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## Market Commentary

A Review of the Markets and a Look into the Future

### What's That Bright Point Up Ahead?

*I saw the light, I saw the light  
No more darkness, no more night*

*- Hank Williams*

#### **Economic Outlook: A Heroic Feat for Bernanke?**

Federal Reserve Chairman Ben Bernanke's predecessor, Alan Greenspan, laid the foundation of his considerable reputation with a widely lauded handling of the first crisis of his tenure, the October 1987 stock market crash now known as Black Monday. The economy emerged from that crisis nearly unscathed, and Greenspan emerged as a hero.

We have watched the first crisis of Bernanke's tenure play out in recent months as credit markets have become increasingly dysfunctional in the wake of the sub-prime mortgage crisis. The dysfunction reached a fevered pitch in mid-March as Bear Stearns, one of the nation's largest investment houses, teetered on the edge of bankruptcy. Worried clients and creditors were pulling cash from the firm, creating an old fashioned, self-reinforcing "run on the bank".

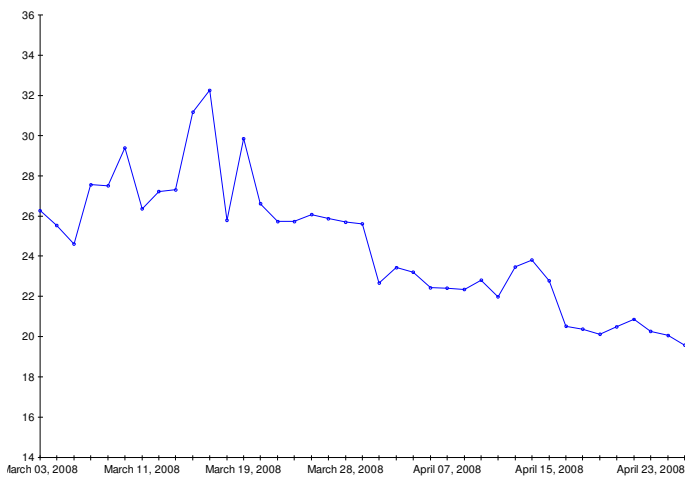
Bernanke and the Federal Reserve, having endured criticism for underestimating the extent of the sub-prime fall-out, acted decisively. Reasoning that a failure of Bear Stearns could start dominoes falling throughout the financial economy, they brokered a sale to J.P. Morgan Chase & Company. The Federal Reserve agreed to provide up to \$30 billion in financing to make the deal happen.

Additionally, the Federal Reserve exercised one of the broadest expansions of its lending authority since the 1930's by allowing securities dealers to borrow from the Fed for the first time ever, on much the same terms as banks do. In the long run, the development of these new tools to help the Federal Reserve deal with increasingly complex problems, some outside of the traditional banking system, may be seen as a watershed in how they manage the economy.

Although some have questioned whether the Federal Reserve overstepped its rightful bounds, there are signs that these actions have helped stem the runaway crisis of confidence gripping the financial markets. Many now believe the credit market has passed through the darkest moments of the sub-prime crisis, and that light is visible ahead.

On the consumer side of the economy, the picture is not as rosy. High food and gas prices helped push the Reuters/University of Michigan consumer sentiment reading for April to its lowest level in more than 25 years.

In the coming weeks, the federal government's economic stimulus checks should begin landing in taxpayers' mailboxes. This may help consumers to get out of their current negative mood.



**Figure 1. The CBOE Volatility Index (VIX: Daily Adj. Close)**

Overall, the positive developments in the credit market has many economists now expecting the current slowdown to be relatively mild and the U.S. economy to begin improving in the second half of 2008, before picking up steam in 2009.

Most observers expect another quarter point interest rate cut at the next meeting of the Federal Open Market Committee, on April 30. But due to a more positive outlook in the credit market, and increasing oil and commodity prices, the Federal Reserve is beginning to set its sights on inflation. The Committee may send a signal that the current round of rate cuts is at or nearing an end.

