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Volume 17, Issue 1

January 25, 2008

Market Commentary

A Review of the Markets and a Look into the Future

Why Bears Can Be Beautiful

Our problem is not to eliminate fear, but rather to harness fear and master it.

- Rev. Martin Luther King

Economic Outlook: Take Two Roloids and Call Me in the Morning

I am thinking about some of the great leaders of the twentieth century, like Dr. King, who provides our opening quote, and Franklin D. Roosevelt, who said that “the only thing we have to fear is fear itself.” The impact of these men was not merely a matter of the policies they promoted, but of how they inspired people.

Now we are in a time when people could use some inspiration on the economic front. Since we last spoke, it has become clearer that the economy is in the midst of one of its periodic “landings”, and the question on everyone’s mind is whether it will be hard or soft. The current problems started in the relatively obscure sub-prime segment of the mortgage market, and have continued spreading to the point that now it is easy to hear the “R” word being bandied about by economic commentators.

The problem in situations like this, as FDR said, becomes fear itself. Economic imbalances that were created by the housing bubble have to be untangled, but as that happens there is a danger that fear will cause the untangling to spread far beyond where it is needed. Investors can become afraid to invest, consumers can become afraid to buy and businesses can become afraid to hire. A

soft landing can become a hard one, and a slowdown can become a recession.

To counteract this possibility, the Federal Reserve Open Market Committee (FOMC) has moved aggressively on monetary policy, punctuating a series of interest rate cuts since September with a ¾% reduction in January, the largest FOMC rate cut since 1984. That the FOMC has done this in the face of inflationary concerns from gas and food prices indicates the seriousness with which they now view the economic situation. On the fiscal side, Congress and the President have reached an agreement on a tax rebate deal that will put more money in the hands of consumers.

The full impact of these monetary and fiscal stimulus actions will depend upon their effect on people’s psychology. Do they cause people to master fear and maintain faith? That is the question that will be answered in the coming months as we learn just how hard or soft this economic landing will be.

The good news is that those who take a view of the economy beyond the current business cycle, who look through fear to see the fundamentals beneath, can position themselves very advantageously to win in the long run. To put it another way, for those who can master fear, the time after the landing is the best time to get on board.

Stock and Bond Markets: Remember the Upside-Down Law of Gravity

Over the past three months, stock markets have taken quite a beating across the globe. The old adage of the world catching a cold when the U.S. economy sneezes apparently still has truth to it.

Overall, stock markets have moved very rapidly to incorporate reduced economic expectations into prices. A relatively hard economic landing appears to have been priced-in to the market at current levels. Still, downside risk remains, even if only from a downward overshooting by the market. We expect equities to remain sensitive to economic and earnings news in the near-term, and corporate earnings could still disappoint.

Fortunately, aggressive monetary moves by the FOMC (see Economic Outlook) seem to have stabilized the markets at least for now and should help offset some of the worst effects that the housing slump and sub-prime jolt have had in the banking, insurance and brokerage industries.

Another potential near-term positive for stocks is a substantial fiscal stimulus package that will give most tax filers rebates of \$600-\$1200, more if they have children. This combination of combined strong monetary and fiscal stimulus should moderate the depth of any economic slowdown and help calm jittery nerves in the markets.

There is additional good news in that valuations have become increasingly attractive of late. The Standard and Poor's 500 index (S&P 500), a commonly followed benchmark for the overall market, is currently priced at approximately 13.5 times the latest median year-a-head earnings estimates by IBES of \$98.74 per share.

For comparison, the median price-to-earnings ratio for the S&P 500 over the last 36 years is 16.4, according to Ned Davis Research, Inc. This gives us some confidence that even if earnings estimates declined moderately, stocks would still be reasonably priced.

If we think about this in terms of a really-good-case scenario, in which concerted global monetary easing led to a significant improvement in credit conditions and sharply limited the economic downturn, we see that an upside target for the S&P 500 could reasonably be above the 1600 mark (16.4 P/E x forecasted \$98.74 earnings per share = 1619). That would represent approximately a 20% gain from current levels.

