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## Market Commentary

A Review of the Markets and a Look into the Future

### A Lesson from a Lion While We Wait for a Bull

*"Courage! What makes a king out of a slave? Courage! What makes the flag on the mast to wave? Courage! What makes the elephant charge his tusk in the misty mist, or the dusky dusk? What makes the muskrat guard his musk? Courage! What makes the sphinx the seventh wonder? Courage! What makes the dawn come up like thunder? Courage! What makes the Hottentot so hot? What puts the "ape" in apricot? What have they got that I ain't got? Courage!"*  
- the Cowardly Lion in the Wizard of Oz

#### **Overview: Looking ahead, somewhere over the rainbow**

Like the lion in *The Wizard of Oz*, the current bear market could use a shot of courage in order to become the bull that we all love. In the meantime, it will take brains to see past the current circumstances to the rainbow that lies beyond. Those who do will realize that a bear market is filled with long-term opportunities, but it will take nerve to act on them.

What precisely is the trouble with the current stock market? It seems there are many concerns, but the thorniest of them have roots in the last financial crisis – the technology bubble of the late 1990's. In the wake of that bubble's collapse, and the chaos and fears brought on by the September 11 terrorist attacks, the Federal Reserve held interest rates artificially low. This achieved the desired result of dampening the fallout from those shocks, but in so doing it sowed the seed of the housing bubble and its collapse, which we are now dealing with.

Frenzied demand for real estate, fueled by low interest rates, inflated the bubble. Mortgage originators began practicing aggressive lending practices with loans that were pawned off to unsuspecting buyers across the globe through securitization.

The upswing in new debt creation stimulated economic activity and employment growth. But in 2006, new borrowers became increasingly hard to find and the collapse began. This caused liquidity to

decrease. Defaults and foreclosure activity increased as ARM interest rates reset higher. This is now causing bankruptcy and foreclosure for many borrowers, especially those who arrived at the party late.

During 2007, nearly 1.3 million U.S. housing properties (about 1% of all outstanding mortgages) were subject to foreclosure activity, up 79% from 2006. The severity of the decline in housing prices is now threatening the profitability and solvency of many banks. This is resulting in a dramatic reduction in new lending as banks attempt to protect their balance sheets from further losses. This situation, and the negative mindset it helps engender among consumers and business people, continues to be the primary impediment to the economy and the stock market.

Adding to these strains, inflation has gained a foothold in the economy. The consumer price index jumped 1.1% in June and is up 5% from a year ago, the most since 1992. Companies are having difficulty passing along these cost increases, so profit margins are getting squeezed – more bad news for the stock market. A weakening dollar serves to compound the inflationary pressures even more.

Other problems for the stock market to deal with include a presidential election that could significantly change the tax landscape for investors, as well as the possibility of a global economic slowdown.

As usual, there is no shortage of opinions on the likely outcome of each of the aforementioned problems. This

has resulted in significant uncertainty and volatility in the market, and we now have our first bear market in over five years. Improved clarity on one or more of the major problems has the potential to provide greater clarity to the other problems. At present these factors are feeding of each other for better or worse.

## The Stock Market

*“Lions and tigers and bears! Oh, my!”*

- Dorothy

The market peaked over nine months ago and has dropped over 20% since, as shown in Figure 1 below. In this environment it's hard to blame people for seeing danger around every corner. This attitude helps reinforce a weak market by way of self-fulfilling prophecy. But in this type of environment successful investors lay the groundwork for superior returns by having the courage to buy when buying is not fashionable, before a new herd of bulls starts to run.

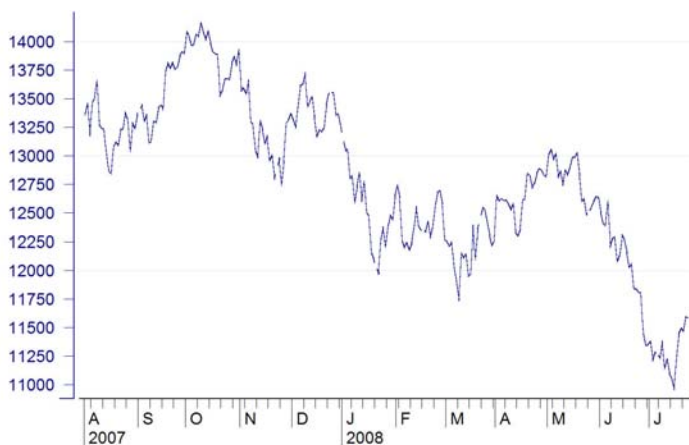


Figure 1. The Dow Jones Industrial Average

It is important in times like these to remember that the stock market enjoys a reverse-law-of-gravity. Things can go down for awhile, but eventually, and over the long haul, the market's natural direction is up.

*“The first question to ask yourself is whether or not you have faith in the long-term growth of our country. Growth that has continued since 1776 based on our democracy and free enterprise system. .... If you do have faith in our country, ask yourself one major question: Would you rather buy stocks after they have*

*been going up for a long time or after a long decline? Bear markets occur approximately every four to five years and do one very good thing — they create great buying opportunities for the long term.”*

- Al Goldman, Chief Market Strategist for Wachovia Securities, July 15, 2008

The market is closely watching the price of oil. A sustained retreat in oil prices would likely trigger an opposite move in stocks, and vice versa. In the past week oil has backed off of its recent highs. Financial and consumer stocks responded positively, while energy stocks declined. It is too early to consider this situation a trend. If it is, it will be a welcome one, as it should help relieve inflation fears and make the market's recovery that much easier.