### **U.S. Equities/Asset Allocation:**

Looking back at the track of the S&P 500 over the past few months, the data point at January 23 stands out. On that day, the S&P 500 hit an intraday mark of 1,270 and the Dow Jones Industrial Average hit 11,645. We believe these were important bottoms in the current market cycle. Subsequent re-testing of these lows in March failed to break through, increasing the odds that they will hold again if tested.

Recent improvements in the levels of the Chicago Board Options Exchange Volatility Index (VIX) are supportive of this view. The VIX (shown in Figure 1) measures the level of volatility expected in the stock market over the upcoming thirty days, based on the behavior of stock index futures prices.

The VIX is essentially a measure of investor fear. It has recently been subsiding from significantly elevated levels in mid-March.

Credit spreads (the difference in yields between corporate and Treasury bonds of similar maturities) have also contracted, reflecting investors' willingness to require less of a yield premium to take on additional risk. These measures of improving investor confidence are an important first step for a market trying to carve out a bottom from which to stage future advances.

What has caused this apparent easing of investor anxiety? We expect the most significant factor has been the rapid and robust response by the Federal Reserve to the credit crisis that in mid-March was threatening to engulf the entire financial system and possibly cause a deep recession (see Economic Outlook above).

These encouraging developments have allowed us to become much more constructive on the outlook for domestic stocks in the coming months. We also realize there may still be some bumps in the road ahead. Earnings for the 1<sup>st</sup> quarter are still being reported and while there have been some positive surprises, there have been more disappointments. In the final analysis, earnings for the quarter may decline as much as 10-15% and GDP growth will probably register around zero. If the earnings forecasts hold, it will be the first time since mid-2001 that the S&P 500 has experienced three consecutive quarters of negative profit growth. The weakness the stock market has experienced in recent months reflects these expectations. Fortunately, the market usually begins advancing an average of seven months ahead of a turn in the earnings cycle, according to a recent study by Goldman Sachs. Standard and Poor's is forecasting more favorable earnings comparisons in the second half of the year, with a total gain in earnings of 11.8% for 2008. A near-term advance in stock prices would therefore be reasonable to expect.

Just how attractive are stocks currently? The S&P 500 index stands virtually unchanged from its January 1, 2000 level (1,401 then, 1,399 now). Excluding dividends, that is almost nine years of

flat performance. During this time S&P 500 operating earnings have risen 60%, indicating a possible source of upward price pressure.

Additionally, Table 1 shows total return performance for nine different asset classes over the 10 years ended March 31, 2008. The S&P 500 has been the poorest performing class over the period.

This picture appears to be upside down versus what one would expect for large cap equities, especially compared to Treasury bonds and Treasury bills. It is very unusual for the S&P 500 index, composed of some of the largest and most successful companies in America, to be beaten over such an extended period of time by low risk fixed income instruments. This tells me that investors have paid their dues for the late 1990's stock boom. Now stocks appear much more attractively priced.

Index	10 Year Annualized Returns
Dow Jones Wilshire REIT Index	11.4%
DJ AIG Commodity Index	10.4%
MSCI Emerging Market Index	9.7%
Lehman U.S. Gov't Long Index	7.5%
MSCI EAFE Index	6.2%
Lehman Muni Bond Index	5.0%
Russell 2000 Index	5.0%
3 Month Treasury Bill	3.6%
S&P 500	3.5%

**Table 1. Comparing performance of alternative asset classes (data source: Morningstar)**

The flight to the quality of Treasury notes in recent years has bid up prices and driven down yields for these bonds. That leaves the S&P 500 with its greatest relative value in relation to Treasuries in years. The S&P 500 currently has an earnings yield (trailing 12 months earnings/price) that is 60% greater than the 10-Year Treasury bond (6% versus 3.7%, respectively). This is one of the best relative values in over a decade and should offer a

significant long-term advantage to equity investors. I suspect when we look back on the performance of domestic stocks a decade from now, we will see a much better picture than shown in Table 1.