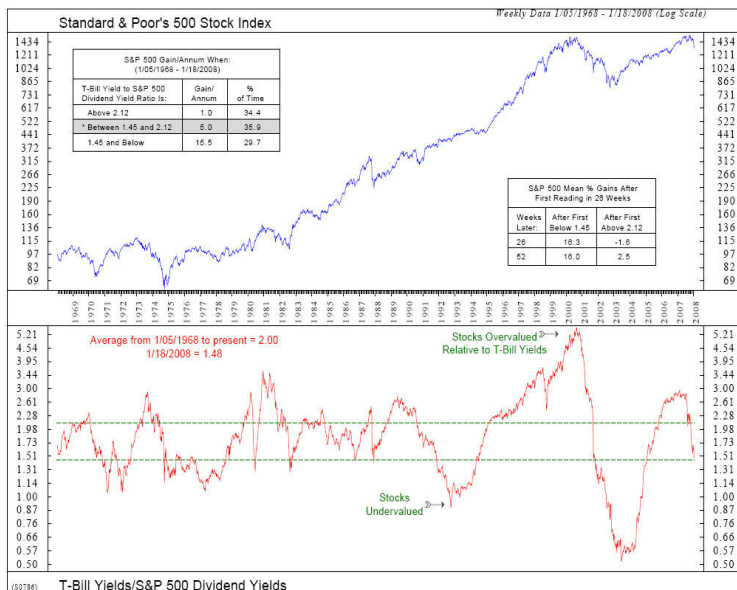
To strike a less positive sounding note, since several domestic equity benchmarks have declined 20% from their peak in October of last year, as of now we are technically in a bear market. According to Goldman Sachs Group, Inc., there have been 9 bear markets since 1950 involving declines of at least 20%. The average drop for those bear markets has been 32%. Readers may recall the most recent and severe bear market during this period since it was not all that long ago. It occurred from March 2000 through October 2002, when the market declined 49%. The average bear market has lasted for 384 days. The shortest lasted 87 days (1990).

With these facts about previous bear markets in hand, a question presents itself. How much farther, if any, does this decline have to go? The answer to this question depends on several factors, including the breadth and depth of any economic slowdown that the stock market decline is foreshadowing. Other contributing factors include the adequacy and timeliness of any further monetary responses by the FOMC or fiscal responses by Congress to sustain the economy and bolster the financial system. Since the FOMC is adopting an aggressive rate stance and fiscal help appears to be on the way, it appears likely that this economic slump will be relatively moderate, which squares with most economists' forecasts.

In the meantime, it's important to remember that the stock market cycle tends to lead the business cycle, reaching a trough well before an economic decline or slowdown is over. Assuming we are only facing a moderate economic slump, this market should be approaching its bottom very soon.

Another point to consider is that from a fundamental perspective, stocks have recently been getting more attractive relative to treasury bills (see Figure 1 below). The continuing realization of economic weakening has triggered a flight to quality in the bond markets that have pushed yields quite low. High yield corporate bonds are an exception to this rule, having fared poorly in recent months as signs of the economic slowdown have multiplied. It is likely that these instruments will act much like equities in the coming months, responding to fiscal and monetary stimulus with a rebound that offers investors the opportunity for “double-edged” returns – attractive income along with capital appreciation. We at Green Investment Management will be watching these developments carefully and aim to take advantage of such opportunities as they arise.

Figure 1. S&P 500 relative to T-Bills



For now, each of our client portfolios is well diversified. All of our Guardian style allocations have varying degrees of cash and/or inverse equity positions to moderate the recent market declines. As we advance through the current cycle these positions will provide "dry powder" that will be needed to participate in the eventual recovery phase. Remember, while down markets are disquieting, they are merely temporary interruptions to a long-term uptrend exhibited over many, many years of stock market history.

It's like the law of gravity, only upside-down. While the overall market can move lower for a time, eventually it always resumes a trajectory of growth.

Foreign Stocks: A Myth is Exposed

An interesting lesson to take from recent events is how remarkably linked the global economy remains to the U.S. economy, despite recent theories of decoupling. In retrospect, this should hardly be a surprise in the era of globalization. Many of the failed sub-prime loans that originated in the U.S. were packaged and sold to investors across the globe, spreading the contagion that those loans ultimately became. Moreover, as technology has drawn the world closer together, it has become much easier for investors to watch and participate in markets beyond their own nation's borders. This means that investor psychology has become increasingly synched up internationally, and that problems in one part of the world can easily spill over into others.

