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## Market Commentary

A Review of the Markets and a Look into the Future

### The Financial Crisis of 2008: A User's Guide

*"An investment in knowledge always pays the best interest."*

Benjamin Franklin

#### Overview: Where do things stand?

Leave it to old Ben Franklin to have the perfect advice for troubled times like these. In a crisis situation, those who keep their heads on straight are the ones who will prosper. The best way to keep your head on straight is to fill it with a sound understanding of what is going on around you. To that end, we are focusing this edition of the quarterly commentary on the problems gripping the world's financial system. While we don't have the space for a dissertation-length analysis, we hope to provide the kind of bird's eye view with which an investor can weather the storm and be positioned for success in the clear skies that will eventually return.

In the meantime there is no shortage of bad news. Last week, panic selling drove U.S. and foreign stocks down into territory not seen in quite a while. The S&P 500 experienced its largest weekly decline in 75 years. Many major indices lost between 15% and 18% of their value over the course of the week. On Friday (October 10) alone, stocks traded across an astounding range of 1,000 points, and 87% of NYSE stocks set new 52 week lows. An indication of how grim investor psychology is can be seen in the fact that many observers were relieved the Dow ended the day down *only* 128 points.

Amid the rampant fears holding sway over investors, the 1929 stock market crash and the Great Depression that followed are being regularly evoked in the media. But while the current financial crisis is certainly real, the reasoned outlook is quite different from what the country experienced in the 1930's.

Just as the medical profession's understanding of diseases and how to treat them has advanced greatly in the last seventy years, so has an understanding of the economic and financial system. As Nobel Laureate economist, Milton

Friedman, said of the attitude of the Federal Reserve governors in the '30s:

*"They tended to regard bank failures as regrettable consequences of bad management and bad banking practices, or as inevitable reactions to prior speculative excesses, or as a consequence but hardly a cause of the financial and economic collapse in process."*

Partly as a result of this attitude, over 9,000 banks failed during the Great Depression, erasing more than one-third of the nation's money supply. The dreadful consequences such a decline implied for the economy were not well understood in that day. Fortunately, today the government recognizes its responsibility to take action to shore up the financial system before it implodes. As a result, a massive and orchestrated effort is underway to do just that, and in the process confidence should eventually be restored.

There is also late breaking good news. As this is being written (Monday, October 13), the Dow is rebounding to its greatest one day point gain in history (963 points). But before going any further, let's take a step back and try to put this whole situation into perspective.

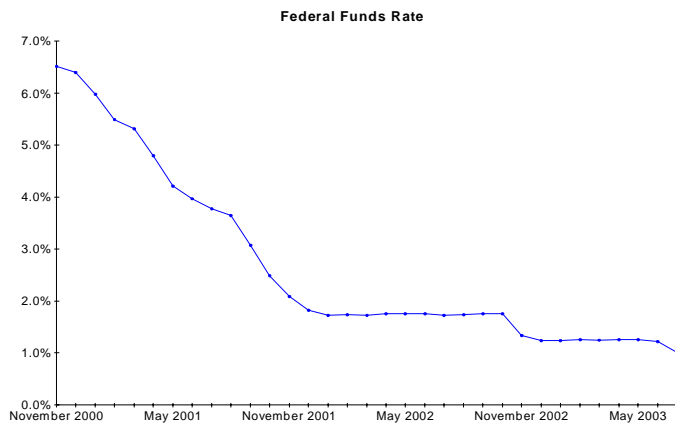
#### From Bubble to Bubble: A Brief History

The seeds of our current woes were sown in the last recession. In the wake of the 2000 tech stock collapse and the recession that followed, the Federal Reserve began lowering short term interest rates, eventually driving them down to a mere 1% (see Figure 1).

These historically low rates became fuel for an unprecedented housing boom, wherein buyers and lenders, in classic bubble psychology, made decisions based on the assumption of ever rising home prices. When this

assumption proved false, many institutions found themselves holding bad mortgage debt. As the bad debt grew, balance sheet write downs and financial institution failures followed. Fear gripped the system and credit tightened as if in a vise. Slowly everyone came to the realization that the healthy operation of the overall economy was at stake if radical steps were not taken.