## Elections: One uncertainty that's certain to be resolved

Short of an electoral quagmire reminiscent of the Bush/Gore stalemate in 2000, the elections (and election year uncertainties) will be decided in November. While the markets famously fret about the election of a Democrat, Ken Fisher, a financial columnist for Forbes, has some interesting insight on the connection between elections and stocks:

*“The U.S. has a long history of elections and S&P 500 returns, and the pattern is pretty clear. First, years in which Democrats capture the White House are usually bullish years for the stock market. Second, inaugural years following a Democratic win in November are better than Republican inaugural years. There is a reason for this pattern. The market expects the worst of a Democratic President and then discovers that he's not so bad for investors. It tends to rebound after the initial premonitions that a Democrat will win. On the other hand, Wall Street expects the most of a Republican and is disillusioned after the election.”*

- Ken Fisher, May 19, 2008

## The Banking Sector: Still working the kinks out

Five banks have failed in the U.S. so far in 2008, the most in any calendar year since 2002. The Federal Deposit Insurance Corporation (FDIC) has 90 banks

currently on its list of problem banks. The recent failure of IndyMac Bank, a giant mortgage lender, and troubles at Fannie Mae and Freddie Mac illustrate how severe the stresses on the financial system still are. But swift, decisive action by both the Federal Reserve and the Treasury Department has calmed the waters in previous periods, creating inflection points for temporary market reversals. Further actions will bring the possibility of a reversal that will stick.

Current problems must also be kept in perspective. During the five years from 1987-91, a total of 1,901 banks and savings & loan institutions failed in the U.S. That is a rate of more than one per day. And in the three-and-one-half years following the stock market crash of 1929, a total of 9,096 U.S. banks failed, more than one out of three (source: FDIC).

### **Inflation: Will the oil spike run out of gas?**

Inflation news of late has been one of contrasts. June consumer inflation has risen sharply to a six month rate of increase of 5.5%, the highest since 1992. But the core rate, which excludes food and energy, has risen at a more moderate rate of 2.4%. This means that the source of much of the inflation picture has come from the oil market.

After a stunning string of increases, oil prices over the past few days have fallen almost \$20. This is a sign that demand is starting to moderate as consumers find ways to reduce their energy usage. This demand response, along with a slowing economy, will make it much harder for oil to be an ongoing source of fuel for overall inflation.

The recent widening of credit spreads may also work to reduce inflationary pressures in the coming months. Considering all of these factors, we expect that as we move into late 2008 inflationary pressures will subside from current levels.

Currently, the Federal Reserve is in the difficult position of having to plan monetary policy with an eye on balancing concerns about both economic growth and inflation. Ameliorating one of these problems tends to worsen the other. There are indications that the Federal Reserve Open Market Committee, which sets monetary policy, is divided on the subject of

whether economic growth or inflation is the greater evil right now. If inflation does recede, it would help prevent any current division from boiling over into real conflict.

### **Dollar: As currency goes, so goes the economy**

We remain mired in a bear market for the dollar, which has lost a third of its value since 2001, as measured by the U.S. Dollar Index (see Figure 2 below). As always, declines in the dollar have the redeeming side effect of fueling demand for American exports by making American products less expensive to foreign buyers. The other side of this coin is that American buyers have to pay more for foreign products, which helps fuel the inflation specter that is currently haunting U.S. consumers.



*Figure 2. The U.S. Dollar Index*

Recent days have seen some stabilization of the dollar, particularly on Treasury Secretary Henry Paulson's comments expressing support for a stronger dollar. But there remains a long way to go before we can say that this bear has been vanquished.

The value of a nation's currency has derivative value as a general indicator of the amount of confidence traders have in that nation's economy. When we see the dollar make a definite turnaround, it will be a good indicator that the overall economy is not far behind.

### **Housing: Don't let the numbers fool you**

Housing starts jumped 89,000 units in June, but these gains were driven by multi-family issuances largely resulting from a one-time change in New York City building codes. Single-family starts and permits once again declined, although the pace of decline has slowed. Mortgage applications are down 20% from last year's levels, but stable within recent ranges. Overall, we expect that housing activity will remain weak at least through the summer.

### **Economic Outlook: Slowing to a crawl to avoid a crash**

The economy is likely to remain soft through most of this year, with weak GDP growth and rising unemployment. The pundits can argue over whether such a state of affairs qualifies as a recession, a "growth" recession or deserves some other such moniker. As William Shakespeare understood, a rose by any other name is a still a rose, and the outlook for the rest of 2008 is not an especially rosy one. We expect consumer spending to slow as the stimulus from rebates fades. The housing market and the resulting tight credit will continue to be a drag on the economy. But exports and spending on the war should continue to support a small amount of growth.

Like Dorothy, who experienced many setbacks and challenges while making her way back home, we maintain confidence that the economy is on the right path, not too far removed from its recovery. We anticipate significantly better growth prospects in early 2009.

### **The Bottom Line: Don't be fooled by smoke and mirrors**

*"Read what my medal says: 'Courage.' Ain't it the truth? Ain't it the truth?"*

*- The Cowardly Lion*

In the Wizard of Oz, Dorothy and her friends learn that the wizard is not as frightening as he appears to be, and that what they needed was inside of them all along. As investors we should take a lesson from this.

The U.S. economy, despite some weaknesses, still possesses wellsprings of strength from which to begin the next growth phase. Brains and courage are needed to get positioned correctly before it begins. Getting to where we want to be will not be as simple as clicking our heels together. But one thing is the same for us as it was for Dorothy. First, we have to believe.

We will continue watching the situation closely here at Green Investment Management 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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