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LLC  
Client  
Letter

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2008 Recession  
Financial Market Update  
Recovery Process  
Economic Review

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Robert Samrah, CFA

# YOLLES-SAMRAH WEALTH MANAGEMENT, LLC

## RECESSION

Q4 was a very difficult capital market environment featuring extreme price volatility across all asset classes be it intraday, daily, weekly and monthly trends. The equity market had few buyers and a high level of fear as measured by the CBOT volatility index VIX trading above 80, T-Bills yields near zero, S.T. Treasury bond yields under 1% and L.T. Treasury yields below 3%. Rationality was challenged each and every day as wave after wave of bad news cascades down Wall Street with the media and its many pundits declaring the end to buy and hold investing. Time horizons become distorted as large portfolio losses create financial stress which inevitably creates emotional stress and even distress. Time compression creates greater price volatility which further compresses investor time horizon and eventually asset prices during liquidation; i.e., **the paradox of deleveraging**. How does investment strategy change if investment time horizon shifts from one's life-time to the next retest of the 2008 low?

Fight this human tendency using investment knowledge and a well-informed financial plan including understanding your balance sheet and expected future cash flows. It is difficult to keep perspective but important to remember that the financial system has been under "extraordinary stress" since Jul07 and the economy contracting since 4Q07. Expect change and test your plan's ability to withstand an extended recession, don't assume that the U.S. economy has lost its resilience or ability to adjust and transform imbalances. Government intervention is not the long term answer and while almost every recession has been solved

with innovation, productivity and technology, few if any can predict the next catalyst to move the economy. Software and computers led the 80's recovery; the Internet, network computing and the rise of India and China the 90's and finally financial innovation the 2000's. The economy will recover but the timing remains uncertain. Perhaps late 2009 or early 2010; watch for the stock market to rally first (confidence indicator) then consumer demand and finally employment growth.

Elements of diversification once again followed patterns observed most recently during the 2001-03 recession and confirm empirical studies that indicate correlation between the U.S. and international markets were higher in down markets. Many domestic benchmarks experienced similar correlation convergence beginning in mid-September as credit markets became frozen. We suspect an ever expanding trade imbalance contributes to correlation convergence because dollar reserve holders tend to lend those same dollars back to America debtors be it consumers, business or government. These transactions close the dollar cash flow imbalances but require unconstrained borrowing capacity. **The global economy is still too dependent on the U.S. consumer and the U.S. consumer is still too dependent on borrowing.** How would the U.S. economy respond to a \$50b monthly trade surplus with China or other BRIC economies?

It appears to that we have crossed the inflection points, Jul07 for the U.S. consumer and Aug08 for the global economy and the adjustment process accelerated during Q4. People can no

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longer borrow money to purchase appreciating assets (Real Estate) then extract growth derived “equity” for consumption with the underlying assumption that the loans will be repaid by the disposal of ever increasing asset prices. Net savings will likely be this year’s fashion; e.g., make a dollar then spend 80%, repay debt with 10% and save 10%. Also remember to buy American in 2009, time to trade the Mercedes for a Jeep. The over-leveraged financial institutions run by managers betting on asset appreciation and propriety trading desks are gone, gone and almost gone.

## FINANCIAL MARKET UPDATE

2008 was punctuated by a steadily deteriorating economic outlook, a burgeoning financial markets crisis, failure of leading financial institutions, an intensifying credit-freeze and unprecedented government intervention as bailout economics replaced capitalism. Not surprisingly there was a massive flight to the safety of government bonds as all other asset classes, both domestic and foreign declined sharply. The Composite **U.S. Treasuries Index gained over 14%** on the year as rates dropped to record lows across the yield-curve including the benchmark 10-year Treasury and 2-year notes hitting 2.03% and 0.63% in mid-December and the 3-month T-Bill trading with a zero-yield on several occasions. On the last trading day of the year, bond prices dipped over one and half points with the 10-year yield closing at 2.23%. During 2008 the 10-yr Treasury price jumped over 16% and the 30-yr price almost 38% while most world equity markets declined in excess -30% with EAFE down -45%.

