



Market Comment Notes

January 19, 2009

Where are we?

1. 2008 was the worst year for the stock market since 1931
2. Equity returns are now negative on a trailing 10 year basis – worst 10 year stretch since the 1930's
3. Most major economic and capital markets indicators are at huge spreads from long term averages

SPX P/E
Credit Spreads
Energy Prices
U.S. Treasury yields
VIX - volatility

4. Valuations appear to be pricing in worst recession since 1930's – SPX earnings are 2x 2002 recession lows, SPX is near 2002 bear market lows

How did we get here?

1. Excessive leverage
2. Underpricing of risk

Where do we go from here?

1. Reversion to the mean remains the most powerful force in investing
2. Current situation for equities is opposite of late 1999-early 2000
3. Common sense strategies are appropriate and have compelling risk-reward characteristics
4. "Safety" is priced expensively, "Risk" is priced dirt cheap – opposite of 2006
5. Smart money bet is that major economic relationships move materially back toward long term averages on balance over next two years – halfway back to average will result in very good returns, back to average will result in outstanding returns

Risks

1. Uncertainty, always higher than we think, is unusually high given "uncharted waters" aspect of current environment
2. Move toward greater government intervention / socialist policies / taxes – implications on equity valuations are negative
3. Deleveraging is painful – and risk aversion will likely mean recovery is slower than usual
4. Volatility is likely to remain high for a while given level of uncertainties, still high debt levels, and perceived risks
5. Are traditional notions of risk and return expectations for the capital markets still valid?

Opportunities

1. Equity valuations are exceedingly cheap, especially for 3-5 year horizon

2. "High Quality" is especially cheap given valuation compression across quality and growth spectrum
3. Timing – equities discount recovery before headlines show economic improvement
4. Investors have a rare opportunity to own the best companies at historically low valuations, both absolutely and relative to all other companies and asset classes, with relatively low valuation risk and execution/business/economic risk
5. Investors can win 2 ways --- stabilization and eventual recovery leads to higher corporate profits several years out, PLUS reversion to "normal" valuation metrics as investor sentiment moves from panic to caution to relieved driving P/Es from 8-12x to 12-20x