

LOOKING BACK TO LOOK AHEAD, AUGUST 27, 2008

A retrospective and commentary on financial market turmoil

— John Blood, Chief Market Strategist

When the music's over

The music stopped for the financial markets on August 9, 2007, and, as The Doors' ballad intoned, somebody turned out the lights. Though the seeds of instability had been planted long before—and indeed had already begun to sprout—it was on a lazy summer Thursday just over one year ago when the seemingly well-oiled global credit engine came to a sudden and grinding halt.

The subsequent 12 months has been a period of remarkable—some would argue unprecedented—turbulence and uncertainty in the financial markets, punctuated by bold and innovative intervention by central banks around the world. These events have shaken the confidence of investors and advisors alike, and, at least to some degree, have reshaped the landscape in which we all make investment decisions. There is no shortage of pundits calling tops and bottoms to the market, as well as making daily predictions on the future direction of the economy, interest rates, oil prices, housing, you name it. Convincing arguments are being made on both sides of each debate; the only consensus seems to be that the global economy is firing on less than all cylinders.

Hockey legend Wayne Gretzky said, “I skate to where the puck is going to be, not to where it has been.” So is our goal for managing our clients' wealth. The good news is that, unlike hockey, our “game” doesn't hinge on making split-second decisions. Economic and investment scenarios play out over months and years, not days or weeks. Our oil dependence will not be eradicated in the next presidential term. So, too, the credit and housing issues that are at the root of current turmoil took years to build up, and it would be Pollyannaish to expect a quick fix in the unwinding phase in which we now find ourselves. At the same time, I believe the issues we're currently working through are far from insurmountable; the fix just may not come as quickly as most would like.

So let's try to heed Gretzky's advice—keep our heads up, be aware of where the future threats might be coming from, and try to identify where the future scoring opportunities might lie.

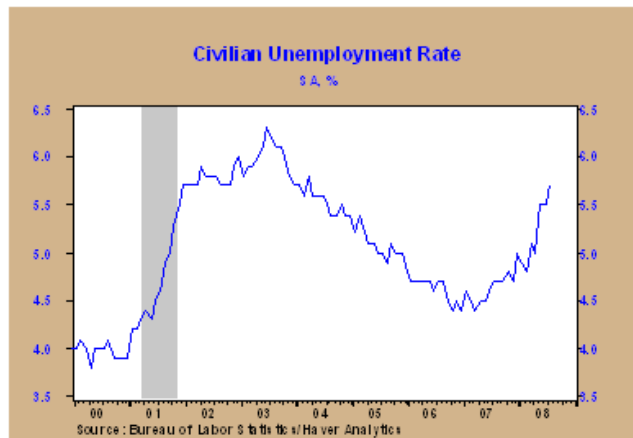
Seeds of a credit bubble

To best gauge where we go from here, it's worthwhile to turn the clock back to the early 2000s and revisit the events and policy decisions that got us here. To spare a forest's worth of charts and data, here are some key highlights:

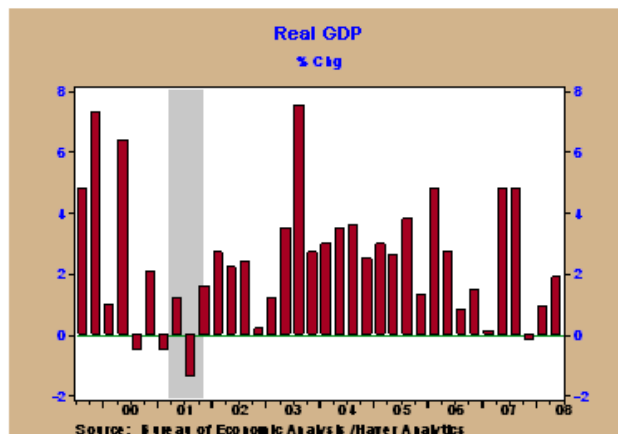
- Beginning with the dot-com crash in early 2000, we experienced one of the worst stock market declines in history from 2000 to 2002. The “New Era” proved more hype than substance, and the once high-flying Nasdaq Composite Index—where so much investor attention and assets had been focused—declined 78 percent, drawing comparisons to the crash of 1929.