The **CRB commodity index dropped 36%** led lower by crude oil -55%, wheat -29% and natural gas -24% while gold gained 4%. The Dollar Index gained 5.8% on the year to close at 81.33; however, the U.S. dollar did drop 19% against the yen as U.S. interest rates approached zero. The CBOE (VIX) volatility index set many a record during the market’s retest of the post-tech bubble low during late-November (S&P500 @ 741) before retracing below 40 in early Jan09 as panic and forced-selling dissipated. The S&P500 price index dropped -38.5% for the year, its worst annual decline since 1937, the R2000 small cap index performed a little better at -34.8% and the NASDAQ slightly worse down over -40%. Russia was the weakest international market down -75% with China close behind down -65%.

<b>Table 1 - Market Data</b>			
	<b>12/31/08</b>	<b>12/31/07</b>	<b>% Chg08</b>
<b>US Equity Indices</b>			
Dow	8,776	13,265	-33.8%
S&P 500	903	1,468	-38.5%
Small Cap	499	766	-34.8%
NASDAQ	1,577	2,652	-40.5%
<b>US Treasury Index</b>			
180 day	.23	3.43	
2 Year	.78	3.11	4.7%
5 Year	1.46	3.50	9.7%
10 Year	2.24	4.07	16.2%
30 Year	2.69	4.49	37.9%
<b>Commodity</b>			
CRB Index	229.54	358.51	-36.0%
Corn	4.07	4.52	-10.0%
Gold	880.5	842.7	4.5%
Natural Gas	5.61	7.39	-24.0%
Oil	42.6	96.0	-55.6%
Soy	9.80	12.23	-19.9%
Wheat	6.30	8.85	-28.8%

Clearly current market prices are predicting a sharp economic contraction for the foreseeable future given **broad-**

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**based equity price declines in excess of 35%** including 25% or 71% of the total decline occurring quickly from mid-September until mid-November; i.e., a second bear market. As discussed in detail in both our Aug08 and Apr08 reports, **the economy's excesses and imbalances have built up over many years and therefore will take time to be absorbed with normal demographic growth.** With that stark reality facing us on a daily basis, we were still surprised by the severity of the second bear market and the complete lack of accurate accounting and reporting by many of the largest corporations in the financial service industry. The degree of fiction among financials helped to push many stocks in the S&P500 to levels first surpassed in 1997 despite a much larger U.S. economy as measured by GDP, corporate earnings, employment, etc. The below table 2 illustrate the valuation impact using Microsoft data for 2007 and 2008.

<b>Table 2 - Microsoft Example</b>			
<b>Stock Price</b>	\$35.60	\$19.44	-45%
<b>Fundamentals</b>	<b>FY07</b>	<b>FY08</b>	<b>Change</b>
Revenue (b)	\$51	\$60	18%
Net Income(b)	\$14	\$18	26%
EPS	\$1.44	\$1.90	32%
P/E Ratio	24.72	10.23	-59%
Dividend/Share	0.39	0.52	33%
Dividend Yield	1.10%	2.67%	143%

Is the **equity market** accurately pricing the expected cash flow in the underlying businesses or do current prices acknowledge the cash flow differential but simply increase the discount factor due to extremely high risk aversion. Much lower fundamental multiples like Price to earnings or Price to book historically offer long-term value but

growing deflation expectations has increased the likelihood that more investment / inventory intensive enterprises will fail before the recovery occurs.

Enterprise pricing power is even more critical with higher financial leverage. This is the valuation impact of investor time compression which creates a lower earnings base, a higher discount rate and the tendency to compound earnings at a slower growth rate for an extended period. Nationalizing the banking system with \$250b of TARP funding further complicates the stock valuation process as does sweeping change to contract law and regulation. How will mortgage pricing evolve to reflect these growing uncertainties as government attempts to financial engineer a recovery that is lacking fundamental economic sustainability?

The **bond market** has exhibited similar extreme price volatility but appears to have reached its low much sooner (10/10/08) relative to equity prices (11/20/08) including a Jan09 price rally above the 9/15/08 inflection point marked by the failure of Lehman Brothers and American International Group. Money supply measures like M1 and M2 have increased sharply as funds exit risky assets like stocks, corporate bonds and commodities in favor of T-bills, money markets, and insured bank products. Expensive insurance products are also chasing frustrated investors as extreme price volatility further erodes investors' confidence and trust in the stock market. Absolute-return investment vehicles are now emerging with 2x and 3x ETF securities gaining popularity and trading volume across a wide array of asset classes including stock, commodity and currency markets.

