



STRATEGIC FINANCIAL
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Investment Strategies & Insights

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Cautiously Opportunistic – Perspective

Let's begin with a little perspective. For every 5% move in the S&P 500 approximately 600 to 700 billion dollars are made or lost. That it is roughly equal to the size of the most recent Bailout program. Over the past 60 years there have only been 19 occasions when the stock market rose or fell 5% in a day. Eleven of those occurred *in the last 6 weeks*. The markets, the economy and Joe six-pack have all experienced a whirlwind of news of late such as bank and brokerage firm failures, dramatic and coordinated governmental intervention both in the US and abroad and an election that resulted in a historic outcome. We are currently living the Chinese blessing/curse: "May you live in interesting times". The pointed question is how much more interesting will they become?

The type of volatility in our (U.S.) stock markets described above rarely occurs in isolation. Let's take a look and see if in fact it really is "a small world after all" or if the "decoupling" pundits are correct. There are 46 individual country stock exchanges that exist today. Of those **43** have suffered bear market declines greater than the 45.8% decline that the S&P 500 reached at its Oct. 27th low. So much for the "decoupling" pundits. Only three were down less: Israel -36.3%, Jordan -38.7% and Switzerland -40.5%. There were 14 stock markets that experienced horrific declines of greater than 70% or more, based on MSCI data. Some notable examples include: Ireland -80%, Russia -79%, Argentina -74%, China -74%, Brazil -72%, India -71% and Korea -70%. The global equity markets are down from their previous highs by over 20 Trillion dollars.

Recognizing that history does not repeat itself (but often rhymes), we remain cognizant of the fact that the stock markets and economies of the world are composed of people who remain emotional beings prone to excesses in times of fear or greed. As such, we suggest the past as a prelude to the future.

Since 1854 the US has experienced 32 complete economic cycles of expansions and contraction (more commonly called recessions). Since World War II (WWII), recessions have lasted 11 months on average. From 1980 forward there have been only three recessions: January 1980 – November 1982 approximately 2 years in length, July 1990 – March 1991 for 8 months and November 2001 – November 2002 lasting 12 months. Therefore, since WWII, the average recession lasted 11 months and since 1980 they have averaged just fewer than 15. Most economists now believe that the current recession began in November of 2007 making this its one year anniversary. Therefore, if this recession proves to be average (no guarantees) then sometime between now and mid to late first quarter of 2009 we will have reached both the more recent as well as the long term average duration. Additionally, if you look at the bear markets from 1932 forward, we've had 15 lasting from 41.5 months at the longest, to 1.5 month at the short end. The average length has been 18 months and the average decline was 36%. The current bear market began on October 9th 2007 and at its most recent low on October 27th 2008 was down 45%. We have now exceeded the average size of the decline by over 30%. From a length or duration point of view, the second quarter of 2009 would historically represent its conclusion. Given that the stock market typically begins its rebound 6 to 9 months before the economy actually comes out of the recession we could well be close to that point right now. Even assuming a longer than average recession, a similar stock market bottoming time line would place the market bottom by year's end. The average S&P 500 performance 12 months following the market bottom **during** recessions since WWII has been 37%. This mandates we focus not on what has past but what lies ahead and what will have real value: looking for opportunities.

"You must look within for value, but beyond for perspective"

Dennis Waitly

SUMMARY:

Volatility in the markets continued to escalate as market swings not seen in 70 years frustrate investors.

Problems continue in the credit markets as the Federal Reserve, Foreign Central Banks and the U.S. Treasury committed to put trillions of dollars into the system to boost liquidity and confidence.

The current economic contraction has reached the approximate average length for post WWII contractions.

There is no assurance that this will be an average economic contraction.

While the current credit issues have had a negative impact on financial markets, future opportunities are coming into focus.

Investment Strategies & Insights is mailed quarterly to our clients and friends. The intent of this publication is to share some of our most interesting views and research.



Inside the Economy

Inflation and Interest Rates

- Inflation concerns are abating as oil and gas prices have dropped by over 50%. In addition industrial metals and agriculture products have all declined significantly. With a weakened economy domestically as well as abroad, demand is softening and prices should remain low.
- The Consumer Price Index (CPI) was flat at 0% for October and up only 0.1% in Sept.
- Inflation at the crude, intermediate and finished goods level are also beginning to fall as well.
- The inflation battle between companies wanting to pass through higher prices because of higher input (commodity) costs has moved the other direction as prices have fallen.
- The Fed has shown a willingness to continue to lower rates and is apparently more focused on avoiding a deep, prolonged recession and will worry about any inflationary consequences later.

Economic Output and Direction

- All of the economic indicators remain negative and are not showing signs of improvement yet.
- The head of the National Bureau of Economic Research, the arbiter of U.S. recessions, stated that he believed that we have been sliding into a recession since December or January.
- The Fed Chairman, Ben Bernanke, and Paulson the Treasury Secretary has also suggested that we are in fact in a recession, but both believe that there should be a bounce in the second half of next year.
- If that occurs, this recession would have lasted longer than the historical average.

