No Man is an island,
Entire of itself
Each is a piece of the continent,
A part of the main
If a clod be washed away by the sea,
Europe is the less.
As well as if a promontory were.
As well as if a manner of thine own
Or of thine friend's were.
Each man's death diminishes me,
For I am involved in mankind.
Therefore, send not to know
For whom the bell tolls,
It tolls for thee.

--John Donne

This famous meditation by the British metaphysical poet and Anglican priest, John Donne, of course inspired the title of Earnest Hemingway's wonderful novel of the Spanish Civil War, For Whom the Bell Tolls. At the present time it reminds us of the interconnection of the U.S. and global economies as we see problems, that began in the subprime mortgage economy, reverberate around the world with most major industrial economies now teetering on the edge of, or entering, a period of recession. We now have the U.S. government creating and entertaining programs of financial support for the financial and automobile industries, and goodness only knows what other industries may follow. As so many corporate risk managers, hedge funds, and bank CEOs have learned, is that when things head south, very often previously believed to be uncorrelated asset classes and segments of the economy all of a sudden can become highly correlated. Whether in real estate, banks, or hedge funds, we have simply employed excessive leverage over the past several years and that leverage is now unwinding. In other words, we are deleveraging.

It is an old dictum in the investment management business that investors move back and forth between the polar emotions of fear and greed. The speed with which market events have evolved over the past three months has been breathtaking, and it does not take a genius to see that we are much closer to the point of maximum fear than we were at Labor Day. The most important relevant question is whether things will get better or worse from here. The second most important question is whether the financial markets and the real economy will continue to move down together, or whether the financial markets have already digested a good bit of the bad economic times that lie ahead. The data on the real economy is troubling, and we are only beginning to see the effects of the issues that have plagued the financial markets for the past eighteen months. In the past week and one-half we have received rapid-fire reports trying to date the beginning of a recession that we had heretofore attempted to avoid acknowledging. First, we had a group of economists emerge to say that the U.S. may have entered into recession as early as this past spring. Not to be outdone, the National Bureau of Economic Research came out shortly thereafter to state that the U.S. economy probably entered into recession in December of 2007. That anyone would not have recognized that we have been in a recession from the carnage in the financial markets would be troubling. I would submit that the NBER conclusion is most likely a positive one for both the financial markets and the real economy.   The average post-war recession has lasted in the neighborhood of eighteen months, with the past several being both shallower and shorter than the norm. With that in mind, being one year into a recession may mean that we are nearer the end than the beginning. Let us hope so. Moreover, the stock market generally begins to show signs of improvement before there is clear evidence that the economy is improving. Thus, it is likely that we will continue to see bad economic data for some time to come, but the market indices may trend higher even in the face of that news. Thus it is that we saw the worst employment report in over thirty years on Friday, December 5th and the S&P 500 Index rallied by 3.7%. One would certainly think that the S&P 500 Index' year-to-date decline of 39% certainly seems to discount a fairly deep recession.

Extreme Liquidity Preference and Mark to Market Mayhem

Over the past two years we have moved from an environment, where the Federal Reserve had been merely accommodative to stimulate demand, to one where rates have been brought down to multi-generational lows in order to underpin the economy with enough liquidity to keep economic activity going. One could argue that the current environment represents a Keynesian liquidity trap in which declining asset prices in the various markets drive rational economic actors to a point of extreme loss aversion, and fear of a capital loss keeps them from making capital investments, whose attractiveness would be obvious in any normal environment. In his seminal book, The Theory of Interest, Irving Fisher posited that rational economic agents will have a preference for liquidity to fund current consumption and will only defer that consumption to invest if they are offered the prospect of a greater sum in the future. And so it must be. Yet, at the U.S. Treasury's auction this past week investors bought $30 billion of bills maturing in four weeks at a zero percent interest rate. The Treasury reported that the demand for the securities was so high that they could have issued four times as much. For anyone who is interested in lending money out at zero percent interest, I have an excellent collection of coffee cans and a nice backyard to bury them in. Other than offering a normal shaped yield curve (which should benefit spread-lending institutions as banks repair their balance sheets and investors move toward being focusing on income statements and earnings power again, instead of being mono-focused on balance sheets), the current term structure of interest rates for U.S. Treasury securities would seem to offer very little to investors as shown below.