Figure 1. The Federal Reserve drove interest rates down to 1%



The announcement on September 19, 2008 of the Treasury's proposal to purchase some of the bad mortgage assets weighing down the books of financial institutions was met with optimism on Wall Street. However, its surprising defeat in the House of Representatives shattered this optimism and sent the Dow Jones Industrial Average down more than 700 points. As Congress debated the merits of the proposal for two more weeks, the credit crisis continued to spiral out of control. On October 3, 2008, Congress finally passed the bill, but the delays proved costly as conditions worsened and more institutions failed both here and overseas.

To summarize recent negative conditions:

- Housing prices have continued to decline, putting added pressure on homeowners and financial institutions.
- There have been runs on deposits at several banks and money market mutual funds.
- Several large financial institutions (Indymac Bank, Freddie Mac, Fannie Mae, Bear Sterns, Merrill Lynch, Lehman Brothers, Washington Mutual, Wachovia, AIG, Countrywide) have either filed for bankruptcy, been forced to combine with stronger companies, or have been rescued by the government.
- Money market mutual funds and other investors, often under liquidity pressure themselves, have become increasingly reluctant to purchase commercial paper, putting a severe strain on the ability of corporations to meet short term financial needs.
- The unwinding of excessive leverage has forced

investment banks, hedge funds and individuals to sell stocks, commodities and corporate bonds in order to raise cash.

- The fear gripping investors has created extreme aversion to risk. Short-term treasury bills are now yielding almost 0%, as the flight away from "risky" assets has overwhelmed risk-free investments.

There are increasing signs the economy is getting weaker and is or soon will be in recession.

### The Government Response: A Timeline

As the severity of the crisis has revealed itself, governments have taken more far-reaching steps to address the problem. Here are some of the recent responses to the emergency occurring here and around the world:

**September 19:** The U.S. Treasury announces a guaranty program for money market mutual funds, effectively stopping a run on these assets.

**October 3:** The U.S. Congress and President Bush approve the Troubled Asset Relief Program (TARP) authorizing the Secretary of the Treasury to spend up to US\$700 billion to purchase distressed assets. Considering that Goldman Sachs estimated the troubled residential mortgage debt in the system at \$1 trillion dollars, this program should be enough to soak up a substantial portion of the non-performing debt and provide badly needed capital for banks.

**October 6:** The Fed announces that it will pay interest on reserves. This policy allows the Fed to expand the amount of reserves it provides without affecting its target interest rate, separating the provision of liquidity from monetary policy.

**October 7:** FDIC coverage is increased from \$100,000 to \$250,000 until December 31, 2009 - diminishing fears large depositors may have had about their bank's stability.

To help free up the commercial paper market, the Federal Reserve says it will purchase three-month unsecured and asset-backed commercial paper directly from issuers through its newly created Commercial Paper Funding Facility (CPFF).

**October 8:** In an unprecedented coordinated effort, the U.S. Federal Reserve, European Central Bank (ECB) and four other central banks lower interest rates to ease the financial crisis.

**October 10:** U.S. Treasury Secretary Paulson announces that the government will initiate a program to buy an ownership stake in a broad array of American banks for the first time since the Great Depression. This policy can be implemented much quicker than the program to purchase bad debt.

**October 11:** Officials from the Group of Seven countries

(G7 - France, Germany, Italy, Japan, United Kingdom, United States of America and Canada) meet in the U.S. and issue a five-point coordinated plan, vowing to do whatever is necessary to prevent systemic failure in the global financial system. As Treasury Secretary Paulson puts it, the G7 committed to an “action plan that provides a coherent framework that will direct our individual and collective policy steps to provide liquidity to markets, strengthen financial institutions, protect savers and enforce investor protections.”