Continued >

- In the aftermath, the economy experienced a mainly corporate recession from March to November 2001, marked by job reductions, lower spending and investment, and countless business failures. Unemployment surged. The initial shock was confined mainly to the technology and Internet arenas, but eventually spread to the broader economy as well. In the midst of this, the terrorist attacks on 9/11 delivered a painful and decidedly unexpected shock, putting further strain on an economy already facing a gloomy employment picture.



- During this time, the Federal Reserve (the Fed) and legislators pursued stimulative monetary and fiscal policies in an attempt to spur economic growth. From January to December 2001, the Fed dropped its target federal funds rate 11 times, bringing it down from 6.50 percent to 1.75 percent. Congress enacted the Tax Relief Act of 2001 and approved a ramp up in deficit spending to help prime the economic pump.
- Despite the heavy stimulus, a meaningful economic recovery failed to materialize. In the fourth quarter of 2002—12 months after the Fed dropped rates to 1.75 percent—gross domestic product (GDP) growth was an anemic 0.20 percent. Economic conditions were subdued, and fears of a decade-long recession or deflationary spiral similar to that experienced by Japan became more widespread, even among Fed policymakers.

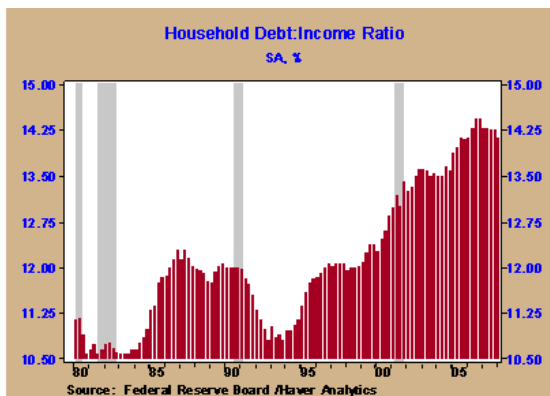


Continued >

- Of note, consumer spending remained strong throughout this period, even in the face of a declining stock market, higher unemployment, and sluggish wage growth.
- In November 2002, determined to avoid the deflationary fate that had enveloped Japan, the Fed began another round of interest rate cuts that would eventually push the federal funds rate down to 1 percent. Importantly, the Fed kept rates at that level for more than 12 months, from June 2003 to June 2004. Interest rates in this country had not reached such levels for some 50 years and had never remained at those levels for such a prolonged period.

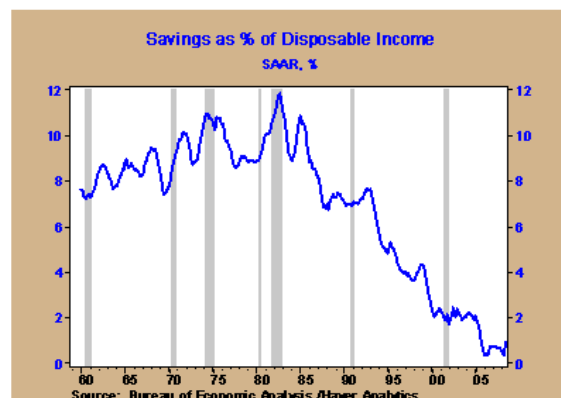
Levering up

With the second round of rate cuts in 2002–2003, Fed policymakers had pulled out all the stops in their pursuit of a robust economy, and the era of super-low interest rates was in full swing. Consumers, investors, and



businesses alike stepped to the lending window with open arms. With cheap capital readily available, Americans went on a debt-financed binge, borrowing aggressively to fund big-ticket purchases like homes, cars, and luxury items, and GDP growth did indeed stage a sharp rebound. Correspondingly, the national savings rate slumped from an already low historical level toward 0 percent—meaning that nearly every dollar of after-tax income earned by the average American household was going out the door to service debt or to fund new purchases. Debt-to-income ratios rose accordingly, climbing to previously unreached heights.