Term	**Yield to Maturity**
1 year	0.50%
2 year	0.76%
5 year	1.52%
10 year	2.57%
30 year	3.05%

It is hard for me to imagine why anyone would lend money to the U.S. government or anyone else for thirty years knowing that 3.05% per annum is the reward. I believe that the post-war rate of inflation has averaged a little over 4%. Buying the long Treasury at this point would seem likely to offer the prospect (and probably likelihood) of a negative real rate of return and a capital loss over the intermediate term, but such is the premium currently being place on liquidity.

Stated another way, no investor is going to accept a negative <u>real</u> return. Bond yields are the sum of expectations for inflation plus a real rate of return to compensate for the risk taken. With bond yields range from 0% to 3%, investors are telling us that they expect only very slight inflation or deflation. This is a more valuable piece of information than any economist hypothesizing about inflation. Why? Because real money is at stake. This forms the true consensus estimate for long-term inflation.

The concept of a liquidity trap is generally referenced in the context of a deflationary environment. The recent bursting of the housing and commodity bubbles may represent a genuine threat, but I am more apt to think that the current environment has been made to appear much worse than it is by the accounting mavens' unwillingness to yield on the mark-to-market accounting standards. I speak, of course, about FAS 157. On its face there is nothing wrong regarding the accounting standard; indeed it would appear to make eminent sense that financial instruments be carried at fair value. The problem is that in the current environment of market stress, the marks necessitated by the standard represent distress sales more than normal market transactions. Our Chief Investment Officer, John Campbell, likes to explain the issue in the following way. Think of your house and what price you would expect to receive for it if you were to sell it through an orderly market transaction over the next six months. Now, think about price you would expect to receive if you to had to sell it by midnight tomorrow. The price that you would expect to realize from these two hypothetical transactions would likely be much different with the latter transaction likely to yield a much lower price. To understand what our financial institutions are going through, suppose your next-door neighbor had to sell their house under the one-day scenario, and you had to mark your house on your personal balance sheet to the same level and take any reduction in value from its previous mark through your income statement. That, in essence, is what is going on in the U.S. banking system. The problem is that you can't buy these assets at that price on any kind of an ongoing basis. A good friend of mine is a bank analyst for a large privately held institutional money manager in Boston. Due to expressions of client interest, they raised a fund to buy the distressed mortgage assets that we read about everyday in the popular financial press. They approached the fixed income trading areas of several brokerage firms and were told that these assets were trading for $0.30 to $0.35 on the dollar. When they enlisted the same brokers to purchase those assets they found that no one was willing to sell them at that price, even though that may be where the last trade (a distressed sale) occurred. Those assets are still sitting on someone's books at that price, even though you would have to pay them a much higher price to get them to remove them from their balance sheet and sell them to you. How can this be reasonably be viewed as an appropriate mark-to-market? FAS 157 went into effect only recently. Some companies were early adopters and began following it last year. The majority of companies have adopted it during 2008. Woeful risk management and horribly lax underwriting standards, combined with creative securitization practices on Wall Street, launched the subprime mortgage crisis that emerged last year. The concept of packaging loans, that never should have been made, into even lower quality asset-backed securities and passing them off as investment grade was fatally flawed. Mark-to-market accounting has made the pain caused by those practices infinitely worse. Financial institutions, staggered by the holes caused in their balance sheets in order to mark these assets down, have been loathe to make new loans until they are satisfied that the magnitude and frequency of the write-downs is diminishing to a manageable level. The TARP funds they have received have permitted them to right themselves in a less dilutive manner than having to issue shares at depressed prices. Treasury Secretary Paulson is puzzled why bank lending has not picked up as much as he intended; he need look no further than the new mark-to-market rules to understand why. It was reported this past Monday that the SEC has declined to modify mark-to-market. The SEC has a lot to answer for. In my opinion, suspending the up-tick rule on short sales and stubbornly refusing to suspend mark-to-market rules in the midst of the current crisis have contributed massively to the equity market's decline since September.

