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PDV *OBSERVATIONS*

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Market Update: Questions and Answers

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I thought it would be interesting for this issue of ***Observations*** to update you on the markets via some questions and answers.

What happened in the Madoff fraud case?

- Bernard Madoff "produced" consistently high returns for many years, and created such an aura of secrecy and exclusivity that people pleaded with him to manage their money. His refusal from time to time to take the money just made people want to hire him more. While the investigation is still continuing, it looks like his company was one giant Ponzi scheme, by which he fabricated account statements and stole from client assets. Clients were comforted by the steady account progress shown on the fake statements. Since new clients were constantly coming through the door, Madoff was able to use their money to settle any client withdrawals and pay interest on client accounts. All this was made possible, because there were no independent third parties safekeeping or valuing client assets. Essentially, Madoff had possession of client money, and was responsible for both managing and valuing client assets!

Thanks for your referrals!

As we conclude our fourteenth year of publishing *Observations*, we would like to take this opportunity to express our gratitude and appreciation to all our clients and friends for their client referrals over the past year. We always welcome the opportunity to be of service to relatives, friends, and acquaintances of our clients. As many of you know, we do not market our services to people with whom we are not acquainted. Our business has grown over the past fourteen years primarily due to satisfied clients adding business and through their referrals. We hope you'll think of us if you come across anyone who would benefit from our services. Thanks again!

How is the market doing?

- The market was down about 38% for 2008; but it rebounded over 20% from the year's low point on November 20 to the end of the calendar year. Those who sold around the low point missed out on a robust rebound.
- The market has done better lately for a variety of reasons:

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    - Oil has dropped from $147 a barrel down to a recent range of $35-45, pushing gas prices down from over $4 to a national average of around $1.60 per gallon (lowest recently was $1.37). The cost of food items has also dropped sharply. All this equates to $100's billion of economic stimulus.
    - Short-term interest rates (fed funds) are now set at 0-0.25% range. The interest cost of many types of debt has gone down as well.
    - Hedge fund forced liquidations have slowed.
    - Mortgage rates have dropped substantially, spurring robust refinancing that also acts as a powerful economic stimulus. Nationwide, 30-year fixed-rate conventional mortgages are nearing 5% (lowest since 1971) and heading lower still. The 15-year fixed-rate conventional mortgage recently averaged 4.92% nationally. Even rates for jumbo mortgages have dropped meaningfully.
    - Deterioration of the housing market has slowed. Very few new houses are being added to inventory; and foreclosed properties in places like California and Florida have reached prices that are stimulating robust sales. Recently, it was reported that the number of unsold new homes fell by 34,000 in November, and the new home inventory is beginning to approach normal levels, especially after taking into account population growth. Houses going through or about to enter the foreclosure process, together with the unemployment situation, are highly troublesome, but the government, through its de facto nationalization of Fannie and Freddie and numerous programs targeted at keeping people in their homes, will slow the amount of foreclosed properties being added to housing inventory.

What is the latest with all the hedge fund forced liquidation?

- Forced liquidations/sales by hedge funds have slowed in the past several weeks. More and more funds have put up "gates," which essentially slow or stop clients from pulling out their money. This has by extension slowed redemptions, relieving pressure off hedge funds from having to continue dumping assets indiscriminately and at any price. In turn, with more time to sell and asset values less challenged, hedge fund performance is generally improving and clients may reconsider pulling money out. Potentially, this could turn the downward spiral of relentless selling around.
- You can tell a lot of the vicious decline this year resulted from indiscriminate, forced selling by hedge funds etc. Normally, some stocks do well even in a bear market, especially those companies that do not depend on the economy. In 2008, close to 98% of stocks in the US and Europe went down, with around 2/3 of such stocks dropping over 40%.

Has all the money being thrown at the financial crisis made a difference?

- Yes, while sometimes ineffective, the sheer size of the taxpayer funds has been beneficial in many ways, such as the following:
    - The Fed has revived the commercial paper market, a critically important market for highly rated corporations to get short-term funding. The rates at which they borrow have come way down from a few weeks ago.
    - By increasing the FDIC bank deposit insurance to $250,000, it has helped depositors' confidence in their banks; it is critical for banks to retain customer deposits as a source of cheap funding for their operations and as regulatory capital.

- The FDIC has improved the corporate bond markets by guaranteeing new short-term senior debt issued by qualified financial institutions, which in turn opens up the bond market for those seeking financing.
- The much maligned TARP, which has been a public relations and political disaster, has stabilized many financial institutions and put up a firewall against widespread financial contagion.
- Three-month London interbank offered rate (LIBOR) has come down substantially (from over 5% a few weeks ago to under 1.5% currently), drastically narrowing the spreads to fed fund rates. This is an indication that banks have started lending to each other again, and some confidence is being restored. This is starting to flow through the financial system, resulting in lower costs for all types of financing.

