# The Outlook

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| As of 12/4/2008 | | |
|---|---|---|
| **Index** | **Market Value** | **YTD % Change** |
| Dow Jones Industries | 8,376.24 | -36.9 |
| S&P 500 | 845.22 | -42.4 |
| Nasdaq | 1,445.56 | -45.5 |

As a result of the near collapse of the U.S. financial system and the impairment of financial systems around the world, the global economy has entered into what looks to be the worst recession in decades, particularly in the United States. Its impact is being felt by countries around the globe including the emerging economies which had recently been the drivers of worldwide growth. **During this time of extreme stress, the interconnections and interdependence of economies have been highlighted showing the absolute necessity of coordinated financial policies to combat a serious recession. Moreover, global equity markets have suffered their worst declines in anyone's memory as an estimated $30 trillion in value has been temporarily wiped away.** This represents more than 60% of world GDP (Gross Domestic Product). The complexity of the problem and its solution involves each country undertaking and coordinating economic policy in ways that support global growth.

**In most democratic political systems, governments' primary responsibilities are to fight recession and deflation by re-inflating their economies.** No government can stay in power for long if it allows deflation and the accompanying rise in unemployment to overwhelm its economy. In emerging democratic societies, it is even more important to avoid deflation as the potential for social instability can lead to a return to autocratic government. Since the problems emanated from the United States, much of the solution will rest with the United States, but coordinated global responses will be one of the several factors needed to repair the global financial system and restore the world economy to more normalized and sustainable growth.

**While the financial system is severely damaged, there is reason for optimism based on the commitment of world leaders to work together to implement the necessary fiscal and monetary policies.** An example is the recently announced stimulus program by the Chinese government of $586 billion, which would be the equivalent of a United States stimulus program on the order of $2 trillion. This program, which is for infrastructure and urbanization, underscores the commitment of the Chinese Government to promote growth to absorb their large labor force and prevent unemployment. **We expect the emerging economies to drive world growth, and portfolios should own the companies that are the beneficiaries. Importantly, it should not be forgotten that the stock market discounts economic change many months in advance, and while our ongoing problems will continue to create headlines, opportunities will present themselves well before we emerge from this economic slump.**

### *Asset Deflation – The Result of the Problem*

Investors around the world have experienced one of the largest declines in asset values in history. In the U.S., housing values, qualified retirement plans, equity and fixed income investments have seen significant declines in a very short period of time, leaving many to try to determine the true cause of this problem. **For many years the global economy was driven by easy money and excess liquidity, which generated a proliferation of complex financial instruments throughout the global financial system. These instruments have been described by no less an investor than Warren Buffet as financial weapons of mass destruction. Much of the problem lies in the failure of the credit-rating agencies to assign the appropriate risk ratings to these complex financial products, lack of proper regulation/supervision and poor or nonexistent underwriting standards for loan originations.** What began as a U.S. housing problem spread throughout the world with a proliferation of sub-prime mortgages packaged into derivative products such as mortgage-backed securities carrying investment-grade ratings that clearly were not investment-grade securities. This market developed from $100 billion approximately eight years ago to no less than $60 trillion and included a variety of asset-backed securities owned by a large number of institutions throughout the world. As the housing market went into decline, all asset-backed paper became questionable and the financial industry froze. **As banks were forced to take huge losses on these securities, their capital bases shrank dramatically to the point where they became unwilling or unable to lend, removing an important engine for economic activity.**

At this time, there is no source of economic stimulus other than the U.S. government and the Federal Reserve. **The most dominant feature of past recessions was that we could always count on the consumer to spend as consumers account for 70% of Gross Domestic Product. This time, the consumer is over-debted and has less access to credit as credit is being withdrawn by the banks.** While many businesses have strong balance sheets, they are limited in their ability to access credit and fund normal business activity. The financial crisis became so severe that banks were unwilling to lend even to each other.