**October 12:** At an emergency Sunday summit of leaders of the 15 Euro-zone countries in Paris, European governments agree to guarantee bank refinancing and new bank debt until the end of 2009. They agree to help banks by buying preferred shares, and to rescue important failing banks through emergency recapitalization.

### Where Does That Leave Us?

So far, all of these steps have not been sufficient to get credit markets functioning normally again. In some ways, the multitude of steps taken, while necessary, may have actually heightened the fears of investors, by highlighting the seriousness of the crisis we are in.

But it should also be remembered many of these programs have not had time to be implemented yet. As they are implemented in the coming weeks we should see direct positive results in the credit markets.

As the crisis has increased in magnitude and scope, the policy reactions by central banks and governments have grown steadily more comprehensive and coordinated. This is impressive, and gives reason to hope that credit flows will revive soon. As a further indication of the appropriateness of the response, an October 13 report from Goldman Sachs concluded that “A little over a year into the acute part of the crisis, all four pillars of the policy mix that eventually resolved the Japanese crisis after a full decade are (already) visible to varying degrees in the United States.”

### Looking Ahead: Equity Markets

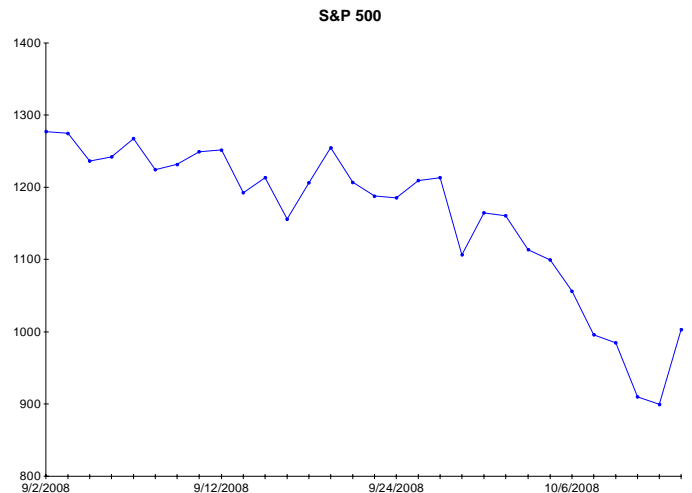
*“What if you concluded then (in the 1930’s, the worst stock market ever) that stocks weren’t the best place to be? You’d have missed out on decades of bull markets.” - Alan Skrainka, chief market strategist for Edward Jones*

There are several factors that support the case that the worst of the decline in equities is behind us. Here are a few points to consider:

**1. Bears are likely getting winded.** Having declined 42% from its high, the current bear run in the S&P 500 has well exceeded the average bear market decline of 34.1% and is approaching the severe 48% and 49% declines of the 1973-

74 and 2000-02 bears. Recent declines in the S&P 500 have brought us to within 100 points of the lows of the 2002 bear market - a level that if reached should provide some technical support.

Figure 2. The S&P 500 over the last six weeks



**2. Valuations are looking attractive.** Barclays Capital asserts that equity valuations are at levels that historically deliver high long-term returns. Trailing price-earnings ratios for global equities are half what they were a year ago. This is true even with financials included in the calculation. The FactSet World Equity Index generated a trailing P/E ratio of 18 in October 2007. That has now fallen below 9. We find similar values in the U.S., with the S&P 500 priced at 12.9 times trailing earnings and 8.6 times forward earnings.

### 3. Signs of capitulation are appearing:

Severe selling in some of the highest quality names near the end of last week suggests a selling climax may be near. Lows are often made when investors are forced to sell their favorite high-quality holdings in order to meet margin calls.

Another sign that capitulation may be near can be found in extreme readings of the VIX Volatility index (“fear index”), a popular measure of the implied volatility of S&P 500 index options. The current reading of 76.9 is the highest since October 1987 and is consistent with the climax of a selling panic.