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Many pundits estimate that 30% to 40% of investable funds have been moved into cash and cash equivalents with many managers waiting for more clarity before redeploying cash. The irony is that the principal enablers of the real estate boom and subsequent credit-crisis, the U.S. government and banking system are ultimately controlling a substantial allocation of these non-invested funds. Funds that were previously invested in common stocks, corporate bonds, municipal bonds and yes even mortgage-backed securities are now controlled by the same **ineffective entities**.

## RECOVERY PROCESS:

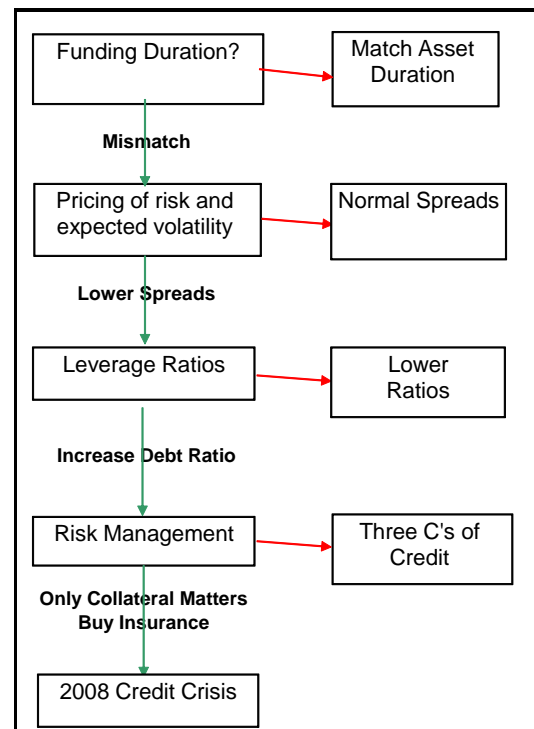
Before we explore the critical elements of recovery let's briefly review the two basic economic problems that must be resolved; credit pricing and acceptable leverage and economic trade imbalances. As with many economic downturns, today's price and supply/demand imbalances grew for many years before reaching unsustainable levels.

The below flow chart A depicts the elements related to **credit-crisis** including; 1) the mismatch of funding duration and asset duration ( $t$ ), 2) the under-pricing of risk and expected volatility of returns ( $\sigma$ ) such that the aggregate cost of capital was too low relative to the aggregate risk, 3) leverage creep by most financial institutions in search of higher returns ( $\beta$ ,  $\alpha$ ) 4) which was further magnified exponentially by the Fed's repeated use of very easy monetary policy and 5) the misperception that insurance ( $\rho$ ) would protect financial institutions and investors from the above mistakes; e.g., credit default swaps, rating agencies, implicit government guarantees, etc.

Despite the severity of the breakdown and our nation's tendency to think in the very-short-term; the financial system is now focused on getting every **Element of Credit** ( $r$ ,  $t$ ,  $\sigma$ ,  $\beta$ ,  $\rho$ ) back to a more sustainable level.

Lending standards and oversight certainly are making a comeback as bankers remember the three C's of credit and their order of importance; **Character** of the borrower, **Collateral** with which to secure the loan and **Cash Flow** including upfront equity or down payment plus appropriate coverage ratios. It will likely take time for the market to find a sustainable equilibrium for risk-taking as unusually narrow credit-spreads from 2003-07 have become unusually wide in 2008-09 as growing uncertainty challenges every layer of management in every financial institution.

**Flow Chart A – Credit Imbalances**



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Both the Federal Reserve and U.S. Treasury have taken extraordinary steps to stimulate credit creation, unfortunately their well-intended efforts have yet to reduce lenders' and investors' aversion to risk-taking. Perhaps cheap government money is not the answer to today's problems? The capital markets exist to allocate capital, higher expected risk-adjusted rates of return will ultimately attract more capital than lower rates. Higher expected earnings growth rates will generate higher stock prices.

