Market Insight Series

Market Bulletin

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Investing Without Precedent

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Introduction

All forecasting, be it economic forecasting, financial forecasting or, for that matter, weather forecasting, relies on precedent. No matter how sophisticated the mathematical model, forecasting boils down to this: In similar situations in the past, things have panned out a certain way, and from this, we predict what is going to happen this time around.

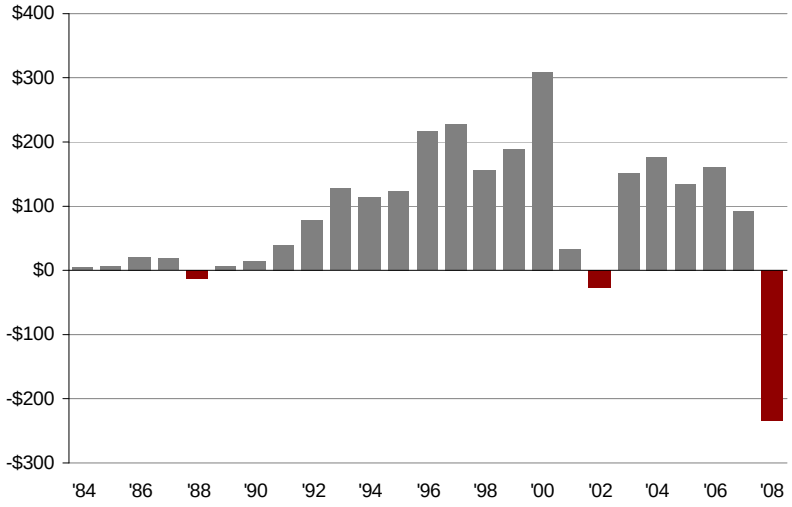
The great challenge facing forecasters in 2009 is a lack of such precedent. We are in a sharp recession, triggered by an *un*precedented financial crisis. This recession is being met by an *un*precedented government response. This makes the short-term outlook very uncertain, although there are some silver linings amidst the rolling clouds of recession.

The natural reaction to investment losses is to withdraw from investing. The natural reaction to uncertainty is to do nothing. Logic, however, suggests the opposite. Investors need to consider long-term economic probabilities and investment opportunities and, while protecting themselves from the whipping winds of an uncertain economy, they also need to position themselves for an economic and market recovery when it arrives.

An Unprecedented Crisis

The magnitude of the current recession isn't unprecedented – we have seen worse – but how we got here *is* unique. There hasn't been a recession in modern history that has been triggered by such a severe financial crisis – one that froze credit markets worldwide and led to the biggest surge in stock market volatility ever. While financial panic is showing some signs of ebbing, it has left borrowers less willing to borrow and lenders less willing to lend, twin trends that will impede any economic recovery.

Equity mutual funds see massive outflows in 2008
(Net cash flow, billions)



Source: Investment Company Institute, J.P. Morgan Asset Management.

Data reflects most recently available as of 1/30/08.

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For markets, the financial panic also had tangible and negative consequences. Last year, more than $200 billion left equity mutual funds, almost 10 times the amount seen in 2002, the next worst year for outflows. In addition, equity fund managers raised cash and margin loans fell, all of which starved the stock market of cash. While some of the decline in the stock market can be justified by the sharp recession, much of it may just reflect too many sellers and too few buyers.

An Unprecedented Response

In the United States, as in many other countries, this economic and financial crisis has been met by an increasingly aggressive government response.

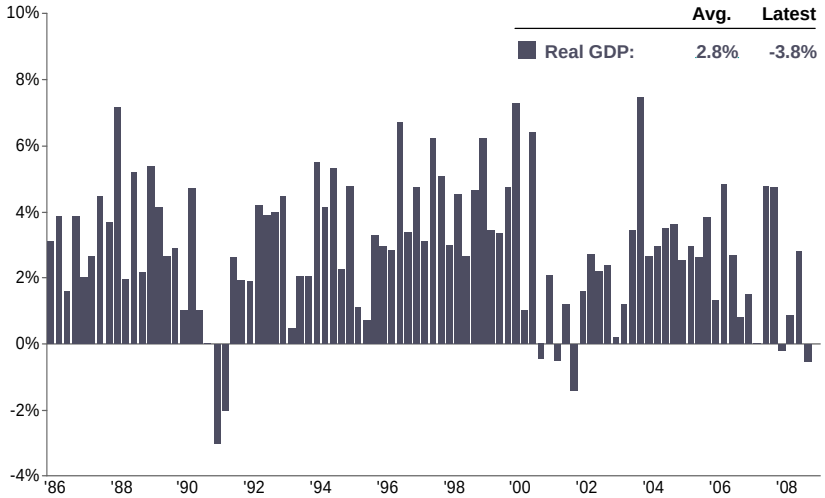
Over the last year and a half, the Federal Reserve has cut short-term interest rates to essentially zero while expanding its balance sheet by buying up assets in many frozen markets. Their actions have been dramatic, aggressive, innovative and, of course, well-intentioned. However, as has been the case in previous recessions, their actions in providing monetary stimulus have been undermined by the psychological impact of their increasingly dire messages and the implication that those who waited before borrowing would be rewarded by lower interest rates.

