

March 16, 2009

The past year on the stock market has been quite a ride. At a recent meeting in our office among our investment committee members, we were discussing the past market and economic events. I want to share with you some of our firm's thoughts about where our financial economy has been, where it is, and where we think it is going. The following discussion is much more technical than our typical letters, however, many of you have been asking for a bit more technical explanation of these events.

Where we were

After the tech bubble burst in the early part of the decade, and a mild recession ensued, the Federal Reserve set out to fight what it perceived as a deflation risk. Money supply expanded rapidly, Federal Funds rates bottomed at 1.0%, and the Fed extended a highly accommodative monetary policy for several years.

Easy money encourages risk, as the low cost of capital allows investors to pursue smaller returns on marginal investments, so long as the net return is still positive. This means more people borrow more money to finance more investments, from commercial real estate development to single family housing; from leveraged buyouts to hedge funds to mortgage securities trading.

Excessive investment – capital formation – should be counter-balanced eventually by higher risk premiums, tighter credit standards, cynical ratings agencies and wary regulators. This counter-balance failed to appear on time and with sufficient force.

Fixed income risk premiums dropped to unprecedented levels, buy-out multiples soared, housing credit expanded, and the financial system became flooded with liquidity.

Over time, most every asset became subject to leverage. Dollar after dollar of borrowed money was continually re-invested, with positive early outcomes reinforcing the riskier trades. Overseas, investors were equally rewarded as developed and emerging markets enjoyed a five-year bull run. Huge trade surpluses in Asia (China, Japan) and the Middle East (petro dollars) created even more liquidity as foreign currency reserves were reinvested into the global financial system. We reached eventually the bizarre condition where the price of almost every asset was rising – from stocks and bonds, to coal and oil, to corn and oranges, to gold and copper – yet at the same time the government insisted there was little inflation.

Far too late, the supply of trade dollars and cheap credit – easy money – balanced out against the reality of economics. Not every property can increase in value ad infinitum.

Not every business can be leveraged through a private equity deal and still compete in a global economy. Not every bond can be sold to an unsuspecting buyer and, regardless of credit quality, be expected to mature at par value. And, not every economy can grow without suffering through an occasional downturn.

Where we are

With the benefit of hindsight, we now know what happens when a liquidity-driven boom comes to an end, at least this version. Real estate activity slows to a crawl, mortgage payments are missed, foreclosures soar, and mortgage-backed securities become risky assets, the AAA-ratings notwithstanding. Banks suffer credit problems, and asset values are written down. This reduces bank capital and therefore lending capacity. Borrowers find credit harder to obtain, rates and terms more onerous. Yields on all risk-based assets eventually rise.

Tighter credit and slowing activity flows through to the real economy – the problems of Wall Street become the problems of Main Street. The economy slows, corporate profits decline and a recession sets in. Jobs are lost, consumers become scared, and austerity budgets are adopted.

As a response, expansionary monetary and fiscal policy will continue, working as a giant counterweight against the contractionary forces of a liquidity crunch and a recession. Odd as it seems, the solution to the crisis – the bursting of a liquidity-driven bubble – will be even more liquidity. For a period of time, stocks face the worst of all worlds: lower profits and higher risk premiums.

When selling begets selling, stocks and bonds trade like commodities. The marginal buyer and seller determine the price and “intrinsic value” temporarily becomes a meaningless notion. This is where we are today.

A hedge fund facing partnership withdrawals is forced to sell its holdings. If the fund is leveraged at 2 to 1, the selling is doubled. A mutual fund swamped with redemptions is likewise forced to liquidate positions. The manager has no discretion to draw a line in the sand and declare his holdings “too cheap to sell”. The decision is made by the client redemption order. As prices decline and investors reach their threshold of pain, more sellers enter the market. Declining prices trigger margin calls, which again forces selling.

Thus, the “virtuous cycle” of easy money and higher prices is countered by an “endless-spiral” of lower and lower prices. But, the spiral does end. Eventually, the last marginal seller is balanced by a new marginal buyer – the seller unwilling to take more pain and the buyer eager to pick up quality assets at deep-discount prices. An equilibrium is found – for every seller there is a buyer. The balance shifts, and buyers regain control. As time moves on and markets settle down, many sellers turn into buyers again.