While rock-bottom interest rates provided a boon to consumers, they were less beneficial to investors in search of yield and those who sought to purchase assets of a known duration to fund future liabilities (like pension funds and insurance companies). These entities were forced to decide between two unappealing prospects—tolerating the lower yields the marketplace was offering on high-quality investments, or accepting more risk by moving down the credit-quality ladder in search of better returns. Worse yet, the price of risk in the market was historically low as well, meaning that investors were purchasing riskier assets for very low levels of additional expected return. This left yield-seeking and duration-matching investors in a quandary.



Securities offering higher-than-market yields, but also seemingly some degree of safety, would be a Holy Grail in this investment climate. Cue Wall Street financiers to meet that ever-growing demand. Without digressing into a dissertation on mortgage origination and securitization, suffice it to say that each link in the chain—the Fed, borrowers, mortgage brokers, lenders, investment banks, credit-rating agencies, investors, and federal regulators—bears responsibility for the breakdowns that transpired. With the wind of easy credit at their backs, lenders tripped over each other to make high-risk loans to ill-qualified borrowers. The loans were subsequently securitized and—carrying investment-grade ratings from credit-rating

Continued >

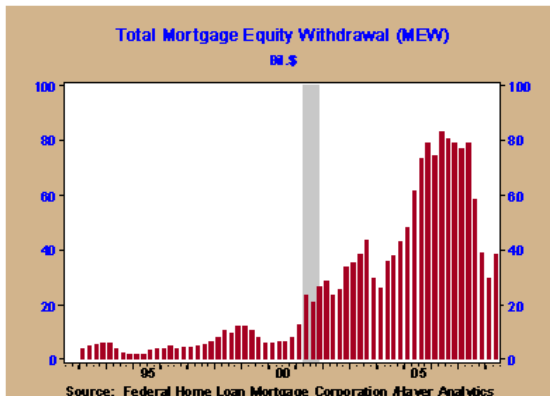
agencies—sold to investors of all types. Some investors, most typically hedge funds, leveraged their initial capital base by twentyfold or thirtyfold, borrowing money at low interest rates to reinvest in “high quality” mortgage paper at higher yields, thereby leveraging an initially tight spread into a notable investment return.

In this era of readily available and low-cost credit, the economy grew rapidly, the U.S. consumer was living life to the fullest, and asset prices—stocks, homes, and most other assets as well—rose sharply. The party was in full swing, and the theme song was “Let the Good Times Roll.”

The economic “recovery”

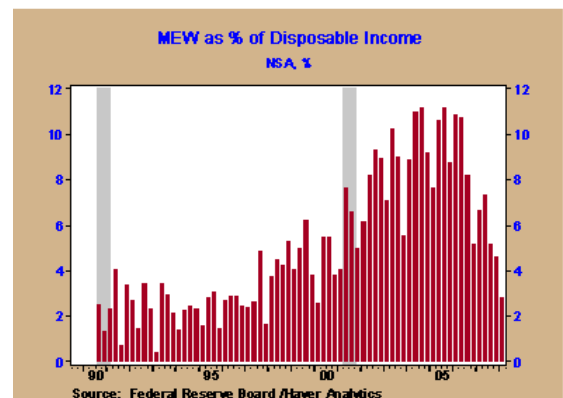
The period from 2003 to 2007 was characterized by a vigorously expanding economy on the surface, but an underlying oddity perplexed many economists. Normally, analysts would expect that an economic resurgence begins with an uptick in business activity, which translates into job creation, lower unemployment, and higher real (inflation-adjusted) wages. The boost in aggregate employment and wages then leads to higher aggregate consumption on goods and services of all types, including housing. This most recent expansion, however, seemed to be missing a key ingredient of previous periods of economic recovery—namely, job creation—and so it was that this era came to be dubbed the “jobless recovery.”

In the absence of robust job creation, consumers needed a source other than real wage gains to fund continued spending. Mortgage equity withdrawals (MEWs) quickly became the primary fuel for the U.S. consumption



engine. With increasingly relaxed lending standards and exotic financing options bringing a whole new segment of homebuyers into the marketplace—and thereby pushing demand for homes to artificially high levels—home prices quite predictably appreciated rapidly. And, in a cart-pulling-the-horse scenario, growth in the housing sector became a disproportionate driver for job creation, as realtors, mortgage brokers, appraisers, construction workers, and a host of other industries all experienced an unprecedented boom. How disproportionate? One study attributes an astonishing 43 percent of private-sector job creation from January 2001 to April 2005 to the housing sector.