## ***Repairing the System***

**While we expect a protracted period of difficulty for the U.S. economy, there is a way out, and when we emerge from this period, the United States economy will be stronger and more efficient than it has been in recent memory. What the United States needs to do to create the correct outcome involves six elements.** First, we need a massive infrastructure spending program to deal with the estimated $2 trillion required to repair and modernize the U.S. infrastructure, which will also create jobs. Second, as this problem began in housing, we need to arrest the rate of foreclosures, which continues to put downward pressure on home prices, thereby leading to more foreclosures. Third, we require a program that will deliver significant grants to the states to offset their rising deficits and remove their needs to raise taxes and cut services during a period of economic contraction. These deficits could total $150 billion dollars due to the recession. Fourth, we must continue to re-capitalize the financial system, reduce the debt burden involving credit cards, auto loans and mortgage debt, and through Federal Reserve action reduce the spread between government interest rates and market rates. Fifth, we must provide tax relief or tax reductions for most income earners. Sixth, we need a significant extension of unemployment insurance and other social programs**. In short, this will involve a multi-year program redefining the economic landscape. All of these programs will have a most salutary effect only if they are massive and immediate. By massive, we mean a total of no less than 5% of our Gross Domestic Product, approximately $700 billion.** Significantly less than that amount, in our view, will not do the trick, but will result in our having to add further stimulus at a time when the economy is weaker, which would then result in an even greater increase in the Federal Deficit and the National Debt.

## ***U.S. Monetary Policy and Fiscal Stimulus Programs***

**The Treasury and Federal Reserve have undertaken commitments unlike any ever made in their entire existence. So far, the United States Government, after guaranteeing $306 billion of Citigroup debt, has committed more than $8 trillion in guarantees or investments to repair the financial system.** From taking over Fannie Mae and Freddie Mac, putting AIG into conservatorship, the Federal Reserve backstopping the $2 trillion commercial paper market which recently all but ceased functioning, the FDIC guaranteeing debt insured by banks (limited to $1.5 trillion), raising bank deposit insurance and the rescue package of $700 billion passed by congress, the government has by no means finished its work. Companies with global financial linkages and large employment dependencies such as the automobile industry are now in line for large-scale government assistance. The monetary authorities continue to do whatever it takes to revive the financial system.

Under president-elect Obama, we expect a major infrastructure spending program and large grants to the States to be passed by congress early in the New Year. Foreign central banks are now coordinating monetary policy which must be hardhitting if it is to be effective. **That means interest rates must be lowered further (Japan's is still near zero) and injections of liquidity must continue to offset the trillions of dollars of asset-backed securities, which now are of questionable value and are largely illiquid.** It should be noted that Germany, the most powerful member of the European Union, is not entirely supportive of a major stimulus program for their economy because the government has a greater fear of inflation than unemployment. This exemplifies the challenges and complexities of coordination facing leaders in solving this problem.

## ***The Employment Outlook***

Since rising unemployment will tend to trigger additional bankruptcies and greater strains on the financial system, we should expect to see more rescue programs created. **We project significant job losses across most sectors of the U.S. economy into 2009 with the financial, retail and manufacturing sectors impacted the most. We estimate unemployment reaching levels unseen since the 1980's.** If the Obama stimulus program is to generate 2.5 million jobs, that would leave a shortfall of at least 2 million jobs since an additional 3.5 percentage points of unemployment would cost at least a total of 4.5 million jobs, assuming unemployment rises to 10%. With respect to employment, the challenge facing the Obama administration pales in comparison to the one that the Chinese government faces as it is estimated that China needs to create approximately 20 million jobs annually to ensure that it meets its GDP growth targets and prevents social unrest. **To reduce the impact of greater unemployment in the U.S., the stimulus program must be massive and targeted at infrastructure.**

## ***The Growing Deficit and the Dollar Problem***

As a result of the Financial Crisis, the Federal Reserve balance sheet, which a year ago was $950 billion, has now ballooned to in excess of $2.2 trillion and is rapidly approaching $3 trillion. It is notable that the balance sheet was increased so significantly by the policy of accepting the unmarketable securities from troubled U.S. financial institutions in an effort to reliquefy the financial system. For many years U.S. deficits, both fiscal and trade, were able to be financed by our foreign trading partners. But now these countries, in order to stimulate their own economies, will not be able to purchase increasing amounts of newly issued U.S. debt to the same degree. So at a time when we have a growing deficit and the need to create a massive stimulus program, we can no longer count on the most important foreign buyers to the same extent. **To offset the reduction of foreign demand, the Federal Reserve will have to maintain a historically low interest rate policy for the foreseeable future. To accomplish this goal the Federal Reserve must increase the supply of dollars, which will cheapen the currency and weaken the exchange rate.** The Fed has already begun a policy of quantitative easing, which essentially involves the direct purchase of asset-backed securities in order to drive up asset prices to reverse the deflationary forces building in the system.