When does this occur? There is no simple rule, no magic formula. Time and price are always the determinants. Price levels have already overshot to the downside. Stocks are cheap, the cheapest they have been in over 20 years. As for time, we will have to wait and see.

Where we are going

Ten years ago we were in investors' nirvana. The internet was blossoming, tech stocks were booming, the economy was healthy, and it seemed nothing could go wrong. Most people were comfortable investing in that environment. After all, stocks rose every year, or so it seemed. So we were in nirvana, or so we thought. But really, we were far from it.

In looking back we can see that ten years ago was the worst time to invest in our stock market in over six decades. Why? Because the past ten years have produced negative returns for the overall U.S. stock market, the first time this has happened since the depression.

With the passage of time, conditions at the starting point become irrelevant, with one exception: Valuation. Stocks were expensive ten years ago. Valuations had risen from fair to lofty to dizzying heights. This could not be sustained. Ten years later, in the grip of the bear market, the situation is reversed. Valuations are attractive. Stocks are on sale. Corporate America is being marked down to discount prices.

Calling a market bottom is a fool's game; worries abound, and there is always a chance the market will head lower in the near term. Likewise, bold predictions make for great headlines and interesting lunchtime chatter, but are worth little more.

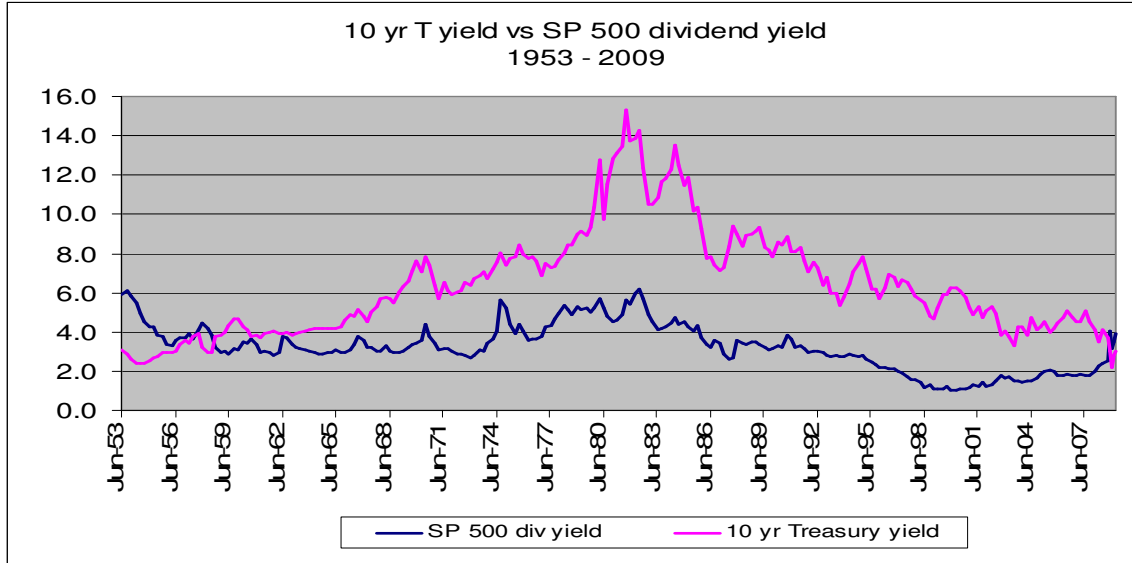
Identifying value is something altogether different. Value exists in today's markets. There will come a time when the marginal seller is exhausted, when buyers once again dominate, when investors look beyond the financial crisis and the economic turmoil and see the recovery in the future. Then, stocks will begin a return to their fair value, and long-term investors will once again be rewarded.

We hope you have found this information helpful. If you have any questions, please do not hesitate to call us.

Doyle Wealth Management, Inc.

Addendum

For 50 years, stocks sold at lower yields than bonds (10 year Treasury), as they should. In November, 50 years of history was turned upside down, as stocks sold at higher yields than Treasuries.



The total value of the U.S. stock market dropped below \$7 trillion, down from nearly \$16 trillion. When compared to the size of the U.S. economy of \$14 trillion, stocks are at their cheapest level since 1990.

