Quarter Notes

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Are We There Yet? Have We Seen the Bottom?

October 2008 will go down in the history books as having the worst week ever on Wall Street. Scholars will look back on this past week as they have looked at the Octobers of 1929 and 1987, trying to make sense of the market's mayhem. Clients have noted, "This time it is different." Truly all bear markets have been different. The causes, the responses by government: all different. Despite all the differences, we are hopeful that the outcome will be the same; confidence restored, markets recovered, so we can move forward with a healthier financial system.

This market is responding to a seizing up of the credit markets. Credit (the ability to borrow) and liquidity (the ease of moving money) fuel the global economy. Currently, lenders don't trust borrowers and even banks don't trust each other to lend money overnight. If the free-flow of money supports the plumbing infrastructure on which the world's economy functions; then this is a case of massive blockages which need to be cleared. Credit must be available and confidence must be restored.

On September 18, the U.S. financial system was on the brink of total collapse. Had this been allowed to happen, it would most likely have taken down the world financial system with it. The previous three days had seen the bankruptcy of the 158-year-old Lehman Brothers, the $85 billion loan to keep the global insurance giant AIG from going under, and the sale of Merrill Lynch to BankAmerica. Just 10 days prior, the government had "nationalized" Fannie Mae and Freddie Mac, the quasi-government mortgage companies. The money available in the private credit markets was insufficient to fund the capital requirements of these institutions. The final investment banks left standing–Morgan Stanley and Goldman Sachs–were rechartered as commercial banks in order to obtain addtional funding via deposits.

	9/30/2008	% YTD
Dow Jones Ind.	10,850.66	-18.2%
S&P 500 Index	1164.74	-20.7%
Nasdaq Comp	2082.33	-21.5%
Russell 2000	679.58	-11.3%
MSCI EAFE	1553.15	-31.1%
10 Yr. Treasury	3.80%	4.8%

Treasury Secretary Paulson and Fed Chairman Bernanke informed a delegation of Congressional leaders of the impending catastrophe. After initially balking at the government rescue plan, Congress finally passed and the President immediately signed a $700 billion revised package on Friday, October 3. When the markets opened the following Monday, they expressed dissatisfation with the government's solution. Over the course of the week the markets fell an additional 18% and brought the losses from the high of last October to nearly 40%.

The rescue package was initially designed to help relieve the credit crisis by allowing the Treasury to buy toxic (bad) loans held by banks. The Treasury was given wide latitude to use other tools as well, including injecting cash directly into the banks by having the government buy stock in the banks. Further tools included the

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Market Records
Monday, October13th the Dow scored its largest one-day increase, closing 936.42 points or 11% higher. In the prior trading session the Dow had swung from a 700-point decline to a 300-point gain over the course of little more than an hour of trading before closing down 128 points for the day.

Dollar Up and Oil Down
The dollar rose against the Euro. After peaking near $1.60 this summer, the Euro has fallen to $1.35. Oil prices have dropped to $80 a barrel after peaking this summer at more than $145.

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Side Bits

Retirement Plans: My 401K is now a 201K. -*Most investors*

Quote: "This is worse than a divorce, I just lost half my net worth and I still have my wife."-*Anonymous Investor*

Volitality Index: The Chicago Board Options Exchange Volatility Index, known as the VIX, rose to an all-time intraday high of 76.94 Friday, October 10th. This "fear" index often signals a market bottom. As the old market pundit says,"When the VIX is high it is time to buy."

ability to renegotiate mortgages on more favorable terms, in the hope of stemming the tide of foreclosures.

Global coordination was needed. At the summit of European leaders, October 12, agreement was reached to buy shares of banks, guarantee bank debt, and inject cash into the banking system. The common goal was to unlock the credit markets.

For the last three decades, individual Americans and their government have been on a binge of borrowing and living beyond their means. That couldn't continue forever. There have been corrections along the way. First we experienced the savings & loan crisis, then the tech bubble, and finally the subprime crisis, which has now metastasized into the current market crisis.

We are unquestionably in a recession. The recession may be deep and might last through 2009. But we are not looking at a 1930s Great Depression. While the economy will contract, we believe the massive coordinated response to this crisis, which did not exist in the 1930s, will limit the downside we face.

The slowdown in world economies, combined with a global credit crisis, bankrupt financial institutions, and virtually unprecedented government intervention, has left the markets reeling and looking for a bottom. There is no possible way to gauge where the bottom is. The issue now is when and how quickly the markets will begin to recover. What we have experienced is that in times of panic, diversification is of little protection as all assets fall in unison. Eventually assets will return to more normal relationships. This is accomplished when the most mispriced assets rebound more quickly.

What do we envision for the future? Whoever becomes president, the new administration will be faced with a series of challenges; the most pressing will be how to get the economy on the road to recovery. Unemployment will rise and millions of jobs will have to be created. We project an economic stimulus package will be enacted. Two important initiatives merit attention: rebuilding infrastructure of roads, bridges, and transportation; and developing alternative sources of green energy to wean our economy from its dependence on foreign oil. Important issues like Social Security, Medicare and healthcare reform also need to be addressed. The massive infusion of cash into the rescue plans will cost huge sums. The national debt will grow. Inflation is likely. Since equities are the only assets that outpace inflation, if there is inflation, we need to hold stocks and real assets.

What we have witnessed is the extremes of the fear and greed cycle. Asset prices are determined by buyers and sellers in the markets at any moment. In periods of market fear, as we are presently experiencing, there are far more sellers than buyers and prices decline. Investors get scared and assume their investments will continue to fall forever. By selling into this panic (often at the worst possible time), investors lock in their losses.

Historically the markets tend to trade six to nine months ahead of where the economy is. So a market rebound may begin well in advance of a sense that conditions are improving on Main Street. During the last nine recessions since 1950, the S& P 500 index rose at least 30% in the first 12 months after the markets reached the bottom.

One of the key skills we need as advisors and investors is the ability to continue behaving rationally instead of acting on emotion. This is especially difficult in times of economic crisis. This crisis didn't happen overnight, and it may take some time to work through. We continue to believe that over the next five years, investors will see their investments grow, even if near-term prospects continue to look bleak.