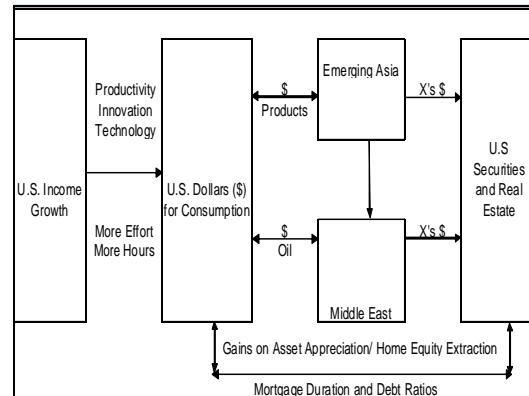
The below flow chart B depicts the elements related to economic imbalances and was first introduced in our 2Q05 report. A brief review is useful to help understand what must occur to produce a sustainable balance but also to highlight that it took an additional three years before the U.S. economy reached another inflection point. **The critical economic elements included the trade deficit, lack of income and employment growth relative to consumption growth and the misallocation of resources.** The flow chart depicts the relationship between U.S. consumers' source of funds, consumption patterns and corresponding price behavior of U.S. securities and real estate.

Moving from left to right, income growth traditionally provides the funding for consumption with growth coming in the form of increased productivity, innovations in technology and good old fashion extra effort. These efficiency gains have generated real income growth and low inflation, as economic history would suggest, and thus facilitated strong consumption growth from 2003 to 2007. The second box represents funds available for consumption. These funds

can be used to consume goods / services or saved for future consumption. The third set of smaller boxes represents dollars leaving the domestic economy to purchase an increasing proportion of products from Emerging Asia and the Middle East.

In a textbook global economy these dollars would then be used to purchase goods / service from Americans or invested in physical assets (infrastructure) to generate products and oil. If the trade /service deficit persist even with supply/demand adjustments then the relative value of importers currency (U.S. dollar) should decline and the exporters' currency should appreciate.

**Flow Chart B – Economic Imbalances**



The most important element of a U.S. economic recovery is **TRUST** in the financial system and federal government programs. Clearly many have made mistakes and there is plenty of blame as dramatic event after event further erodes confidence and challenges even the most optimistic among us. The decline in consumer confidence suggests a complete collapse in trust with monthly readings near or at historical lows. These data series don't include the 30's but do encompass other deep recessions such as the early 90's and late 70's to

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early 80's suggesting recovery will likely be slow as the painful lesson learned during the current boom-bust cycle are fully assimilated into the economy.

Anger and frustration abounds and screams sell, hoard cash and, don't buy. Investors seemingly have few other options when the U.S. Government nationalizes risk ex-post and rewards moral-hazard, the same behavior that created **too-big-to-fail** entities. Perhaps less is more in 2009 and the high operating leverage, high financial leverage and cross-sell everything models of Citigroup and Bank of America are just **too-big-to-succeed**.

What do you get when you combine Wachovia, Merrill Lynch, and Countrywide Mortgage with a handful of smaller regional banks? Are four troubled companies combined less troubled? We are not sure but these transactions do not appear to be restoring confidence in the financial system. Do shareholders matter after the government determines that your company will be nationalized? How will investors respond? How will valuation metrics change to adjust for new uncertainties?

Clearly trust is the first step in the recovery process. **More transparency will help to advance the rebuilding process including full disclosure on all outstanding TARP and Federal Reserve funding programs.** Confidence to spend and invest will follow trust as we relearn that liquidity is a function of money velocity not absolute money supply.

**PURCHASING POWER** is the second critical element. The prices of many goods and services have retraced to more

sustainable levels relative to aggregate income. Monitor your expected 12 month net cash flows including all goods and services consumed relative to your net worth. Try to understand the likely net worth impact if return on capital and tax policy change. How will purchasing power change? More American employment growth and productivity are required to better balance the U.S. trade deficit. What is the willingness of the average U.S. worker to accept a lower wage and longer work week in 2009? How has perceptions changed since the last recession given the structural change to our labor force?

Reduction in federal government spending and balanced government budgets at all levels including a national consolidation of local government will improve after-tax disposal income. Operational and administrative resource sharing between states will offer additional cost saving opportunities. **21<sup>st</sup> century capitalism will be built on interdependence** not dependence with the notion of a sustainable export economy quickly becoming obsolete. Look for a **more balanced global economy with less and less reliance on the U.S.** to maintain a perpetual net buyer (importer) position.

