



A Panic Is Usually Not A Good Time To Panic

Bill Hackney CFA
Chief Investment Officer
September 17, 2008

One of the more memorable scenes in American cinematic history is in the 1976 Academy Award winning film *Network*. In a fit of on-air rage, newscaster Howard Beale, played by Peter Finch, instructs his audience to “go to the window, open it, and stick your head out and yell, *I’m mad as hell, and I’m not going to take this anymore!*”

In recent days many investors are expressing similar sentiments as they dump stocks into increasingly panicked financial markets. The subprime mortgage crisis which began here in the US about 18 months ago has morphed into a worldwide financial crisis of unprecedented scope and severity.

While not belittling the seriousness of the current crisis, we do see several constructive factors which could lead to improved market conditions in the weeks ahead.

- 1. Commodity prices have declined sharply, leading to an easing of inflation pressures.** Crude oil is now \$95 per barrel, down sharply from its July peak of \$145 and back to near year-end 2007 levels. Most other industrial and agricultural commodities have likewise declined in recent months. Lower commodity prices will eventually help bolster discretionary consumer spending as food and fuel prices drop.
- 2. The deterioration in housing has begun to slow.** Housing starts in August fell to a 17-year low of 630,000. Depressed levels of starts help remove unwanted inventory from the market, eventually leading to a firming in home prices. Indeed, over the past several months the rate of decline in housing prices has moderated. Measures of housing affordability have improved.
- 3. Government policy response to the crisis has been enormous.** The Federal Reserve has not only slashed interest rates but provided unprecedented levels of liquidity to the banking system, including the investment banks. Fiscal stimulus has been applied in the form of tax rebates and bonus depreciation. A comprehensive housing bill has been enacted. Fannie Mae and Freddie Mac have been put into a conservatorship. These policy responses usually work on the economy with a several quarter lag, but they do usually work.

4. **US export growth has surged, helping keep overall economic growth in positive territory.** A steep decline in the US dollar over the past seven years has bolstered US manufacturing competitiveness, leading to a decline in our non-oil trade deficit. This has kept US GDP growth limping along at 1-2% this year versus going negative.
5. **Stocks have declined sharply from their 2007 peaks and recent activity suggests a selling climax reminiscent of prior market bottoms.** The S&P 500 index's 26% decline from its peak last October is right in line with the average bear market of the past 60 years. The S&P Financials, which have borne the brunt of the crisis, are off almost 50% over the same period. These declines discount much of the recent bad news. On a shorter term basis, almost 80% of NYSE stocks sell below their 200 day moving average and the VIX index (a measure of stock price volatility) is now over 30, an extremely high reading. Both these measures are consistent with near term bottoms in stock prices as they suggest extremely negative investor sentiment.

But what about the recent terrible news about AIG, Lehman Brothers, Washington Mutual and other financial institutions? Yes, it's bad. And continued problems in the world's financial system could drive stock prices lower still. But we wouldn't bet on it. Free-market economic systems which dominate global economic activity are amazingly resilient and capable of correcting their own excesses and failures, sometimes with government aid, sometimes not. The corrective phase of the present crisis is well advanced in our view.

Stock prices typically bottom when investor sentiment is at its worst, just like they peak when investor sentiment is at its best. (Remember the strong economy and low unemployment rates during the dot.com boom of early 2000?) With sentiment now so negative, you don't necessarily need *better* economic news in order for the market to improve. The economic news just has to get *less bad*. Our suspicion is that the economic news gets less bad in the weeks ahead and stocks begin to rally.

What should investors be doing in these chaotic markets? The urge to bail out of equities and end the pain of falling prices is great, of course. But history suggests that the scary events of the recent past are more suggestive of a near-term low in stock prices than a further broad-based decline. Strange as it seems, there is probably wisdom in doing nothing—just hold what you've got and wait for conditions to improve. Trying to reposition your portfolio in today's panicked and illiquid market may be a costly and foolhardy endeavor. ♣♣♣

This information is not intended as investment advice or a recommendation to purchase or sell specific securities. These opinions may change at anytime without prior notice, there is no guarantee that any forecasts or opinions expressed in this material will be realized. While every effort has been made to verify the information contained herein, we make no representation as to its accuracy. Company names are used for illustrative purposes only and should not be construed as a recommendation to buy or sell any financial securities. Index and commodity changes are based on price-only percentage change. It is not possible to directly invest in an index. Past performance does not predict future results.