While MEWs had historically accounted for less than 2 percent of disposable income prior to the early 2000s, a surging housing market and willing lenders brought that number to more than 4 percent by 2002. By 2003, it had risen to 6 percent. And by 2004—when MEWs hit a peak—the “home as ATM” model accounted for more than 10 percent of disposable income for U.S. consumers. To put this into context, home equity extraction accounted for up to 75 percent of total GDP growth in the recent expansion—up from 25 percent in the late 1990s. Without MEWs, the period would have been characterized by lackluster economic growth, if any at all. Our economy was grossly dependent on continued strength in the housing market, and the bubble in both credit and housing was at its peak. To coin a phrase from the 78th Annual Report by the Bank of International Settlements, the “unsustainable had run its course.”

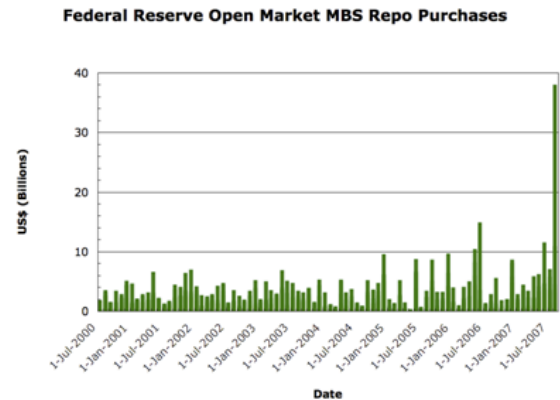


Continued >

Into the breach

Although the statistical peak in home prices actually occurred in the fall of 2005, and isolated mortgage-related dislocations had already occurred in various corners of the financial system, the underlying decay went largely unnoticed until the events of August 9, 2007. On that day, the systemic aha moment hit, as BNP Paribas, one of Europe's largest banks, suspended subscriptions, redemptions, and the calculation of net asset value for three investment funds with exposure to U.S. mortgage-backed securities. The firm cited "the complete evaporation of liquidity in certain market segments of the U.S. securitization market" in its announcement; and suddenly the market for all types of debt had changed seemingly in an instant. The music was over, and the lights were out.

The London Interbank Offered Rate (LIBOR), the overnight rate banks charge each other, skyrocketed to its highest rate since the dot-com crash, as fear and mistrust took hold. The European Central Bank (ECB), the Eurozone's equivalent of the Fed, immediately injected more than \$130 billion into European money markets to make capital available to those who depended on it for survival. In the U.S., the Fed mirrored the ECB action, using its open-market operations to send an immediate infusion of billions of dollars to the credit markets. For example, on August 10, 2007, the Fed purchased \$38 billion worth of short-term, mortgage-backed securities from the open market, in an attempt to provide liquidity and to counteract the credit lockdown that was occurring. Other countries, including Canada and Japan, followed suit with similar, but smaller, capital infusions.



In the many months since, central banks around the globe have engaged in financial triage for the global banking system, guarding against a systemic collapse while providing financial institutions critical recovery time—time to engage in an orderly valuation and liquidation of assets, and time to repair balance sheets torpedoed by staggering mortgage-related losses. This is a crucial point; there is little governments and central banks can do to "fix" the underlying issues in the financial markets. Rather, their goal is to try to ensure an orderly unwinding.

Steps taken by the Fed have included slashing interest rates to 2 percent, providing direct injections of liquidity, opening the discount window to previously restricted firms, and loosening its standards on accepted collateral to include previously unwelcome mortgage-backed assets. Of course, the coup de grace of Fed intervention was its role in facilitating the sale of failing investment bank Bear Stearns to JPMorgan in mid-March 2008—signaling to the markets that Uncle Sam did indeed stand ready to backstop any entity whose collapse could have a calamitous systemic impact. At present, Fannie Mae and Freddie Mac appear to be the next likely candidates.