Business and Consumer Indicators

- Weakness persists in both the service and manufacturing sectors with a substantial decline in new orders.
- Even though personal income rose last month, spending was down indicating that the consumer is finally beginning to tighten the purse strings.
- This attitude is reflected in continued declines in consumer confidence, which we believe is related to recent weakening in the employment data.

Inside The Markets

The Stock Markets

- The Bear market continues in the 4th quarter as every attempted rally eventually failed with stock prices reaching a low in the last week of October.
- The current negative economic news has put a downward bias on the market.
- In addition, earnings for the troubled financial sector as well as an increasing number of other sectors continue to provide a daily reminder of a poor corporate outlook.
- Even though the downside risks are clearly not as great at this point, stocks could continue to struggle or remain in a narrow trading range for a while.
- International markets have corrected as well, with emerging economies down substantially more than the US.

The Bond Markets

- The price of Treasuries continued to rise as investors looked for safety as uncertainty in the credit markets rose.
- As a result, the spread between interest rates on U.S. government and lower quality bonds widened, increasing the cost of borrowing for corporations.
- Shorter-term yields have dropped as the Fed has continued cutting the Fed funds rate, and this trend should continue in the foreseeable future.
- Even though the U.S. dollar has rallied a bit lately, it remains relatively weak compared to the Euro as well as other currencies.
- As a result, the European Central Bank is under continuing pressure to cut interest rates to curtail the rise in the Euro, as well as stimulate a recessionary European economy.

Commodities / Alternatives

- Commodities suffered a -28% correction during the 3rd quarter. This continues the recent downtrend.
- Falling prices have not only been in oil, but grains and materials as well.
- The alternatives, like infrastructure and alternative energy, should receive upward pressure on prices from current levels as global demographics and political factors cause increasing demand when economic conditions improve.



Cautiously Opportunistic – Opportunity

The massive dislocations all around the world as evidenced by global markets' data on page one and in our own credit, debt, banking and housing markets, creates (for the poised and patient) an opportunity to capitalize on these dislocations. Daily vacillations between extreme fear and wide-eyed optimistic euphoria create pricing imbalances that we can possibly exploit. Just since the end of September we have had days where the market losses were -9.0%, -8.8% and -7.6% as well as several days when the market was up 10.8% and 11.6%. What this means when viewed from a historical perspective is that just over the last month we've had days that would normally represent a year's worth of performance, both up and down. These excessive and irrational swings create price opportunities in the marketplace that can be exploited. We believe that there are a number of situations that will afford us, in time, opportune and advantageous buying points. They may require some patience and perseverance but we know from history and in some cases demographic necessity or political expediency that they will be positioned to benefit from the rapidly evolving world we live in. As Bob Dylan sang, "the times they are a changing".

In addition to the stock market leading the economy up, there are a number of additional conditions we find encouraging.

- Corporate balance sheets and overall debt levels are in much better shape than is usual in recessionary environments.
- Cash on the sidelines (in money markets, short term CD's, treasuries, corporate and municipal bonds etc.) are at the highest level reached in over 25 years, significantly higher than was reached before the last bear market low in March of 2003.
- The impact of the coordinated Central Bank activities, reducing interest rates and establishing various credit facilities are now beginning to show some promising results.
- Consumer sentiment is at all time lows, which is typically coincident with market lows.
- The economy has yet to benefit even slightly from the \$700 billion Troubled Asset Relief Program (TARP) as they are only now implementing this program.

We certainly don't believe that the economy or the stock market will instantly do a 180 and surge up substantially or sustainably over the short term. We do, however, believe that the stock market has already priced in a moderately severe recession and that at this point there are a number of increasingly attractive investment options to evaluate and, at some point, exploit :

- Good quality companies or sectors that have both the

balance sheets and market position to weather almost any conceivable environment.

- The yields on oil and gas pipelines using Royalty Trusts or MLP's are getting quite attractive. Longer term we feel that in addition to the yields there is an opportunity for capital appreciation as well.
- Alternative energy and infrastructure will be two themes that the Obama administration will be committing billions of dollars to over the next 4 years.
- As we saw earlier the international markets have been hit even harder than the US, in particular the emerging and BRIC (Brazil, Russia, India & China) countries. They may well lead the world out of this global downturn.
- Municipal bonds are trading at historic spreads relative to Treasury bonds. When you tax adjust the muni's for what will most certainly be higher tax brackets in 2009 they become even more attractive.
- High yield bonds have reached coupons of nearly 14%, this is consistent with levels that have previously provided very compelling returns.

We are not necessarily advocating buying these immediately, but feel they bear watching closely for timely entry points. With China and the Pacific Rim representing a growing and soon major player in the economic world it seems only appropriate to look eastward for inspiration. The Chinese symbol for crisis means "opportunity in a time of danger". We take this to heart and will, therefore, be alert for the opportunity and continue to be vigilant to avoid the dangers.

Best regards,

Investment Strategies & Insights
is written by the scribes at **Strategic Financial Management Group**.

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