The week before Thanksgiving I heard Senator Gregg of New Hampshire comment in an interview that the blind application of mark-to market accounting was a problem that needed to be addressed. He called for a moratorium on the rules, and also stated that we had until the end of the year to enact it in order to avoid the problems that would be associated with further write-downs. Sadly, he was only partially correct. Morgan Stanley and Goldman Sachs have November fiscal year-ends. It is already too late to help them avoid the problem for their fiscal fourth quarters. Goldman will report earnings December 16^{th}; Morgan Stanley will report the following day. Analyst estimates for both companies' earnings have been dropping like a stone for the past few weeks. Hopefully the expectations for further deterioration are now embedded in their share prices. How the market reacts to these reports will be a very strong indicator of equity market performance over the next several months.

From the perspective of a long-only U.S. equity manager, stocks appear to offer tremendous value at present. By our estimation the equity risk premium is now something in excess of 12%. Pairing that with a risk-free rate of 2.69% implies that stocks are now priced to offer returns of nearly 15%, or about 50% more than the long-term rate of return on equities seen in the post-war period. This is not without risk, and if earnings performance were to deteriorate materially from here, the expected returns would be lower. The key is that with the risk premium as high as it is, equity prices are discounting an incredible amount of bad news. One hears the year 1981 thrown about a lot lately, as in "stocks are the cheapest they have been since 1981" or "unemployment is at the highest level it has been since 1981." 1981 ended with an unemployment rate of 8.5% and an inflation rate of 8.9%. The S&P 500 Index returned –4.9% for the year. The political and social landscapes were not entirely stable either. We were at the height of the cold war, a mentally ill young man shot President Reagan in March, and a Soviet sponsored would be assassin shot Pope John Paul II about a month later. By the grace of God both men survived. I remember seeing Milton Friedman interviewed on a morning news show in June of that year. When asked about where to invest money, the Nobel Laureate cheerfully replied that he would put money in the U.S. equity market because he felt that share prices would double over the next few years from the depressed valuation levels where they traded. The interviewer looked at him as though he had two heads, but the great man was correct. The table below lists the returns for the S&P 500 Index for the remainder of the decade of the 1980s.

Year	Annual Return	Cumulative Return
1982	21.55%	21.55%
1983	22.56%	48.97%
1984	6.27%	58.31%
1985	31.73%	108.54%
1986	18.67%	147.48%
1987	5.25%	160.47%
1988	16.61%	203.73%
1989	31.69%	299.99%

While no one knows what the future may bring. The rebound from depressed valuation levels, similar to current levels, combined with the magic of compounding, led to spectacular returns in the last eight years of that decade. It is important to note that we will not see the dramatic attendant drop in interest rates that we saw in the eighties. Rates are already at record low levels, making the current equity valuations all the more surprising. Also of note is that the equity market began to rise in the early eighties before the economy bottomed, as it always has in the past. Our guess is that the answer to the second question that I posed at the beginning of this piece is that we will continue to see bad economic news for some time to come, but that it may not have a severe negative effect on the equity market. The ironic thing about this year's sell-off is that stocks were not expensive when the year began. At the beginning of this year looking at our 800 stock universe, we found that 416 of the 800 traded at fair value or below on our normalized value measure. The median stock traded at 98% of our estimated value. Essentially, the market was fairly valued. Presently, 710 of the 800 stocks trade below our estimate of fair value, and the median stock trades at 58% of fair value.

To summarize, stocks are cheap, as are various other asset classes. Whether they are banks, hedge funds, industrial corporations, or personal balance sheets, our country is undergoing massive deleveraging, and in that process financial assets have been in excess supply, leading to a decline in asset values. As we began with John Donne, no man is an island, and there is virtually no one who has not felt some pain in this year's financial turmoil. Let us all hope that better days are ahead. Equity valuations would suggest that they are.

Dean Morris
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