April 4, 2008

2008 First Quarter Review

The best thing about the first quarter of 2008 is that it is over! By some measures, this was the worst quarter for stocks in nearly 6 years. The S&P 500 Index fell 10% while the Nasdaq Index fell nearly 15%. Long-term Treasury bond prices improved somewhat. Short-term interest rates fell quickly as the Federal Reserve slashed its rates and investors fled to the safety of Treasury Bills. Volatility of price swings in stocks and commodities increased at the end of last year and came to a crescendo in March. Prices have tanked and snapped back so fast that observers needed neck braces. It has been a wild ride as the problems that we foresaw in the "sub-prime" mortgage market exploded, with the spillover effects now well documented by the breathless financial press. At least we know that we have been right to play defense. Now we try to gain a little perspective to help us proceed from here.

One of the primary economic lessons to be learned by investors is that all bubbles look great and end badly. Recently, we've had two. In 2000, the tech stock bubble started deflating. In 2007, the real estate mortgage and derivatives markets began to unravel. At the risk of oversimplifying the drama of the last 9 months, the bursting of the real estate bubble has caused a credit crunch which may now generate a recession.

The Federal Reserve Board, at first reluctant to "bail out Wall Street," finally realized the seriousness of the situation and moved aggressively to prevent a collapse of leveraged financial institutions. The Fed has kicked into high gear by lowering rates, providing liquidity to banks and getting into the mortgage-backed securities business by accepting them as collateral. The Fed is now lending to investment banks like Goldman Sachs and Merrill Lynch, something they have not done since the 1930's. Congress is even getting into the act (never a good sign). As one economist said, "We're all capitalists on the way up and socialists on the way down."

Financial stocks continued to decline, but housing stocks began a surprising rebound. Drug and healthcare stocks were under pressure as the cry, "the Democrats are coming," rings around Wall Street. Commodities have been a great place to be for the last year or so. Oil has gone from $60 to $100 in a year while gold and agricultural commodities have risen nicely. But metal and mining stocks took a hit after a strong rally the last few months. With the massive amounts of money being injected into the system, it is reasonable to believe that inflation might work its way higher. The dollar has already tumbled and the increased money supply may provide the fuel for longer term rallies in precious metal and commodity stocks as they provide an "inflation hedge."

From the financial world, there is probably still more bad news to come. Goldman Sachs estimates that the "leveraged losses" to banks, brokerages, hedge funds, and assorted participants in the financial arena now stand at $460 billion. Even Senator Everett Dirksen (who famously said, "A billion here and a billion there, pretty soon you're talking about real money") would be shocked at the magnitude of the losses. The people at Goldman further theorize that there is *another* $450 billion or so still to be written off. We shouldn't be surprised by more bad news.

Still, the markets have recently rallied. Bear market rallies tend to be sharp and fast. They make one feel like an idiot for not being fully invested at the bottom. Then they roll over, prices come back down and the process begins again from a lower level. “Surely THIS must be the low,” the thinking goes. Then when stocks take off once more, the average investor piles in and has his capital trimmed yet again on the next decline.

I have previously mentioned that declines of this magnitude in the market usually don’t end until a high-profile bankruptcy brings the selling to a climax, thereby cleaning out the last of the sellers and setting the stage for a recovery. We’ve had two “climax” days in the first quarter, both bottoming out around 1,270 on the S&P 500 and 11,700 or so on the Dow Industrials Index. The first climax was a nasty sell-off in January that we later learned was exacerbated by the French Bank Société Générale dumping unauthorized trades for a $7.2 billion trading loss. The second was the Bear Stearns “takeunder” in March that saw the Wall Street firm’s stock fall from $60 to $2 in three days (down from a high of almost $160 a year ago. Now *that’s* real pain). The collapse of Bear Stearns may have provided the classic “bankruptcy bottom” for the market, with a simultaneously successful “re-test” of the lows that the indexes made in January.

We’ve had nine months of growing recognition of the problems and six months of aggressive activity by the Federal Reserve Board. The Fed is pumping money into the system like mad to keep lending from freezing up. This massive injection may work its magic. The usual lag time of 6 months between interest rate cuts and their effects has just passed, so the medicine might start to work soon. We won’t know until later, and only time will tell.

We do know that stock prices have come down, dividend yields have gone up, and money market rates have dropped below 3%. Until now we have benefited from not being aggressive. Last June we cautioned against being overly optimistic while the market went up without a care. Now we have to caution against being overly pessimistic. Recent surveys show that anywhere from 75% to 90% of investors believe we are already in a recession, with a healthy majority expecting the market to head lower. When things get this gloomy, the surprises are often to the upside. We have to remember that if we wait until skies are blue again, the investments we wanted to make will likely be significantly higher by then. So we will continue to cautiously buy value where we find it. Or, to continue to beat the proverbial dead horse, we will hitch at least a few wagons and head west again.

Enclosed you will find your quarterly statements and reports. As is our regulatory duty, we also make our annual offer to provide you with our Schedule ADV part II if you would like to learn more about Carmichael Capital, Inc. Please review these reports at your convenience and give us a call if you would like to discuss your portfolio or any investment ideas.

Sincerely,

Claude R. Carmichael CFA