

## ASSET CLASS UPDATE

**GENERAL COMMENTS:** Historical relationships between asset classes and underlying fundamentals have disappeared in a global flight to cash. All asset classes are being liquidated. We are in the process of repricing equity, complex debt instruments, and real estate assets downward after a decade of flagrantly increasing leverage and debt. No one knows what these assets may be worth without so much leverage in the system, what the true value of the debt might be, most of it will not fail, or when the bottom will be reached.

Although the Fed, Treasury, FDIC and other entities are attempting to slow or stop this repricing, so far, all the bailout, backstop, and reliquification programs have done little. Treasury Secretary Paulson's plan has morphed into something entirely different from what Congress approved. Corporate governance from the folks who leveraged up the system will not be changing in any significant way and acquisitions and mergers are being encouraged by new tax breaks. For example, on Friday the 27<sup>th</sup>, PNC Financial announced it is accepting over \$7B from Treasury and is spending over \$5B to buy National City Bank, an acquisition that will allow PNC to immediately deduct any losses on National City's books. JPM has accepted \$25B and its CEO announced that the money will help it, "be a little more active on the acquisition side or opportunistic side..." Nothing was said about using the money to make new loans.

One year ago the Dow closed above 14,000 and the Fed, Treasury, FDIC and others assured investors and the nation that a problem in subprime loans was contained and was very unlikely to have any significant effect upon the economy or financial markets. One year later, this crisis is being framed as the most serious since the Great Depression. An unprecedented global credit bubble has popped and we are in uncharted territory. History suggests that a severe economic contraction will be next.

The good news here is that this is all happening very quickly. I am strongly optimistic that we can complete the liquidation and repricing process in a relatively short time frame and won't have to suffer a decade or longer bear market and global recession. Information and capital flow instantly around the globe today, completely unlike the 1930's. Asia and Mideast economies are expected to continue to grow despite contractions in Euro-American economies. It is very uncomfortable to watch almost all asset classes decline but we will hit bottom and begin to grow again. We are relearning an old lesson taught again and again by financial markets, wealth built on paper and debt is an illusion.

**EQUITIES:** US and global equity markets continue to be very volatile and prices are still within a few percent of their lows set two weeks ago. Fear is widespread but capitulation isn't here yet. Numerous pundits and money managers keep calling bottoms. We've had several clients express a desire to increase their equity holdings in the past week. Optimism keeps sprouting up despite a general agreement that the economy is in recession and slowing down, corporate profits are declining, and the credit system is still in serious trouble. Bear markets typically end when optimism has totally disappeared. Our recommendation is to avoid selling or buying equities until we've clearly achieved some stability in the credit markets. I would define this as at least 3-4 weeks without near daily bad news from the credit markets. Don't change allocations in the center of the storm. I don't think it prudent to let fear or greed affect our allocation choices and it's very tempting in these market conditions.

US markets have generally fared better than foreign markets over the last two quarters due to an unprecedented US dollar rally and the repatriation of money from asset sales overseas by cash hungry hedge funds and financial companies. But, US stocks aren't cheap. The S&P is selling at an 18:1 trailing twelve month p/e ratio despite big price declines and corporate profits. Earnings were projected to be stable or slightly up at the beginning of Q308 but now appear to be down over 20% for the quarter and an accelerating economic contraction won't help future earnings.

Equities depend upon corporate profitability longer-term and profitability depends substantially on the macroeconomic backdrop. The IMF and World Bank predict a global GDP growth rate around 3% in 2009 but a shrinking or flat economy for the US. China, India, and the Middle East are expected to show strong growth and this, plus the risk of a US dollar collapse, imply that foreign equities will do better than the US over the next 3-4 years and maybe longer. We recommend equally weighting US and foreign equity though global market cap is now about 40% US so a pure passive strategy would dictate 60% non-US equity.

**FIXED INCOME:** The only debt that can be considered safe and certain to repay principal and interest at this time is guaranteed debt, T-bills, CD's, GSE's, and all money markets. Money market accounts are now temporarily guaranteed by Treasury at their value as of Sept. 19<sup>th</sup>, and the Fed will purchase any commercial money market paper that is in trouble and has \$600B available from Treasury to do so.

We have even seen small declines in what is generally considered very high quality short-term fixed taxable and tax-free funds and indexes in the 1-2 year range, and yields on all fixed income remain below even the BLS's stated trailing inflation rate. History suggests that the reliquification programs underway will not reflate the credit bubble and may make matters worse downline and will, with virtual certainty, result in inflation and higher interest rates ahead. This poses a substantial risk to bond holders because secular bear markets in bonds (declining prices/rising interest rates) typically have lasted 10-15 years and we're starting from record low interest rates below the rate of inflation.

