

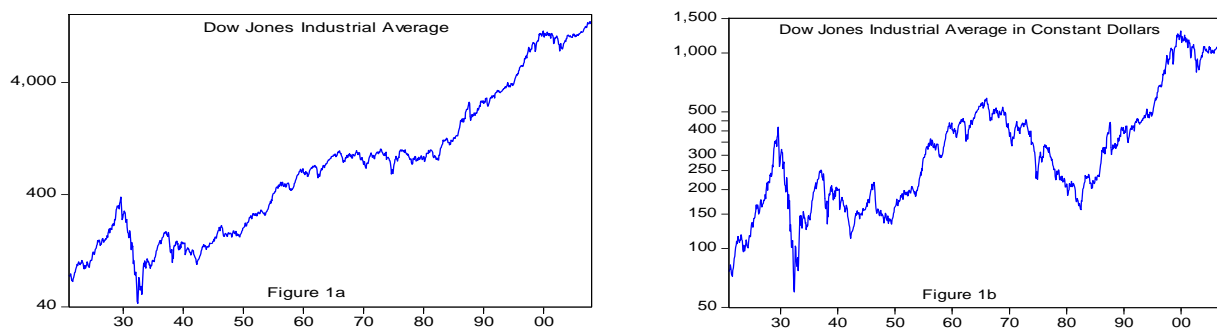
C *Economic & Market* Commentary

Purgatory

Investors have experienced dramatic highs and traumatic lows during the past decade. A market high in 1999 followed by a significant decline as the technology bubble burst, resurging to a new high in 2007, followed by yet another decline as the real estate bubble burst. Low interest rates and low inflation followed by rising interest rates, rising inflation, and high commodity prices. Rounding out the experience has been a significant terrorist attack and two ongoing wars. During this period, stocks have been in a Purgatory of sorts, and have underperformed other investment classes.

E.S. Browning wrote in *The Wall Street Journal* that “*Over the past 200 years, the stock market’s steady upward march occasionally has been disrupted for long stretches, most recently during the Great Depression, and the inflation plagued 1970’s. The current market turmoil suggests that we may be in another lost decade.*” This is a classic long-term view, and in both of the previous cases, it took well over a decade to sort things out.

I just finished reading a very detailed treatise by Victor Canto comparing the stock markets of the 30’s and 70’s. At first glance, one could surmise that the market performance of the 30’s was much worse than the 70’s in terms of the magnitude and duration of the declines and recoveries, and that both were worse than the most recent period. Figure 1a shows that the 30’s experienced a defined peak and trough while the 70’s remained relatively flat, but a closer look (see Figure 1b) shows that the 70’s were every bit as nasty as the 30’s when adjusted for inflation.



Graphs sourced from *La Jolla Economics, Lost Decade?* by Victor Canto on April 2008

The 30’s were characterized by little or no inflation, the 70’s by double digit inflation, and the most current period by low inflation. When the corrosive effects of inflation are considered, the duration of the 70’s cycle almost triples from 10 years to approximately 26 years, putting it almost at par with the Great Depression. In the end, and after much more analysis by Canto, the data support that, in contrast to the Great Depression period and the 70’s, our current period has been much milder than the previous two.

It is important to understand that almost every asset class passes through Purgatory; it's just a matter of when and for how long. It's also important to understand that a solid investment plan includes more than one asset class, and the more experience one has with the ebb and flow of investment cycles, the more one realizes the importance of diversified investing.

At the moment, the massive decline in real estate values and the pain and suffering being endured by the companies lending into that space is fresh in our minds. There has been some collateral damage to other market sectors from both issues, and the popular thing to do has been to run with the herd as far away from these sectors as possible. Granted, it's been a tough market of late, but opportunity often lurks within troubled sectors. One just has to be careful and patient.

There are a few things troubling the markets these days: 1) The combination of a weakening job market and rising food and energy costs; 2) The financial system is operating in recovery mode and is limiting new credit creation; 3) November's election marks the first time since 1952 that neither candidate is an incumbent President or Vice President, creating some significant leadership questions; 4) Increased odds that tax rates will increase regardless of who wins the Presidency.

Decreased lending, higher tax rates, rising inflation and a slowing economy create a tough economic equation, and put the Federal Reserve (Fed) in a tough spot. In order for the financial system to regain its footing and support the underlying economy the Fed may have to hold its nose with regard to inflation, and keep interest rates low for a prolonged period. It may also require more reminders of the government's willingness (albeit standing on the wallets of taxpayers) to back the financial system. As far as the leadership and tax rate questions...that's what elections are all about.

The overall equity markets have taken a nasty spill over the last eight months, and there are reasonable points being made by both the bears and the bulls that either the markets have further to drop or markets will reverse themselves. The previously described cross currents will continue to drive the markets until investors become more certain in their economic outlook. History shows that periods of price declines are typically followed by periods of price advances...it may just take some time.

Some of our current clients and many of their parents were investing in high-quality stocks and bonds during the rough patch in the 70's. These investments eventually blossomed as the economic outlook stabilized and the markets advanced during the 80's. Our most successful investors have credited their success to focusing on the long-term during the rough patches. It is quite obvious that we are in a period of adjustment in terms of valuation for many assets. During this time, patience may be the best virtue a successful investor can have.

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