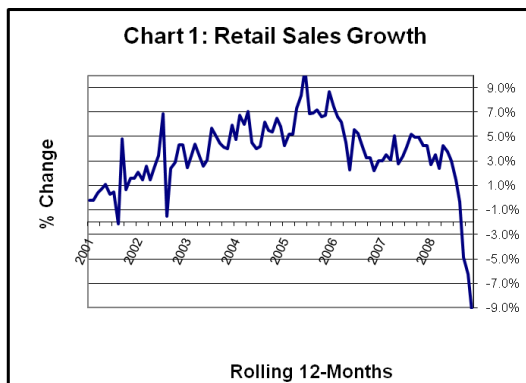
## THE ECONOMY

The domestic economy eventually experienced a **very-hard landing in Q4** after attempting numerous failed soft landings between Jul07 and Aug08. Government intervention was massive in scale and scope but has yet to prove effective in stopping the decline with consensus Q4 real GDP at -5%. Quarterly S&P500 earnings dropped sharply for a fifth straight quarter with

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weakness across all sectors. The consensus real GDP growth forecast for 2009 suggests some improvement as the year progresses with an average forecast around -2%. The economy officially entered recession in 4q07.

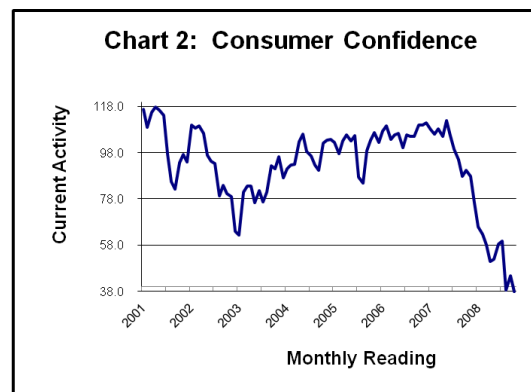
Fourth quarter **consumer spending** as measured by retail sales tumble at an average annual rate of **-28% with Q4 monthly declines of -3.4%, -2.1% and -2.7%**, brutal. Sharp declines in many price categories combined with lower demand drove same-store comps into double-digit declines. **Chart 1** depicts the rolling 12-month U.S. retail sales growth rate from 2001 through Dec08.



Weekly crude, gasoline and distillate inventory levels continue to climb despite sharply lower prices at the pump. Discounters like Wal-Mart and Costco report better relative performance with downward trends most noticeable in autos and other highly discretionary products and services. GM and Chrysler reported unit sales of -41% and -47% respectively in Nov08 then -31% and a stunning -53% in December. Even financially stronger manufactures like Toyota, Honda and Ford experienced declines in the low -30% range during Q4. Large losses on residual values continue to adversely affect lease pricing and availability but recent zero-financing circa post 9/11 has returned after GMAC

and Chrysler Financial received TARP funding.

Consumer confidence has just tanked. The conference Board's **consumer sentiment** index dropped to 38.8 in October, managed a post-election bounce to 44.9 before setting another record low at 38.0 in December. **Chart 2** helps depict the steepness of the recent decline with the index reaching tail-like levels which are much lower than past recessions.

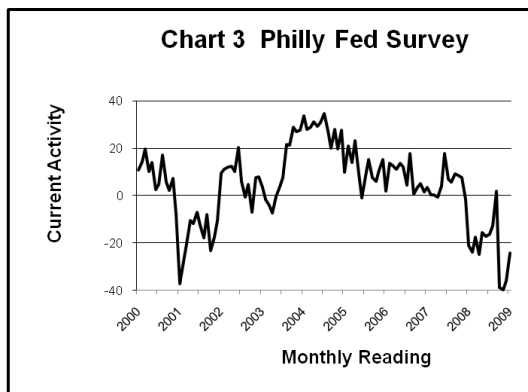


The U of M sentiment index exhibited a similar decline but appears to have bottomed in Nov08 at 55.3 and has slowly drifted higher reaching 60.1 in December and 61.9 in the Jan09 preliminary reading released mid-month. Clearly sentiment needs to improve for the economy to regain upward momentum. **Expectations are very, very low which raises considerable concern at the Fed and Treasury but might also provide a base for a rally in 2009** if we see any signs of improvement; e.g., 1991 was good year for stocks although the economy didn't recover until late-92.

