker Economy which leads to a weaker Financial market which lead to a weaker Credit market – which

the leads to weaker Housing. Containing unemployment will be critical to breaking the cycle as unemployment puts even non-subprime borrowers at risk of default.

**Oil & Commodities:** In the face of rapidly deteriorating demand by both consumers and producers global commodity prices have responded swiftly. Oil which traded at \$145 per barrel in July, closed the year at \$44.60 (that’s a 70% decline) and is now trading in the mid 30’s! Lower fuel prices are something we can enjoy as the global economies work through this period – but then watch out!

**The Obama Administration:** Shortly Obama will take the White House and there will be a new administration ushered in on a message of hope. Because I believe psychology is important to the markets, this should be a positive event, particularly in light of the fact that he appears to have postponed certain aspects of his tax proposal – specifically an increase in cap gains rates – that the market might have viewed unfavorably.

## Going Forward

How long will the recession last? No one can know for sure, but the recession will most probably last through 2009 and once it begins to emerge, the economy will be slow to reflate, in part because there will be much tighter lending standards, and people will to some extent change their behavior. Will it get worse? Probably, but everyone is expecting terrible economic data (corporate earnings, housing statistics, employment numbers, etc.) so it’s possible that much of the bad news is already baked into current prices. But you can expect a lot of volatility as investors struggle with the relationship between stock prices and the economic news being released. So what should we do?

**Bonds:** My expectation is that bonds (other than Treasuries) will have a good year in 2009 when all is said and done. Buyers will begin to move back into the markets, the credit spreads which have been at extreme levels will begin to narrow, bonds will appreciate and the more attractive bond buying opportunities will have evaporated. Where will the money come from? Well, much of it will leave Treasuries putting selling (downward price) pressure on these instruments. This normalization of the bond market will be a necessary precursor to sustained equity market recovery.

**Large Cap Stocks:** Large Cap Dividend paying stocks and stock funds currently have a very attractive risk profile. Yes, earnings may decline and some companies will be cutting dividends, but there are a lot of great franchise companies with a dividend yield that is significantly higher than the 10 year Treasury – so you can buy income and great growth potential.

**Mid/Small Cap Stocks:** These stocks often show the best performance coming out of a recession, but may be vulnerable in the near term.

**Foreign and Emerging Markets:** These markets have become more attractive. Their poor performance coupled with the strengthened dollar makes overseas investments relatively more attractive. A weakening dollar is a tail wind (helps) for overseas investments, so you want to buy foreign investments when the dollar is strong to catch the tailwind when it weakens.

Emerging Markets may continue to deteriorate in the short term, but the long term story remains in tact. These countries have nascent middle classes; technology and global capital

flows will bring massive populations into the 21<sup>st</sup> Century. As these countries expand both their economies and consumer populations, the US will lose its position as the preeminent consumers of the world's resources.

**Commodities:** Commodities tend to over-correct significantly in both directions. Many of the oil producers and service companies have dropped significantly along with the recent price of oil. The Oil Serviceholders ETF (OIH) is trading at about a third of its 52 week high. Precious Metals such as gold should provide an attractive hedge against any declines in the dollar that might result from the massive stimulus. Commodities are always volatile but over time should certainly benefit from the mainstreaming of emerging populations and the struggle for supply to keep up with demand.

Finally, I suppose I would be remiss if I did not mention the Bernie Madoff scandal. I can't wait to read the book and see the movie, because it is an unbelievable story. Both the mechanics of pulling it off, and the psychological programming and compartmentalization that would allow someone to lie for such a long period of time should blend to make an incredible tale.

Every time I hear about this kind of thing, invariably the investment manager has custody of the clients' funds –so there is no safeguard for the client. Let me emphasize, Schwab has custody of your funds, not us. Schwab sends monthly statements directly to you showing each and every position and any activity.

As always I am available to discuss the markets, the economy, your portfolio and your concerns.

**JOHN VREELAND**

## SUMMARY OF INDEX RETURNS 2008

Global Markets Year to Date				
INDEX	4TH QTR of 2008	Year to Date 2008	Calendar Year 2007	UNMANAGED INDEX DESCRIPTION
Russell 1000	-22.48%	-37.6%	5.77%	<i>US Large-cap Stocks</i>
Russell 1000 – Growth	-22.79%	-38.44%	11.81%	
Russell 1000 – Value	-22.18%	-36.85%	-0.17%	
Dow Jones Industrials – Total Return	-30.04%	-35.65%	8.88%	
S&P 500 – Total Return	-21.94%	-37.00%	5.49%	
NASDAQ Composite	-24.47%	-40.54%	9.81%	
NASDAQ – 100	-24.02%	-41.89%	18.67%	
Russell Mid-Cap	-27.27%	-41.46%	5.60%	<i>US Mid-cap Stocks</i>
Russell Mid-Cap – Growth	-27.36%	-44.32%	11.43%	
Russell Mid-Cap – Value	-27.19%	-38.44%	-1.42%	
Russell 2000	-26.12%	-33.79%	-1.57%	<i>US Small-cap Stocks</i>
Russell 2000 – Growth	-27.45%	-38.54%	7.05%	
Russell 2000 – Value	-24.89%	-28.92%	-9.77%	
MSCI World ex USA	-21.09%	-43.23%	12.92%	<i>Morgan Stanley World ex USA (US\$)</i>
MSCI Emerging Markets	-27.56%	-53.18%	39.78%	<i>Morgan Stanley Emerging Mkts (US\$)</i>
30 Day Money Market – All Taxable	0.31%	2.03%	4.55%	<i>Cash</i>
Consumer Price Index – US	0.12%	4.31%	4.15%	<i>Measure of Inflation</i>
Barclays US Corp. High Yield Index	-17.88%	-26.15%	1.88%	<i>High Yield (Junk) Bonds</i>
Barclays US Aggregate Bond Index	4.57%	5.24%	6.96%	<i>General US Bond Index</i>
FTSE NAREIT REIT: All	-36.54%	-37.34%	-17.83%	<i>Real Estate Investment Trusts</i>
Dow Jones – AIG Commodity Index Tot Ret	-30.04%	-35.65%	16.23%	<i>Basket of Commodities</i>
Crude Oil – Arab Light Crude	-55.68%	-49.94%	51.3%	<i>Price of Arab Light Crude</i>
Gold – London PM	-1.67%	4.91%	31.17%	<i>London Spot Price</i>

Source – Thomson Financial Company