As a result of this positive outlook, our Guardian and Opportunity allocations are currently at a neutral position relative to our benchmark allocation of domestic and international equities. This is a significant change from the situation prior to mid-March, when we held considerable cash and hedged positions in these portfolios.

Zooming in to look at things from a sector perspective, there has been a clear trend toward outperformance in the materials, energy and utilities sectors. Additionally, a weak dollar combined with strong overseas economic growth has contributed to solid international sales and healthy earnings comparisons for the consumer staples and information technology sectors. Meanwhile, companies that are heavily reliant on the domestic economy are mostly struggling to keep pace with prior earnings forecasts. Going forward we expect to see continued strong performance in the information technology and basic materials sectors, and in exports generally.

We are currently neutral on growth vs. value in our portfolios, but are over-weighted in small caps, relative to the benchmark. We expect a more robust recovery from the small-cap segment of the market in the coming months. From an international perspective, in our Guardian Country allocation we are currently holding iShare exchange traded funds focusing on Mexico, Taiwan and Spain

### **Bonds: A Sea Change in the Markets**

With a general feeling that the worst-case scenario of the credit crisis has been avoided, bond investors have been in a selling mood lately. The expectation remains that the Federal Open Market Committee is most likely to indulge its fear of a recession and cut interest rates at the next meeting (see Inflation section below). But the bond markets are already looking toward a post recession recovery period. Ten-year Treasury rates have climbed from 3.3% to 3.8% in just the last month, putting downward

pressure on prices. Expect more of the same if the economy gains momentum as the year progresses.

In recent weeks we have moved to significantly increase our exposure to high income bonds while reducing our Treasury positions. In our opinion, high yield bonds offer a much more attractive value at current price levels. Municipal bonds, in general, also share an unusual yield advantage to Treasuries at present, and our positions reflect this.

### **Inflation: A Growing Worry**

In recent weeks many investors have begun re-allocating their anxiety away from the credit crisis and toward inflation. While the slowing economy has put downward pressure on many prices (i.e. houses, automobiles), skyrocketing oil and food prices are beginning to worry central banks across the globe. Prices of basic foodstuffs such as rice are being driven markedly higher by a combination of transportation fuel costs, expanding bio-fuel production, weather and hoarding. This is particularly worrisome in developing nations that have populations that depend upon these staple foods to survive.

Increases in energy and food prices will become more obvious in advanced nations as their economies turn the corner, because at that time there will be fewer price decreases to offset the core inflation. While most traders are still betting that the Federal Open Market Committee will see recession as the biggest worry, and cut rates a quarter of a point at the April 30 meeting, there is a feeling that inflation is looming ever larger on the Federal Reserve radar. Many expect a rate cut will not come without a fight among the committee members, and a possible signal to not expect any more cuts for awhile.

### **The Bottom Line: Every Silver Lining Has its Dark Cloud**

When economic prognosticators with names like Alan Greenspan and Martin Feldstein say that the

current economic slowdown could become a long and severe recession, people get worried. The unfolding of the sub-prime mortgage debacle even had some people using the dreaded "D" word (Depression. Don't say it out loud). Fortunately, the Federal Reserve's actions in response to the near failure of securities giant Bear Stearns in March appear to have calmed things down quite a bit. It appears that Federal Reserve Chairman Ben Bernanke, who spent an academic career trying to figure out ways the Great Depression could have been avoided, was given the test of his life when he faced down the current credit crisis. So far, it appears he passed.

But just as every rose has its thorns, the economic news is not uniformly good. Receding concerns in the credit markets have been mirrored by rising concerns on the inflation front, with oil and food staging particularly worrisome advances of late. As investors, both good economic news and bad economic news can be used to our advantage if we react correctly. That 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 that 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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