

Deloitte & Touche Investment Advisors Special Update: Keeping Your Cool Through a Financial Crisis

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The Special Economic & Market Review is presented to provide perspective and context within which to evaluate your portfolio performance as well as a forward look at the questions, events, and circumstances that may impact performance in the quarter ahead.

“The time to buy is when there is blood in the streets, even if it’s your own.”

-Baron von Rothschild

Our Financial System Under Pressure

The U.S. banking system is going through a massive de-leveraging of its balance sheet. Symptoms of the stress on our economy include:

- The freezing up of the municipal variable rate demand note market
- The sharp decline of the Asset Backed Securities (ABX) market
- The collapse of the securitized debt issuance system
- Margin calls on heavily leveraged hedge funds like Carlyle
- An unwillingness of some financial institutions to transact business with others whose stability they question. An example of this refusal to take “counterparty risk” was the refusal of other banks to do business with Bear Stearns
- The potential bankruptcy of insurance companies (the so-called “monolines”) that guarantee bonds, particularly municipals

A similar de-leveraging is taking place on a household level. Home prices, household net worth and consumer spending are all on the decline. This is obviously bad news for the economy at a macro level as it is U.S. consumers who have propped up the economy over recent years with spending supported by home equity loans and other forms of credit. Unfortunately consumers are now closing their wallets. Lower consumer spending, particularly for large ticket durables, is a further drag on our economy.

Another victim in all of this is the U.S. dollar. It has plunged in value against most major currencies due to wider spreads between dollar and non-dollar debt and an overall lower return on capital in the U.S. compared to the rest of the world. The dollar’s fall is likely to continue until both interest rates and the pace of growth slows overseas.

The Fed to the Rescue

The Federal Reserve has responded with exceptional efforts to maintain banking system liquidity, offering special terms to commercial banks and an extraordinary lifeline to troubled investment banks. The Bear Stearns buyout is the latest in remarkable developments in this process. Normally, the Fed only lends to commercial banks that are supervised and regulated. However, thanks to the Fed Bear Stearns was preserved long enough to be bought out by JPMorgan Chase.

The Fed is risking higher inflation in the short run as it drops rates and increases the money supply in its attempts to provide stability to the U.S. financial system. With import prices up 13.6% from a year ago and both gold and oil hitting record highs, inflationary expectations are rising. In the longer run credit crises of this nature historically have been deflationary; the Fed is hoping that to be the case this time.

Could the Overall U.S. Financial Systems Fail?

When you see a major bank fail you may begin to think, "So what could happen next?" Some of us fear living through a remake of, *It's a Wonderful Life*, namely the nightmare version. Behind the teller window stands not George Bailey, but rather Uncle Sam. And who is the angry mob across the counter demanding their money? No, it's not the anxious faces of citizens from Bedford Falls. Rather, in our worst fears it is Japan, China, the United Kingdom, the oil producing countries, and others around the globe that hold our debt. They have lost confidence in our economy and they want their money now.

What's this? No fear in Uncle Sam's eyes? There shouldn't be as he has a weapon that George Bailey lacked, the U.S. Mint. Uncle Sam can print as much money as necessary to pay our foreign debts. About our worst scenario is that future lenders to the U.S. who have lost all confidence in the dollar could require debt denominated in some other currency, like the Euro, or even a return to the gold standard. However, that nightmare appears extremely remote at this point.

Keeping Your Perspective

As the media blares news of the recession, bank failures and plunging stock prices many of us naturally want to take action to prevent further losses. At times like this it often helps to put your losses in some sort of broader context.

Take a moment and reflect just how profitable your stocks have been over the past five years. The following table provides cumulative returns for the different equity indices that are typically components of a diversified portfolio.

Index	Cumulative Returns 2003-2007
MSCI Emerging Markets Index	383%
MSCI EAFE Index	166%
Russell 2000 Index	112%
S&P500 Index	83%

Reflecting on how much your stocks have gained during the last five years should ease the hurt of recent losses, especially if your portfolio had appropriate small cap and international exposure during the great run.