How can the stock market rally when the economy is so bad?

- We all know that the economy will get worse before it gets better, corporate earnings are in decline and unemployment is destined to worsen in the coming months. Research has shown that in many past instances, stocks ***rallied strongly*** in the midst of an economic environment during which earnings were ***dropping***. In the same vein, there have also been many instances when stocks rallied strongly in the midst of a worsening unemployment situation. **Another way to look at this is that the early stages of a bull market after a recession almost always coincide with poor and deteriorating earnings and economic data.** This is very consistent with the empirical evidence that markets rally ahead of an economic recovery. So we ought to be careful concluding that the markets must stay weak because the economic news is so poor. As Warren Buffett said in his highly publicized opinion piece in the NY Times back in October**: "Be fearful when others are greedy, and be greedy when others are fearful."**
- Here's some perspective on how long this slump might last. This recession began last December 2007. The average post-war recession lasted 10 months. The longest recession was the Great Depression, which lasted 3.5 years. The next two longest recessions were 1974 and 1982, both of which lasted 16 months. The stock market discounts the eventual recovery and typically begins moving up 4-6 months <u>before</u> the end of a recession. We are already 12 months into this recession. It is an open question when the market will start improving in a sustainable way, but this gives you some perspective as to timing.

How big a bounce might be expected ahead of economic recovery?

- Historical data show a 25% median market rebound from the worst point in a recession to the end of the recession. So there is a ***25% median gain even before the economy starts growing again. We of course won't know that a recession has ended until some months after the fact, at which point the market is likely to have rebounded further, beyond the initial 25%.*** That is why waiting until the "coast is clear" doesn't work. As Warren Buffett said in his NY Times opinion piece: "So if you wait for the robins, spring will be over."
- The average time for completely retracing a bear market drop has been 22 months (excluding the Great Depression). A lot of the market recovery comes while we are still in a recession, when nobody wants to be in stocks.
- In one study by William Hester, the average first-year market return following 9 recessions was 37%, and as high as 44%!

The economy is in a recession; what might help contain its depth and duration?

- News reports indicate a 2-year fiscal stimulus program in the area of $800-850B is on its way. The new incoming president will have much political capital, and Congress is under great pressure to work together to get the economy going again. I'm no expert on politics, but I think the prospects of passing some program of this magnitude are pretty good.
- The Federal Reserve have begun buying over $600B of agency debt and mortgage-backed securities (MBS). This, coupled with The Treasury's buy program directed at MBS, will help lower mortgage rates further and support values of assets owned by our financial institutions. Also this year, the Fed will begin a $200B lending program that will lower interest rates for small business and consumers as well. Further, it is considering directly buying longer-term Treasuries to lower longer-term interest rates.
- These actions don't just help lower interest rates for debt that is priced off those benchmarks. As Treasury yields head down, there will be increasing pressure for investors to take on slightly more risk to get higher yields. This will help further revive the investment grade bond market, which would make that market available to lots of companies to issue bonds and get financing. This is starting to happen, as there have been some new bond issues brought to market and the spreads to Treasuries have narrowed. Even junks bonds have rallied, possibly discounting improving credit conditions.

How can the stock market be undervalued if we are in a recession?

- The worth of a company (in which a stock represents an ownership interest) depends on its future free cash flow. The timing and size of this cash flow are then discounted at some appropriate interest rate back to the present to determine its worth. While cash flow received today is worth more than the same cash flow received a year from now, the present value of a company (and its stock) involves discounting a very long sequence of cash flows. **As such, the near term cash flow amounts represent a very small portion of the present value of a company. A company and its stock can have substantial value currently, even in face of temporary difficulties, as long as we can expect a long period of strong cash flows in the future.** Another way of saying this is that the profit and financial status of a company in the next 12 to 24 months have very little impact on the value of the company; the fact that the market is obsessed with the short run and overly punishes a stock based on what might happen in the next 12 to 24 months would not materially affect the underlying worth of the company, which mostly depends on what happens beyond the next 24 months. A stock market works on the same principles, as it is simply an aggregation of many individual companies (and their stocks). The fact that the near term prospects for the economy are poor does not per se mean the stock market is fully or overvalued. Patience is key for the market to recognize the longer term prospects. In fact, it is often the market's obsession with the near term which leads to undervaluation of longer term (better) prospects; in this way, undervaluation tends to occur during tough economic times.