Similarly, while slowing economic growth has been a concern in the US for some time, it now appears that growth prospects in the rest of the world are following suit. The leading indicators of the economies of the industrialized countries have been heading down of late, and foreign markets are falling along with domestic markets. With the aggressive policy stance the U.S. is taking to offset economic weakness, we may see relatively greater strength for U.S. stocks versus those of other nations in the year-a-head.

Some of the strongest foreign economies remain India, Brazil, and China. We favor an overweight to the Pacific and Asia regions. In Asia, there are currently wide valuation spreads in country valuations with South Korea and Taiwan both having price-to-earnings multiples of under 12 times expected earnings per share. India, on the other hand, has a multiple of 23.8 times earnings, while China's has recently dropped from 24 to 17.

Commodities & Inflation: Inflation Less of a Worry, But Not Out of the Picture

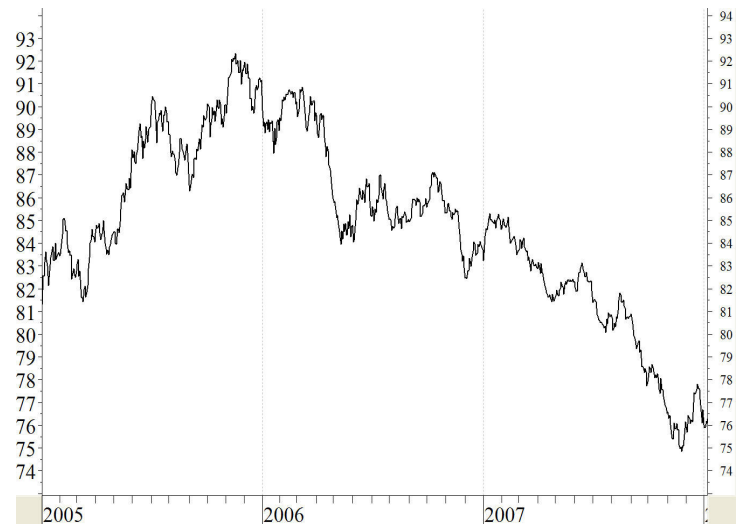
Commodity futures are currently up 14% year-over-year as measured by the Dow Jones AIG index. These prices have already declined 5% from their January highs. The progressing slowdown in the global economy will likely place more downward pressure on commodities and inflation in the months ahead. The FOMC is counting on this. The aggressive rate cutting stance they have taken could turn problematic if inflation decides to make a strong showing.

In the U.S., merchant wholesalers are currently experiencing shrinking inventory levels. They will likely do what they have done before in these conditions - place more orders to replenish stocks. This decision could stimulate the U.S. manufacturing sector, which has already been the beneficiary of a weaker dollar. Such a development could help cushion the current economic slowdown, but also holds the potential for driving inflation.

U.S. Dollar: A Bottom Reached and Not Breached?

The current global economic picture leads us to believe that the dollar's long period of weakness (see Figure 2) could begin to reverse soon. A disparity between U.S. and foreign economic growth prospects, with the U.S. playing fall-behind, has been part of the dollar's problem recently. A re-coupling of U.S. and foreign growth prospects (see Foreign Stocks) could therefore become a strong counterweight to the dollar's decline. Much will depend on how the U.S. economy responds to recent expansionary monetary and fiscal policy. Assuming the response is robust, U.S. growth prospects will rebound and foreign appetite for U.S. assets will follow. Additionally, foreign governments may be encouraged to buy dollars as their economies weaken, in an effort to reinvigorate demand for their products by devaluing their currencies.

Figure 2. The U.S. Dollar Index (USDIX)



The Bottom Line: The Image is Clearing

In the time that has passed since the last commentary, there has been downside news on both the economy and the markets. On the positive side, there is now much less uncertainty than there was before. We now have a clearer picture of what we are facing, and that is a good thing. As I mentioned above, the down phase of the business cycle, or of the stock market cycle, is only to be dreaded by those who cannot control their fear. For those who can, it is the time when bargains can be found, the time when the brave position themselves to reap the full value of the next inevitable expansion. This is what we will be endeavoring to do here at Green Investment Management. And we will continue watching the situation closely in order to respond quickly to any changes in outlook. As always, we send thanks to those of you who are our clients. We appreciate the trust you have placed in our firm to manage your money and we sincerely appreciate your business. If you have any questions or concerns, please don't hesitate to give us a call. 🐾

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