Current climate

Having traveled this long and winding road, we find ourselves here in August 2008. The fraternity party in the housing market has long since ended, the cleanup is well underway, yet there is more work to be done and it will take time to finish the job. In aggregate, American consumers are being buffeted on many economic fronts: unemployment is on the rise, inflationary pressures are being felt loud and clear, and the two largest components of most people's net worth—their home and their investments—have each seen sharp declines in value. The Fed finds itself between a rock and a hard place, wary of dropping rates below 2 percent for fear of creating the next bubble, but unable to raise them to fight inflation due to the sputtering economy. What does it all mean for investors?

Continued >

I believe it is a time for caution. For the investment climate we face going forward, I see an environment lacking in strong catalysts to the upside, but with some factors—namely, a soft housing market, tighter credit conditions, and the deleveraging of both consumers and the banking system at large—that could constrain economic growth, and therefore stock prices, at least in the short term. My outlook rests on several main tenets:

1. Economic expansion is unlikely without strength in U.S. consumer demand.
2. The artificial boom in housing contributed significantly to the recent economic expansion.
3. The housing correction has not yet bottomed and will remain a drag in the near term.
4. The cycle of mortgage-related write-downs by financial institutions is not yet complete and will continue to impinge on credit conditions
5. Weak data persists on key drivers of consumer spending.
6. Current stock valuations may not reflect the potential economic slowdown.

Let's begin our discussion with a basic equation of GDP, and let the analysis flow from there:

$$\text{GDP} = \text{Consumption} + \text{Gross Investment} + \text{Government Spending} + (\text{Exports} - \text{Imports})$$

or

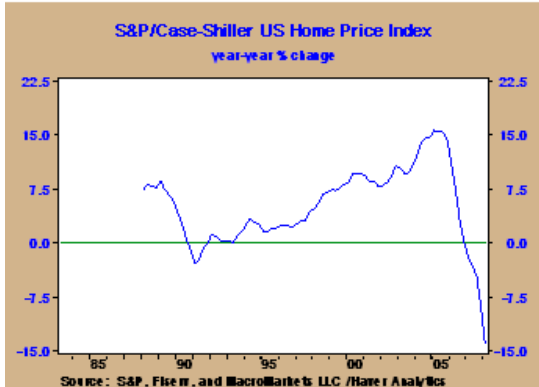
$$\text{GDP} = C + I + G + (X - M)$$

The consumption component includes all goods and services purchased by private households and has always been the largest component of GDP. In recent years, however, its relative importance has become even more prevalent; in 2002 it breached 70 percent of GDP for the first time since the Depression era, and has remained above that level ever since.

Period	Consumption as % GDP
1950–1959	62.5%
1960–1969	61.8%
1970–1979	62.4%
1980–1989	64.3%
1990–1999	67.0%
2000–2001	69.1%
2002–2007	70.1%