With rates now as low as they can go, attention has switched to fiscal policy and the stimulus package heading through Congress. While there is intense political debate on the appropriate mix of spending increases and tax cuts, the most important feature of the package may just be its scale. Last year, the federal government ran a budget deficit of $455 billion or 3.2% of GDP. This year, the number will likely exceed $1.5 trillion or over 10% of GDP. The change in the deficit is the simplest measure of fiscal stimulus – the difference between what the government is putting into the economy in the form of spending and what it is taking out in taxes. And a move from 3.2% of GDP to over 10% of GDP will represent the biggest federal kick in the pants that the economy has received since World War II.

An Uncertain Economy

Last Friday's report on fourth-quarter GDP confirms that we are in a sharp recession. The 3.8% annualized drop in real GDP, although better than expected, was still the worse decline since 1982. The end of 2008 was ugly, and going forward, the outlook is particularly murky.

GDP data confirm U.S. in sharp recession



Source: BEA, J.P. Morgan Asset Management.

Data reflects most recently available as of 1/30/08. GDP values shown in legend are % change vs. prior quarter annualized and reflect advance 4Q 2008 GDP.

In a best-case scenario, GDP falls again in the first quarter but begins to grow in the second as fiscal stimulus kicks in and housing and autos rebound from extraordinarily low levels. In this scenario, the unemployment rate continues to move up, surpassing 8%, and doesn't reach a peak until the fourth quarter, making the economy feel miserable. After a very rocky start to the year, earnings improve, reflecting both a recovering economy and the removal or upward revaluation of the toxic assets which have haunted the banking system over the past two years. Overall, inflation turns negative year-over-year in early 2009, but recovers to a positive later in the year, reflecting only a slow downward drift in core inflation (which excludes food and energy) and a mild reversal of the huge slide in commodity prices.

In a worst-case scenario, GDP falls throughout 2009, the unemployment rate soars over 9% and the year sees unrelenting corporate writedowns and layoffs. By the end of the year, even core inflation is close to zero and threatens broad deflation.

What We Know About The Long Run

While there is much we don't know in the short run, there are some important things which we do know for the long run.

First, every year the economy has the potential to grow by about 3% – a combination of 2% productivity growth and 1% population growth. We don't always take advantage of this potential – we didn't in 2008 and we won't in 2009. But this potential doesn't go away, and, in fact, the deeper the recession, the sharper the rebound.

Second, most of the time the U.S. economy does takes advantage of that potential. Since 1900, the economy has been in expansion 76% of the time. In the last 50 years, it has been expanding 85% of the time.

Third, valuation matters. The last decade has tested people's faith in "buy-and-hold" investing. But the truth is that buy and hold investing only ever makes sense if you look at the price tag when you buy.

Looking at some price-tags, there are clearly some asset classes on sale:

- Even with cyclically-depressed earnings, U.S. stocks are selling at average P/E ratios and dividend yields are above Treasury yields for the first time in 50 years.
- International stocks have fallen even further, and for the most part have P/E ratios below U.S. levels.
- High-yield bonds also look cheap, with spreads to Treasuries in many cases, only making sense in a 1930s scenario.
- Municipal bonds also generally look very cheap relative to Treasuries, particularly given the likelihood that a large chunk of a stimulus package financed with Federal debt will be used to reduce credit problems for state and local governments.

Finally, we know that positioning portfolios appropriately takes discipline and logic, and never more so than at the start of 2009. Investors will need high-quality defensive investments in case this recession turns out even worse than expected today. They will need assets which protect them against inflation, should the economy bounce back sharply from the kick of fiscal stimulus. They will need active managers who can distinguish between assets which rightly got trashed in 2008, and those which are more

valuable but are currently undervalued by an illiquid market. And they will need to be invested in long-term assets, and not just cash, so they can take advantage of the revival in financial markets which will accompany a rebound in the economy – a rebound which is as certain in its occurrence as it is uncertain in its timing.

Financial Silver Linings

While most economic data are ugly (and likely to get uglier before improving), there are some encouraging signs, particularly in some indicators of financial stress:

- Volatility is easing: The VIX index, a measure of stock market volatility soared to an unprecedented level of 81 in the fourth quarter. Since then, it has fallen to 43 – still above normal but clearly moving in the right direction.
- Bank lending is improving: One analyst estimates that bank lending in 4Q among the nation's 12 leading lenders increased by nearly 5% over 3Q. While credit markets are still in significant stress, this improvement in bank lending can help lay the foundation for an economic rebound.
- Positively sloped yield curve: A traditional way banks make money is by accepting deposits at low short-term interest rates and lending at higher long-term rates. In just the last month, 10-year Treasury yields have risen from 2.25% to 2.84%, indicating a steeper yield curve which should boost bank margins.
- Housing is more affordable: Average new home prices are down 25% from their peak and 30-year fixed rate mortgage rates are hovering at near 5%, leaving housing at its most affordable level in decades. Inventories of unsold homes are also down sharply, hinting at a bottom in the price declines which have wrecked havoc on financial assets.
- Money on the sidelines has surged: M2, which includes cash, small CDs, money market funds and savings accounts, now stands at over $8.2 trillion, earning close to a zero interest rate. This compares to a capitalized value for the S&P500 of less than $7.4 trillion, pointing to a heavy potential flow of money into the stock market when sentiment improves.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

The S&P 500 Index is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 Index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. An investor cannot invest directly in an index.

Indexes are unmanaged. One cannot invest directly in an index.

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