

July 7, 2008

2008 Second Quarter Review

“Sell in May and go away.” That is an old stock market adage that grizzled market mavens used when I first started working on Wall Street in the late 1970’s. The idea is that not much happens in the summer, except that prices drift lazily lower as torpor sets in and all the big boys are playing in the Hamptons. This year it was advice to be followed, although “torpor” is not the word for what has set in. The entire first half of 2008 has been, by some measures, the worst for the stock market in 38 years. June was still worse. You have to go back to 1930 to find the Dow Jones Industrials sliding more than 10.2% in the first summer month.

So far in 2008 the Dow Jones Industrial Average is down over 14%, while the S&P 500 and Nasdaq are both down about 13%. There have been few places for investors to hide. Bond prices slid in general, with corporate as well as municipal bonds declining. International investors fared no better. Most “foreign” stock markets lost more than their U.S. counterparts. Emerging growth countries did about the same. Even popular Chinese stocks have swooned dramatically with the Xinhua ETF down 43% from the highs it reached last October. Financial and housing stocks have continued to perform dismally. Healthcare stocks and consumer staples, which often provide a “safe haven” for investors fearing recession, fell sharply. Virtually all sectors except energy and commodities have declined in value this year.

The Federal Reserve has paused in its massive rate cutting actions. Ben Bernanke and his cohorts at “The Fed” are in an uncomfortable position. They have cut rates dramatically and pumped massive amounts of money into the economic system in order to avoid a domino-like collapse of highly leveraged financial institutions and to keep the economy moving. At the same time, however, banks are belatedly doing what they should have done before. They are tightening credit standards and are now reluctant to lend. This is the classic “credit crunch” with the Federal Reserve “pushing on a string” to get the economy moving. At the same time, inflation is popping up in many other parts of the economy as price increases sneak in. If the Fed lowers rates more, it may exacerbate inflation. If they raise rates to fight inflation, they risk exacerbating a recession. An increase in inflation is usually bad for bonds with their fixed yields. That is one of the reasons we have not added to fixed income investments recently.

Because of the economic prosperity of the “Greenspan Era,” many have come to “believe in the Fed” and the power of central bankers to manage the economy without significant disruption. The unprecedented actions taken by the Fed in the first quarter (to counter the twin crises of January and March) appeared to many investors to be all that was needed to save the day. I believe this “faith in the Fed” to be ill-placed, leading to a complacency that is now being beaten out of investors. It may very well be that the actions of the Federal Reserve in 2000 and 2001 created and prolonged the string of asset-pricing bubbles that we have seen; first in stocks, then in real estate, and now in commodities. It is possible that “faith in the Fed” will deteriorate along with any continued bad news. When investors no longer believe the Federal Reserve Board can save the day at will, it will be closer to a time when the bear market will have run its course.

You won't hear it often on Wall Street, but I have always contended that there are times when money market funds are a good place to be. This has been one of those times. Small positive returns are better than negative ones. As Warren Buffet puts it, I've had to listen to the crowd yelling "Swing, you bum!" while waiting for the fat pitch down the middle that value investors seek. Money funds are no long-term answer, particularly since rates have dropped and inflation is rising, but they are certainly appropriate as a method of keeping "powder dry" until bargains are compelling again. And they will likely become compelling again. The trick is to have enough cash and courage to take advantage of them.

The pendulum of market valuation usually swings too high in times of euphoria and too low in times of gloom. Last quarter we had taken precautions and waited to see if the "double bottoms" in January and March would hold. They didn't. Now we should be prepared for two things, more deterioration punctuated by sharp rallies. The worst may not be over, and we should prepare for the possibility that it isn't. But I am confident there will be some sharp rallies in the market that make everyone think it is. (It was just as recent as the middle of May when a one-week surge of 2.7% lifted stocks near their 2008 highs.) As we mentioned last quarter, bear market rallies are sharp and fast. They leave you thinking that you have missed the opportunities and that you'd better get in fast. If we pick our investments carefully and move incrementally, we will likely avoid the temptations that lead to being "whipsawed" by buying enthusiastically as prices rise and selling gloomily as they fall. Hopefully, we will then have enough cash and courage to invest when the prices are lower and the opportunities the greatest.

We have benefited from being cautious while many others either never saw it coming, or believed the worst was over in January (Société Générale crisis) or in March (the Bear Stearns collapse). We have reduced exposure over the last year in preparation for the possibility of these problems occurring. Although we have "circled the wagons" and "played defense" to preserve capital, capital preservation does not mean never having a down quarter, or a down year. It means keeping most of what you've got and, thereby, being able to benefit from the recovery when it eventually happens, or "living on to fight again" in the words of Jeremy Grantham. The math is simple. It takes only a comparable 5.26% gain to recover from a 5% loss, while a 50% loss requires a 100% gain (twice the loss). These are difficult markets, but we continue to do our best to identify the risks as well as the opportunities, and to act accordingly.

Enclosed you will find your quarterly statements and reports. Please review these reports at your convenience and give me a call. We can discuss individual investments as well as how much of each asset class you would like to hold as the year progresses.

Sincerely,

Claude R. Carmichael CFA