Source: Commonwealth Investment Research Team

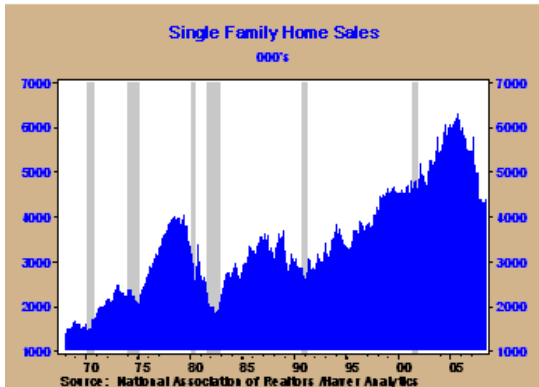
Continued >



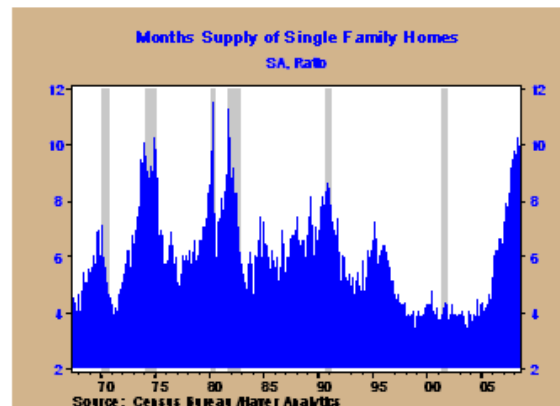
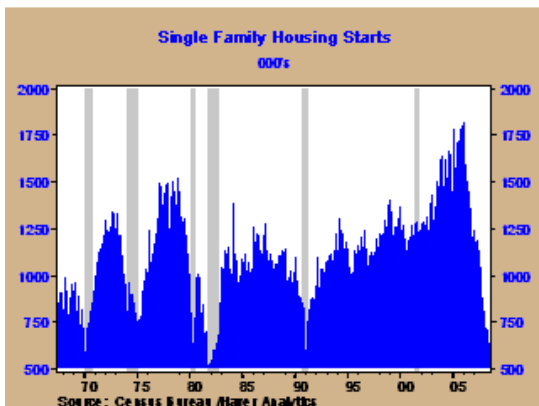
As we have already seen, this consumption boom was facilitated, at least in part, by a cycle of MEWs fueled by artificially high home prices, which, in turn, had been driven higher by easy credit conditions and an unsustainably inflated demand for homes from marginally qualified (at best) buyers.

The subsequent downturn in housing has been marked by falling home prices, rapidly rising delinquency rates, slowing sales of existing homes, and housing starts falling to levels last seen in the real estate crash of the early 1980s.

Even with fewer new homes being built, many areas of the country are still seeing up to 11 to 12 months of inventory on the market based on current sales rates.



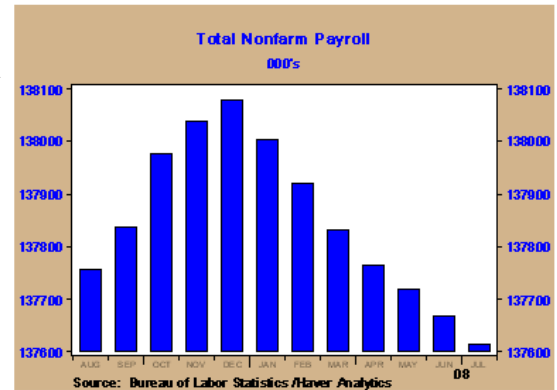
While the housing correction is clearly ground zero for the current economic malaise, its effects have spread throughout the economy. I questioned early predictions that the subprime mortgage crisis would be “contained”—the assertion being that it represented such a small percentage of the overall debt markets that any disruptions were incapable of causing more widespread damage. In reality, it is reasonable to expect that in the absence of MEWs, consumer demand will slacken from recent levels. As such, I also cast heavy skepticism toward calls for a near-term bottom or a V-shaped recovery.



Continued >

Studies have shown that consumer spending is most closely influenced by real wages and income—by far its biggest driver—followed by housing wealth and financial (investment) wealth. Of the latter two, consumers have interestingly shown a penchant for spending housing wealth more readily than investment wealth. Housing wealth has clearly declined, as has investment wealth, perhaps not for every individual but certainly in aggregate. This leaves us to turn to aggregate employment and income to look for bullish signs.

The official Bureau of Labor Statistics (BLS) figures show the U.S. economy has lost 463,000 jobs from January through July 2008, as total non-farm payrolls have declined for seven consecutive months. (The last three times this occurred were the recessions of 1981–1982, 1990–1991, and 2001.) The nation’s unemployment rate now stands at 5.70 percent. And while these numbers certainly don’t look rosy on the surface, they get even more troublesome when you peer under the hood.



The BLS statistics include a “birth/death” adjustment that is intended to account for jobs created and lost by small businesses, which open and close with such frequency that they are difficult to track. Basically, this adjustment hypothesizes how many jobs are created or lost in a variety of sectors based on historical patterns. So far in 2008, this birth/death adjustment has added a net 564,000 jobs to the official BLS statistics, including a whopping 80,000 jobs in the construction sector. Given the precipitous drop in housing starts, as well as tight lending conditions making construction loans more difficult to obtain, one might hypothesize that the official BLS stats are painting an overly optimistic employment picture of the current environment.