Since credit markets are still unstable and massive liquidations in all forms of assets including debt are still occurring, I think it prudent to stay two years and under in debt if adding new fixed income at this time. Normally, we might go out as far as seven years and assemble 4-7 year bond portfolios. We're not recommending that pre-existing debt out more than two years be sold.

**FOREIGN CURRENCIES AND BONDS:** The US dollar rally has been phenomenal, rising from 71 on the dollar index to over 85 while virtually all the news has been dollar negative and the long-term prospects for the dollar are terrible. Two explanations are circulating: 1. Central banks, including our Fed, can intervene in currency markets and have done so to support the dollar or other currencies on several occasions. US dollar support drives down oil and gold and commodities prices and is much needed by the US. 2. Massive liquidation of overseas assets of all types by US hedge funds and financial institutions and investors have resulted in the conversion of massive amounts of foreign currencies into US dollars and that has underpinned the rally. The dollar's gains are certainly not based on the robust financial condition of the US. We have low interest rates compared to most other major economies, we have a very high trade deficit, we have double digit money supply expansion, we rely upon foreign entities to fund our deficits and we are offering them net negative yields after inflation. All these factors are very negative for the dollar yet foreign currencies and bonds have plummeted in a rush to cash.

FAX, an intermediate bond index with Australian and Asian government bonds, is selling at an 18% discount to NAV and a yield over 10%. GIM, an intermediate bond index with a Euro/Anglo focus, is selling at a 15% discount and 7% yield. FXA, FXE, FXC, MERKX, MEAFX, and DFSHX (DFA's selectively hedged short bond fund) all yield substantially more than equivalent US paper but have declined due to the maniacal US dollar rally. Since a peak of 120 in early 2002 the dollar index declined

to 71 eight weeks ago and then exploded upwards. About 65% of global investment grade debt is outside the US and we continue to recommend holding about 20% of fixed income in unhedged or selectively hedged foreign currencies and bonds.

**GOLD:** Since Oct. 8<sup>th</sup> gold has fallen in 10 of 11 sessions in New York and dropped over \$200/ounce. These are unprecedented declines and they are occurring in the face of record demand for physical gold. Gold in the form of GLD, often called “paper” gold since it trades like a stock and can be shorted, is now selling at or below the cost of producing gold. The gold supply held by GLD for investors hasn’t declined significantly so this suggests short sellers, not gold owners, are driving the price down. Moreover, reports from the London Bullion Exchange and other sources of gold market data indicate record demand for physical gold with mines and refineries on maximum output, long delays for deliveries, and premiums of over \$100 above the spot price in many cases. Even the US mint stopped issuing gold coins due to a shortage of gold. Moreover, the current credit crisis and the massive US and Euro government debt created in an attempt to reflate credit markets are highly inflationary.

Long-term data from Ibbotson suggest the inclusion of gold will smooth returns and diversify portfolios. This time it’s been different so far with no safe havens. Massive liquidation in virtually all asset classes and central bank intervention in markets have caused oddities and dislocations in prices, including gold. We continue to recommend holding between 5 and 10% of portfolio value in gold bullion. Long-term gold smooths returns in equity/fixed portfolios, adds a few basis points to returns, and is the perfect proxy for inflation and protection against currency debasement. Plotted against the price of gold the DJIA has lost about 75% since Jan. 4, 2000. In US dollars the DJIA has lost 23%.

**COMMODITIES:** From its record high 3 months ago oil has declined over 50% and most commodities have come down hard with it. Yet, the IMF, International Energy Association, and the World Bank report no decline in global demand for commodities. In fact, like gold, global demand for oil hasn’t dropped at all over the last three months while oil futures prices have been cut in half. Explanations abound. Large long positions are forbidden by the SEC/CFTC while large short positions are permissible. Massive liquidations by hedge funds long gold/short the dollar/long borrowed yen, are being unwound. And some analysts suspect government intervention in oil futures. Prior to the 2006 elections oil futures prices dropped 35%, only to rise again soon thereafter. OPEC just cut production by \$1.5M bbls. daily and said it will consider cutting more if the oil price declines continue.

Long-term data from Ibbotson, Gibson, Jenson, and indicates commodities indexes are important portfolio diversifiers, usually at 10-25% of total portfolio value. But, for the time being the massive liquidation process underway has hit commodities as hard or harder than equities. We recommend up to 10% in commodities and consider gold a special case commodity. Often, we’ll hold 5% in a commodities index and 5% in GLD.