**Business sentiment** showed severe weakness with the Institute of Supply Management's (ISM) purchasing manager index averaging only 35.8 in Q4 down from 47.8 in Q3. The index has

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remained below 50 since Jul08 with a 45.6 average reading for 2008. The Philly Fed index of regional manufacturing growth remains well below zero but has also improved during the recent months. The index averaged -38.2 during Q4 after reaching a record low of -39.8 in Nov08 then recovery to -24.3 in Jan09 and perhaps finding support near the first bear market cycle low of -24.9 in Apr08. **Chart 3** depicts the second leg down in business sentiment then the recent bounce. Also note that thus far business sentiment has held above the 2001 low readings.

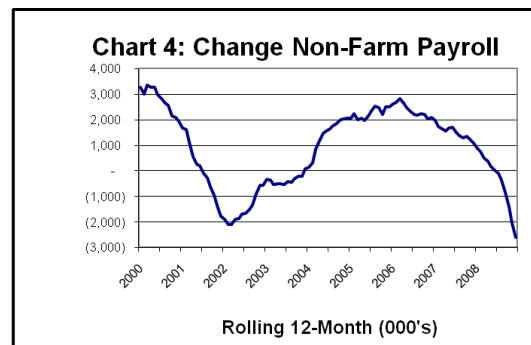


**Capacity utilization** has broken its 2002-03 low in December falling to 73.6% after averaging 75% in Q4 down from 77.7% in Q3 and 79.8% in Q2. **Industrial production** remained in negative territory for a fourth consecutive quarter with an average Q4 monthly decline of -0.5% which is a slight improvement over -1.8% in Q3. Manufacturing and construction continue to provide the biggest declines.

Non-farm payroll **employment** continued to contract in Q4 but at an accelerating pace with an average monthly payroll decline of -510k as compared to -199k during Q3. **Total non-farm payrolls contracted by 2.6m in 2008** and the unemployment rate continued to drift upward reaching 7.2%

in December. The average hourly earnings growth rate has softened to 3.7% but is now positive relative to the CPI inflation rate by 380bp.

Weekly jobless claims reached a new cycle high of 586k in the week ending December 20<sup>th</sup> with the four-week moving average holding above 550k in December. In early January, continuing claims reached a staggering 4.61m workers as Congress passes legislation to extend benefits for 26 weeks. **Chart 4** depicts the rolling twelve month change in non-farm payrolls from 1997 to 2008 with a clear break lower during the last five months of 2008.

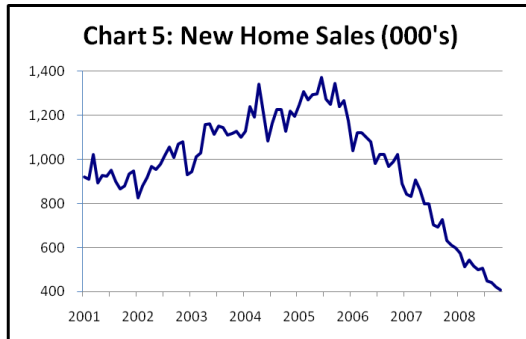


**New home sales** and housing starts have resumed their month-by-month decline after stabilizing over the summer to reach another cycle low in Nov08. New homes sales dropped to only 407k annual units over -35% below Nov07 and -70% from the Jul05 peak. Inventory of unsold new homes contracted further during Q4 with 374k unsold homes at the end of Nov08, down sharply from 502k in Nov07.

The supply of new homes for sale remains elevated at 11.5 months and has held above eleven months since Aug08 despite a continuing decline in the absolute number of homes for sale. The Nov08 median home price was up slightly to \$220k from \$219k in Dec07

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with average selling price still up almost \$20k from last year at \$287.5k. The below **Chart 5** illustrates the steady three and half year decline.



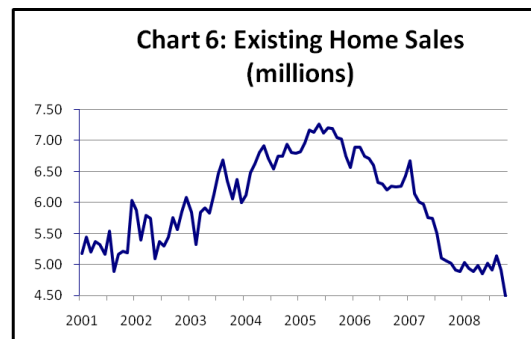
**Housing starts** dropped decisively below a million annualized units in Q4 with starts reaching 625k in Nov08, another multi-decade low. The impact of the post-Lehman credit freeze can be seen in the 21% Nov08 monthly decline from already very depressed levels in October and September. Tight credit has clearly caused market conditions to worsen from an already weakened state with builder sentiment collapsing during 2008.