The United States enjoys the unique characteristic of being the largest reserve currency country in the world. Therefore, since all its debts are in dollars, it is able to discharge its obligations by printing U.S. dollars. Because there has been a need for dollars overseas causing our currency to appreciate, the Federal Reserve in one day arranged a currency swap program of $620 billion with 14 countries. This program gives countries access to U.S. dollars in exchange for their currencies. This was necessary to satisfy the overseas demand for dollars, which had contributed to the strengthening of the dollar exchange rate causing our export sector – the last remaining pillar of economic strength for the U.S. – to weaken. **Because of all the liquidity being created to stimulate the economy, there is a substantial probability the dollar will begin to decline in 2009.**

## ***Demand for Gold Increasing***

**Historically, investors have long considered gold as a safe haven asset and a place to turn in times of economic crisis. According to the World Gold Council, gold demand for the third quarter of 2008 reached an all-time quarterly high of $32 billion.** Investors sought refuge from the financial turmoil at the same time that jewelry buyers were attracted to lower gold prices. Dollar demand for the quarter was 45% higher than the previous record in the second quarter of 2008. At the same time, tonnage demand was 18% higher. The bankruptcy of Lehman Brothers triggered peak demand in late September and for five consecutive trading days an unprecedented 111 tons were traded**. However, forced liquidation by hedge funds has contributed to keeping the price of gold uncharacteristically low in the face of rising demand.**

Retail investment demand rose 121% to 232 tons in Q3 as strong buying was reported in European and U.S. markets. We are also aware that gold shortages exist among bullion dealers around the world. In Europe, third quarter demand reached an all-time high of 51 tons and France became a net investor for the first time since the early 1980s. India was a major contributor to increasing demand, as were China, Indonesia and the Middle East. All this comes at a time when many Central Banks, which had been reducing their gold reserves, have stopped selling. Furthermore, worldwide production costs have been rising. **The result of the combined forces of increasing demand, limited supply and concerns about the value of currencies worldwide could give rise to significant increases in gold prices in the coming months.**

## ***Positioning Your Portfolio***

Since our firm's inception in 1971, our investment approach has focused on investing in the securities offering the most assets, earnings and cash flow for the fewest dollars. **For the short term, the undervaluation of many companies in the U.S. equity market has become totally irrelevant as de-leveraging, large-scale redemption activity and loss of investor confidence have completely overwhelmed the equity markets. As we emerge from this period, the great**

**values that are being created could result in investment returns that are easily the most attractive that have been seen in many years.** The biggest challenge for investors is getting from Point A to Point B. Point A requires investors to ensure that their portfolios are effectively positioned for this period of asset deflation. Point B involves positioning the portfolio to take advantage of the distinct opportunities which are being presented. **Perhaps the greatest challenge for professional investors is to position portfolios for the downside risks present today, while being able to participate in the rapid moves that will inevitably come with the return to a more normal functioning of the financial markets.** There is an estimated $4 trillion of cash on the sidelines waiting to take advantage of the values being created. Professional investors including hedge funds, mutual funds, institutional managers and pension funds are holding cash levels at all-time highs.

**With this in mind, equity portfolios should be positioned to take advantage of owning the beneficiaries of massive infrastructure spending from the domestic and global stimulus programs. We also plan to target securities that benefit from a weaker dollar including gold investments and export-driven companies.** Moreover, leading health care companies, especially those with strong positions in the generic drug space, should be represented as well as defense companies whose services are needed to maintain the U.S. position as a world leader. We continue to emphasize dividend income as an important element of total return. We intend to take advantage of opportunistic investments, including merger arbitrage situations, which exist due to the unusual valuations in the market. Finally, in the coming weeks, an allocation should be made to select financials, energy, industrial and materials companies whose shares have been oversold as a result of deleveraging and forced liquidation as selling pressures abate.

**For fixed income investments, there are significant opportunities in investment grade corporate securities of high quality companies in the 3-4 year maturity range**. At the present time a bubble has been created in the short-term treasury market as investors have been interested only in absolute safety without regard to yield. This has caused short-term treasuries to sell at prices that produce virtually no income. When this short-term phenomenon reverses itself, as it inevitably will, interest rates on treasury securities will begin to rise.

**We wish our readers a happy, healthy, peaceful and prosperous new year!**