

Investment Outlook & Commentary

Third Quarter, 2008

The Bear Market is here. We suspected as much earlier, noting that between the great unraveling of America's Ponzi-like financial industry, a weakening economy, and higher future tax rates, the market looked grim. With major market indexes down some 20 percent from the highs, and after seeing failed market rallies leading only to lower lows, our belief in focusing on preservation of capital has strengthened.

To be sure, the "tax bomb" noted previously creeps closer, and the unwinding of Wall Street and other financial companies continues, its end unlikely for some time to come. Despite what seems to be every pundit on CNBC calling for an imminent bottom and quick turnaround in the financial sector, we just don't buy it. It's not like banks, insurance companies, and all the other financial players involved in bad loans and other toxic assets can simply sweep them off their books and start anew.

The Hit-Man

A growing threat, perhaps more tangible and damaging to both Wall Street and Main Street, joins the already growing list of market worries: global inflation. Ronald Reagan described inflation "as frightening as an armed robber and as deadly as a hit-man." Inflation now stands at over 4 percent in the U.S. Commodity prices have soared with oil prices up 50 percent in just the past six months and corn and other food commodities rising even faster. Consumer confidence is at its lowest level in decades.

Globally, the inflation picture is worse. Inflation worldwide has risen to 5.5 percent, the highest since 1999. China, India, Indonesia, and the Gulf states have seen inflation rise to 8-10 percent this year. In parts of Latin America inflation now exceeds 20 percent. Soon, some two-thirds of the world's population could suffer double digit rates of inflation.

Governments' treatment of the newly arrived inflation adds to worries. Policy makers worldwide are assuming the rise in inflation reflects a short term supply shock that should abate relatively soon. Central banks will likely abstain from tightening money supplies (politically unfeasible given recessionary fears), and administrations will instead opt for price controls, rationing, and temporary subsidies.

Domestically, although Federal Reserve Chairman Ben Bernanke has acknowledged rising inflation, he remains focused on America's financial system and possible recession and will not raise rates anytime soon. He's betting that food and fuel prices will ease, just how so remains unknown. The market seems accepting of this rosy view and anticipates the inflation rate will fall to the 2.5 percent level over the next year.

We're not so sure, but are convinced hedges must be put in place in case Mr. Bernanke and the market are wrong; hence the addition of Treasury Inflation Protected Securities (TIPS) in portfolios.

Investing in a bear market

Our overall market concern is accompanied by a growing sense of opportunity. Indeed, preserving capital is an overarching goal here, and portfolios are holding generous amounts of cash along with some Treasuries, TIPS, and gold in balanced accounts to counteract a falling stock market. At the same time, there will be opportunities to make money, possibly in a few ways.

First, through taking advantage of Great Businesses at sale-like prices. Despite the economic and market headwinds, there are companies out there that due to outstanding business models, scale, and competitive position, can generate *increasing* earnings year after year. These companies have a certain intrinsic value, and we'll jump on them or add more money to them (we hold some of these companies already) should the market underestimate their worth.

Second, by using relief rallies as oversold markets quickly give way to new optimism. This was how some made money between 1964 and 1980, even as the stock market was flat over that 16 year period. (Let us hope this isn't the environment for the *next* 16 years!)

Third, by correctly identifying favorable market sectors. There is always a bull market somewhere, even if the overall market is bearish. Admittedly, this is no easy task, especially in this environment.

Some of our team's biggest challenges and investment work lie ahead. Delivering performance amidst economic and political headwinds requires an even more diligent research effort. We are up for the task; and we are looking forward to it, knowing that it is times like these, when asset prices are depressed and market sentiment is poor, when one can make a huge difference in adding value. We intend to do just that.

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