The last leg of the consumer spending picture is credit—the availability of which, combined with rising home prices, helped to prime the pump in the last expansion. Today’s environment is markedly different, however. Financial institutions around the globe have been forced to absorb large mortgage losses, de-lever their balance sheets, and find new sources of capital. The result is a new era for the credit markets, where I believe higher risk premiums, tighter lending standards, and reduced availability of credit is the new standard.

Back in the fall of 2007, initial estimates for subprime-related losses were mostly in the \$50–\$100 billion range. Those estimates came mainly from proponents of the “contained losses” theory. Other analysts, outliers at the time but now proven to be on the mark, made early projections that losses would eventually be at least \$500 billion and possibly above \$1 trillion. The most pessimistic numbers I have seen thus far claim that total system losses will eventually be north of \$1.5 trillion. So what will the final number be?

Thus far, banks around the globe have written down roughly \$500 billion of mortgage-related investments—and the hits just seem to keep on coming. In its second quarter earnings report, Merrill Lynch valued a basket of mortgage-backed securities at \$31 billion dollars. Weeks later, it sold the same securities to an outside investment firm for \$7 billion—a haircut of roughly 78 percent from the previously stated value. A key issue is that there is a distinct lack of transparency surrounding the valuation of mortgage assets, and disclosure comes begrudgingly. Loss estimates of \$1.5 trillion and above rely on scenarios that seem to me to be overly pessimistic. But to think that Merrill is alone would be naïve.

More likely, other banks, insurance companies, and investment firms are carrying similar assets on their books at values far higher than they would fetch in the open market. Slowly, these assets will be jettisoned—at a price a

Continued >

willing buyer will pay. What will have occurred, as I said early on, is that central banks around the globe will have bought time for financial institutions to engage in an orderly liquidation of assets and avoid a systemic collapse of the scope that could have unfolded in the aftermath of a Bear Stearns-like failure. The unwinding is in process, but I simply don't believe we are there yet.

This current environment—characterized by weak labor conditions, deflation in housing and investments, and tighter credit—is only exacerbated by the effects of troubling inflation. As such, I find myself unable to compile a bullish case for consumer spending, and therefore GDP growth, at least for the immediate future.

Valuation equation

If the thesis for weaker consumer spending proves correct, do current market valuations reflect that possibility? I would assert that they do not. The chart below shows actual reported earnings for the S&P 500 from 1990 to 2007 and the year-end P/E based on those trailing 12-month earnings.

Year	S&P as Reported Earnings	S&P Year-End Close	Year-End Trailing P/E
2008	\$63.01 (est)	??	??
2007	\$66.18	1,468.36	22.19
2006	\$81.51	1,418.30	17.40
2005	\$69.93	1,248.29	17.85
2004	\$58.55	1,211.92	20.70
2003	\$48.74	1,111.92	22.81
2002	\$27.59	879.82	31.89
2001	\$24.69	1,148.08	46.50
2000	\$50.00	1,320.28	26.41
1999	\$48.17	1,469.25	30.50
1998	\$37.71	1,229.23	32.60
1997	\$39.72	970.43	24.43
1996	\$38.73	740.74	19.13
1995	\$33.96	615.93	18.14
1994	\$30.60	459.27	15.01
1993	\$21.89	466.45	21.31
1992	\$19.09	435.71	22.82
1991	\$15.97	417.09	26.12
1990	\$21.34	330.22	15.47

Source: Commonwealth Investment Research Team, Standard and Poor's

Two aspects of the table are worth noting:

1. The record earnings generated by S&P companies during the period of 2004–2007.
2. The \$63.01 estimate (by S&P) for full-year 2008 earnings. First and second quarter results are known at \$28.86, so their forecast reflects an 18-percent increase in earnings in the year's second half to \$34.15.