**Existing home sales** are showing more weakness and have yet to make a clear bottom (**Chart 6**) as inventory levels remain near record levels. The number of existing **homes for sale** remains quite high at 4.2m units and is holding near the cycle high (4.495m) with 11.2 months of supply. Inventory levels are not adjusting downward as might be expected given sharp price declines in 2008 and suggests lower prices will be needed to reduce inventory.

The national median selling price has steadily declined to \$181k in Nov08 after peaking at \$215k in Jun08, down 13.2% from 2007. The national average selling price fell to \$224k from \$257.9k

at the Jun08 peak, down 12.3% from last year.

Mortgage rates have fallen below 5% which further improves home affordability when combined with a lower purchase price. This combination should help buyers in 2009 especially those who have managed their credit well and grown their income in recent years. Remember average hourly earnings were up 3.7% last year. Mortgage applications increased after the steep declines in the ten-year Treasury bond yield finally started to filter through to lower mortgage rates; however, conservative risk management assumptions continue to keep some potential buyers from qualifying for a mortgage.

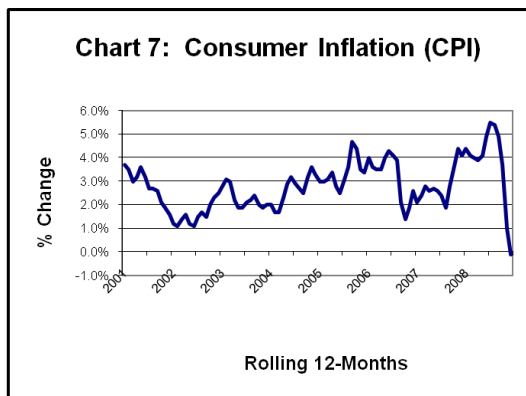


**Inflation** rates dropped precipitously in Q4 as slowing demand pushed prices lower throughout the economy. The rolling 12-month CPI peaked in Jul08 at 5.5% then tumbled to 3.7% by October before turning negative in December to close 2008 at -.1%. The core CPI inflation rate decreased at a much slower pace because food and other consumer products have not fallen as much as wholesale input prices. Recent broad-based commodity price declines should reduce core inflation at a faster pace in 2009. Regular unleaded gasoline reached \$1.50 per gallon in December as crude oil dropped below \$40. The

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producer inflation (PPI) has also declined sharply in recent months as has the input price sub-components of the ISM manufacturing (18) and ISM services sector (36).

**Chart 7** illustrates the sharp move higher in the first six-months of 2008 followed by a most unusual six-month collapse using the CPI rolling 12-month price change. The roller coaster ride has certainly caused additional difficulties up and down the distribution channel as holding inventory moves from a highly profitable activity to a highly dangerous strategy. Getting caught on the wrong-side proved to be fatal for many a retailer in 2008.



In sum, U.S. **economic fundamentals weakened substantially in 2008** as falling durable-goods sales and industrial demand created growing capacity imbalances across almost every industry and sector. Corporations were forced to respond by slashing costs including a massive round of layoffs from Sep08 to Dec08.

Consumer and business sentiment collapsed with holiday sales turning negative. Downside risk remains quite high for 2009 as a meaningful recovery will take much longer because so many financial institutions are deleveraging their balance sheets and reassessing risk-taking. Accessing consumer credit is clearly much tougher and those who can obtain credit will face a large down payment and more costly repayment terms including higher interest rates, LTV ratios and much higher cash flow coverage ratios.

The recovery process remains uncertain and growing consensus suggests that 2009 will be a year to survive. The future of the “American Spirit” will likely be challenged as government intervention moves from monetary to fiscal stimulus. Remember failure is required to learn and grow and not every organization will reach the other side. Balance sheet and income/expense management are critical success factors in 2009. Plan, analyze and make adjustments and most importantly be flexible and open to change.

1) Form ADV II, as filed with the SEC, is available upon request. Also, quarterly client letters are available on our web site ([www.yswm.biz](http://www.yswm.biz)).

2) Our privacy policy, as per regulatory requirements, is mailed annually and is available in PDF on our web site.