

December 31, 2008

2008 Year End Review

The unfortunate thing about the current financial crisis is that it did not have to happen. While our economy has always gone through cycles, a crisis like this one cannot happen without a lot of help from a lot of people. A tremendous lack of oversight allowed Wall Street firms to run wild and take enormous amounts of risk. These same firms cultivated a self serving culture, seemingly creating products that served no purpose other than to make themselves vast amounts of money. Government regulation not only allowed the emergence of an unregulated shadow banking industry, but required financial firms to make mortgages to borrowers that had little ability to repay. People cared little about what they paid for a house because they had the mistaken belief that home prices would never go down. Leverage can be a good thing, but too much can be devastating. This is true for individuals, businesses, and the economy as a whole.

The U.S. economy has been in a recession for twelve months, but the stunning events of September, October, and November surprised almost everyone. With the near collapse of the financial sector, consumers and businesses basically stopped spending money, causing further economic contraction. With consumer sentiment readings reaching all time lows, it is clear that people are bracing for the worst. At this point it is impossible to know when this recession will end, although it seems clear that we are not as of yet out of the woods. There are those that have stated that we are headed for another 1930's like economic depression. It is important to keep in mind that there are major differences between today's crisis and the depression:

- During the 1930's the U.S. economy contracted between 25-30%. Since then the worst contraction we have seen was from 1973 to 1975 when the economy contracted by 3.4%. Also, the 1930's saw unemployment reach 25% as opposed to 6.5% today.
- The 1930's saw thousands of bank failures. During this crisis we have seen twenty two banks fail, and with Federal deposit insurance, no depositor has lost money.
- During the 1930's the Federal Reserve decreased the money supply and kept interest rates high. Today, huge amounts of money have been pumped into the economy.
- We are also seeing a global response to this crisis as opposed to the 1930's when global trade collapsed due to the implementation of trade restrictions and tariffs.

While our economic problems may be bad, they are certainly a far cry from the depression we experienced in the 1930's.

What are the implications for the capital markets given this economic uncertainty? Is this a buying opportunity or is there more risk to the downside? These are legitimate questions as we head into the New Year. Markets of all kinds fluctuate as future expectations change and they tend to over shoot their true values, both on the upside and on the downside. This is why stocks can rise during bad economic times. In fact, the stock market rose 72% during 1935 and 1936 and it's unlikely there were many predictions of that kind of rally in the middle of the depression. Given the very fast and severe sell off we have suffered since September, a fast and sharp rally would not be a surprise in 2009. Certainly from an historic viewpoint, the probability of a big rally after dropping 40% is much greater than the probability of having a big rally after gaining 40%.

Any time we see a big rally after such a large fall there is always the question whether it is a new bull market or just a bear market rally. Bear market rallies are normally led by the same sectors that led the last bull market, in this case energy, commodities, and emerging market stocks. If we see a rally led by out of favor sectors it should be a signal that the rally is more sustainable.

On top of all of the other negative news in late 2008, we also witnessed the unveiling of Bernard Madoff, the architect of the largest ponzi scheme in history. Ponzi schemes have been around as long as there have been investors and describe frauds where old investors are paid with money from new investors. They get their name from Charles Ponzi, who, a hundred years ago, made a fortune by getting people to invest in a bogus mail coupon scam. The amazing thing about Madoff is that he operated for decades and his scam totaled fifty billion dollars. Scams such as this give a black eye to the entire investment industry and cast doubt on everyone in the business. It is important to know that Bernie Madoff operated his own broker dealer and held custody of all of his client's money. When independent custodians such as Fidelity Investments or Charles Schwab are used, scams like Madoff's are impossible. In our eleven years in business, we have never taken custody of any client funds. Our clients can feel safe that while markets sometimes have bad years, your portfolios are protected from this type of fraud.

Almost no investment asset classes had positive returns in 2008. This is almost unheard of, and it would be a mistake to assume that these asset classes will never make money again. While it is likely we will see continued volatility in the months ahead we have to remember that it is almost always a bad idea to make major changes in your asset allocation based on the market's actions over the past three months. The massive government stimulus that we have seen and will see more of in 2009 will take time to show up in the economy, but it will have an impact. Please feel free to call us to discuss your investments during this turbulent time. Also, please let us know if you would like to receive an updated copy of our Form ADV, which outlines details of Wabash Capital and the information we provide with the SEC.

Wabash Capital