We are seeing an extreme level of risk aversion that is consistent with a market bottom. During the most recent week, T-bill yields went negative at one point as investors were actually willing to pay for the security of owning a T-bill.

According to FusionIQ, investors’ current allocation of cash is at the highest level since ’02, ’98 and ’90 market bottoms.

**4. Pressure from high oil prices has subsided.** In the last

few weeks oil prices have fallen about 45% to \$80 per barrel. A new report from Deutsche Bank suggests that crude may fall further, to the \$60 range, as the economy weakens. That would represent a gasoline price of just over \$2 per gallon.

**5. The stock market should lead the recovery.** Although many economists now expect a weak economy for most of 2009, that doesn't mean the stock market will be weak. The stock market typically begins rising in anticipation of an economic recovery, not in reaction to one.

**6. Don't be caught on shore when the tide starts rising.** In an October 10th publication titled *Looking Ahead*, Wachovia Securities notes that "historically, the average 12 month performance of the S&P 500 from the troughs of the 10 official recessions is about 33.1% (according to Haver Analytics)."

### Looking Ahead: Credit Markets

If we think of sub-prime mortgages as ground zero for the current crisis, the credit markets represent primary fall-out zones. Thus we are seeing some unprecedented things in this area. The size and the speed of recent declines in corporate bond prices have been extraordinary. According to Garman Research, based on some measures the drop in high yield bonds that occurred in September (the largest monthly fall ever) should have occurred only once in 27,777 years.

October has continued the downward trend. Through October 10<sup>th</sup>, the Merrill Lynch High Yield Master Index II declined 23.2% year-to-date, and is now yielding 18.25%.

The current state of the high yield bond market reflects forced de-leveraging, cash hoarding and panic selling. The current 15.4% interest premium over Treasuries is the highest on record. Such a premium is sufficient to offset a 17.5% default rate into perpetuity with normal recovery rates, or more than a 11.4% default rate into perpetuity with no recoveries – both unreasonable to expect, in my opinion.

On October 8th, Moody's projected global default rates of 7.9% by this time next year. During the S&L crisis in 1990, default rates rose to 10% for one year and fell rapidly over the next several years. In 1991, as the credit outlook improved, the Merrill Lynch Index II returned 39.2%. In light of this, we expect outstanding opportunities in the credit markets going forward.

*(Please note, you cannot invest in the Merrill Lynch High Yield Master Index II, it is presented simply as a benchmark for historical returns. Past performance does not guarantee future success and investing in corporate bonds involves risk.)*

### Conclusion: First knowledge, then power

*"I always say you should get greedy when others are fearful and fearful when others are greedy." - Warren Buffet*

Despite the cries from some frightened corners, this is not 1929. While government officials will need to continue to take aggressive action to prevail over the current crisis, they realize the seriousness of their task and appear ready and willing to do what is necessary to unfreeze credit markets. The TARP and CPFF programs, in particular, should begin to take effect and provide relief soon.

There are many indications the bears rampaging through equity and credit markets are on tired legs. Great values should abound. I expect many buyers are waiting on the sidelines for confirmation credit markets are beginning to respond to the massive policy efforts that have been undertaken around the world.

Nonetheless, these are difficult times, for both us and our clients. Everyone is concerned and anxious about what is happening and what it means for our portfolios and our lives. We are listening carefully to our clients' concerns and guiding them in making rational decisions about their portfolios.

Be especially careful to avoid making decisions driven by panic. Knowledge and rationality are the keys to success. In the history of our great country we have always recovered from difficult periods, and this one should be no different. I expect one day, when our grandchildren ask us about the financial crisis of 2008 that they read about in school, we can tell them how we kept our cool and came out on top when the dust settled.

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 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. 🐮

*The views expressed are those of Byron Green as of October 15, 2008, and are subject to change. The information contained herein does not constitute investment advice or take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Additionally, this publication is not intended as an endorsement of any specific investment. Information contained herein is derived from proprietary and non-proprietary sources. We encourage you to consult with your tax or financial advisor.*