Continued >

LOOKING BACK TO LOOK AHEAD, AUGUST 27, 2008 *continued*

Any prediction of where the S&P will go for the rest of 2008 fundamentally depends on two factors: earnings for the companies in the index and the valuation multiple (P/E) applied to those earnings. Currently, the S&P is in the neighborhood of 1,270, trading at roughly 21x the last four quarters' reported earnings of \$60.39.

Let's look at a range of possible outcomes to try to gauge a likely level for the S&P 500 at year-end:

2008 Full-Year Earnings

P/E	\$63.01	\$57.72	\$52.52	\$51.31
12	756.12	692.64	630.24	615.72
14	882.14	808.08	735.28	718.34
16	1,008.16	923.52	840.32	820.96
18	1,134.18	1,038.96	945.36	923.58
20	1,260.20	1,154.40	1,050.40	1,026.20
22	1,386.22	1,269.84	1,155.44	1,128.82
24	1,512.24	1,385.28	1,260.48	1,231.44
26	1,638.26	1,500.72	1,365.52	1,334.06

Source: Commonwealth Investment Research Team, Standard and Poor's

- Column 1 = Standard & Poor's current estimate of \$63.01 per share, an 18-percent *increase* in earnings for July to December 2008—what I would consider a bullish case.
- Column 2 = 0-percent earnings growth for the remainder of the year, or simply a doubling of the January to June results, representing full-year earnings of \$57.72.
- Column 3 = An 18-percent *decline* in earnings in the year's second half—down to \$23.66—for full-year earnings of \$52.52.
- Column 4 = A return to \$51.31, the rolling 10-year average of as-reported S&P 500 earnings.

While not meant to be predictive, this type of analysis can provide a good reality check for expected equity returns going forward. No, I don't believe a 12-handle on \$51 in earnings that would cut the S&P 500 in half in the coming quarters is a likely scenario. On the other hand, I don't think it's beyond the realm of possibility that we see earnings of around \$60 and a market multiple (since that earnings result would disappoint Mr. Market) falling to the high teens from its current 21x. That would produce a value on the S&P 500 at year-end of about 1,025–1,080, or a further decline of 15 percent to 20 percent from current levels. That is not intended to be bearish—although it's certainly not bullish—but rather seeks to present an objective assessment of the current environment.

Conclusions

As the saying goes, there are times to focus on return *on* capital and times to focus on return of capital. In my view, today's environment may be suited to lean toward the latter. That is in no way a call for abandoning your long-held principles on asset allocation—whatever your views may be—as that would reflect overconfidence in predicting future outcomes.

Continued >

For example, there is no underestimating the ability and willingness of government policies to spur economic activity or to re-inflate flagging asset prices, at least in the short term (see 2003–2007). And there is no way to predict with any certainty the exact start of a recovery. The multiple 300-point one-day jumps in the Dow Jones Industrial Average in August are testament enough to that. But to my view, charting a more risk-averse course—by overweighting less volatile asset classes and underweighting those you consider more volatile—represents a prudent option in this market.

The four factors I think will be crucial to watch for in the coming months and quarters are:

1. Payrolls to reverse their downward trend
2. Financial company quarterly reports to show signs that the cycle of write-downs is finally behind us, closing the book on financial system deleveraging
3. Signs of a bottom in the housing market, not necessarily prices so much as activity, via an uptick in the volume of home sales and a reduction in months of inventory on the market
4. Government intervention, which always has the potential to influence market forces

The housing and credit bubbles built up over many years. So far, we are one year into the recovery phase—and there is more work yet to be done.

***Disclosure:** Certain sections of this commentary contain forward-looking statements that are based on our reasonable expectations, estimates, projections, and assumptions. Forward-looking statements are not guarantees of future performance and involve certain risks and uncertainties, which are difficult to predict. Past performance is not indicative of future results. All indices are unmanaged and investors cannot invest directly into an index. The Nasdaq Composite Index measures all Nasdaq domestic and non-U.S.-based common stocks listed on the Nasdaq Stock Market. The S&P 500 Index is a broad-based measurement of changes in stock market conditions based on the average performance of 500 widely held common stocks. The Dow Jones Industrial Average is a price-weighted average of 30 actively traded blue-chip stocks.*

© 2008 Commonwealth Financial Network®