Furthermore, as you consider how this recession compares to others, there are some reasons to be positive:

- Growth overseas remains strong and the weak dollar gives another boost to US exports.
- Non-financial balance sheets were strong going into this event with record levels of cash.
- The fact that there was modest hiring on the upside will likely mean fewer layoffs on the downside. The rise in initial unemployment claims has been modest.
- Inventory levels remain low, reducing one of the historical causes of deeper recessions.

Finally, while your stocks may be down, hopefully your portfolio is well diversified. Holdings of fixed income, commodities and other assets classes with a low correlation to equities have helped blunt the pain from the stock market during this period.

If you assume that the current recession follows history, you can start to gain some perspective on key questions:

U. S. RECESSIONS SINCE 1950						
Recession ¹	Peak ¹	Trough ¹	Duration (Mos.) ¹	S&P 500 ²	1 yr ²	3yr ²
1	Jul-53	May-54	10	-14.82%	35.80%	109.42%
2	Aug-57	Apr-58	8	-20.66%	31.02%	36.79%
3	Apr-60	Feb-61	10	-13.40%	30.67%	62.52%
4	Dec-69	Nov-70	11	-34.73%	43.73%	55.78%
5	Nov-73	Mar-75	16	-45.93%	33.93%	42.79%
6	Jan-80	Jul-80	6	-17.07%	37.09%	54.60%
7	Jul-81	Nov-82	16	-25.01%	58.33%	83.20%
8	Jul-90	Mar-91	8	-19.61%	29.10%	55.99%
9	Mar-01	Nov-01	8	-28.16%	-16.75%	2.87%
Average			10	-24.38%	31.44%	56.00%

¹ National Bureau of Economic Research ² Bloomberg S&P500 Index Price Returns

- **How long is this recession likely to last?** Based on this data recessions typically range from six to 16 months in duration. Assuming this recession started last December, this would suggest that on average we would be moving out of it as we head into this fall and in the worst case (the 16 month scenario) the recovery would start next spring. But, as it always says in the fine print, "Past performance is no guarantee of future results!"

- **How much more is the stock market likely to drop?** Since 1950 the average recession-related price decline for the S&P500 from peak to trough is roughly 24%. On that basis the 20% decline in the S&P500 that we have experienced through March 17th would mean that much of the pain is already behind us. Having said that, we draw your attention to the 35% and 46% pullbacks included in this data. The difficult thing to judge of course is the depth of this recession and also to what extent its occurrence is already factored in to current asset prices.
- **How long will it be before I begin to recover these losses?** First, since the markets are forward looking, we would generally expect, and history has shown, that the respective highs and lows for the S&P500 typically occur 4-10 months prior to the peak or trough of the actual business cycles listed in the table above. Or, in more simple terms, the stock market will start its recovery well before the talking heads on television figure out that the recession is behind us.

Next, observe the average one year and three year returns for the S&P500 Index measured from its recession-related low. The S&P500 has rallied on average by 31% in the twelve months following its recession-related low. Notably, there has been only one period where the following one-year return was negative. Over a three-year period, all cumulative returns were positive and the average has been 56%.

What Are The Signs That We Are Out Of The Woods?

At the end of the day, how will we know when this is over? There are several financial and real economy pieces of data that will give us some clue to the duration of the current downturn. The financial market problems began in the housing market. Falling home prices are depressing both household and bank balance sheets.

On the financial side, keep an eye on the Fed's Term Auction Facility (TAF). This is a special source of funds for the banks. When the banks no longer need this extra liquidity it will be another sign of financial market stability. In many ways this financial crisis started when the banks began having problems turning over their asset backed commercial paper (ABCP). Beginning in early August of last year, the volume of commercial paper outstanding shrank for 18 weeks in a row. More recently it has shown some signs of stabilizing. A recovery in the ABCP market would be another sign of financial market stability.

Unfortunately, the normal reaction for most investors is to lighten their equity exposure after most of the declines have already occurred and then miss all, or a good portion, of the subsequent recovery rally. Given the market's historical tendency to recoup most of its recession-related losses within a single year, we believe that long-term investors would be making a mistake to sell equities and sit in cash at this point in time. Attempting to stop the bleeding may well result in the failure to participate in a strong rally. On the contrary, and consistent with the quote from Baron von Rothschild above, this environment more likely represents a buying opportunity for long-term investors than a good time to sell.

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