

*By Jeffrey G. Johnson*

### Challenging Times

The crisis that gripped the world's financial landscape in 2008 sent shock waves through the stock and bond markets, fundamentally reshaping Wall Street and forcing unprecedented government action. With massive Federal bailouts and the collapse of some of the most prominent names in the financial industry, this past year qualified as the third worst decline for domestic markets in the past one hundred years. The S&P 500 ended the year with a total return of -37%, having fallen a total of 52% from its October 2007 peak to its November 2008 low. International markets proved the decoupling theories (foreign markets independent of U.S. markets) remain a myth as they also experienced synchronized declines of -41% for the EAFE index and -48.9% in Emerging Markets.

Stalled economic activity and slackening demand sent commodity prices tumbling in the last few months of the year as oil plummeted from \$146/barrel to under \$40/barrel. Profit erosion, forced selling and scandal left no safe haven for equity mutual fund investors. Out of over 15,000 pure equity funds, not a single one posted an annual gain and the average loss was 36.5%.

The current recession is hardly mild in terms of duration or magnitude and economic statistics are likely to get worse before they improve. Unemployment is above 7% and rising, mortgage defaults are at unprecedented levels, and "deleveraging" on a global basis ensues. Housing is still in depression and the consumer is both tapped out and cautious. Historically however, even in the face of such dismal fundamentals, the stock market can and has made positive progress. Current investors may anticipate spending on infrastructure and rebuilding of inventories to gradually lead to recovery.

As the Fed targets 0% to 0.25% for the Federal Funds rate, the channels of credit remain constricted. Fears of credit defaults and deflation triggered a flight to safety at all costs (despite unfavorable yields approaching zero) causing long-term Treasuries to rally over 30%. This may continue for a period of time, but intuitively when the economy stabilizes and begins to improve, money will likely rush out of these conservative investments as fast as it flowed into them rendering Treasuries one of the worst investments in 2009.

To date, the Fed and Treasury have made nearly \$2 trillion of emergency loans in response to the economic crisis. Looking at just one example, in December Treasury Secretary Paulson made the unilateral decision to guarantee \$306 billion of Citigroup's assets, an amount equal to what our government spent in 2007 for the departments of Agriculture, Education, Energy, Homeland Security, Housing, Urban Development and Transportation combined. Even with the Fed "all in" and the government doing all it can to encourage renewed investment there is still an overhang of continuing economic difficulty that may require more write-downs, restructurings, and displacements.

The Financial Instability Hypothesis suggests that over periods of prolonged prosperity, capitalist economies tend to move from a financial structure dominated by hedge finance (stable) to a structure that increasingly emphasizes speculative and Ponzi finance (unstable).

Although the depth of the financial morass has made the investment environment one of the most challenging in generations, economic crises and sharp stock market declines serve to clear the excesses that previously dominated and distorted economic systems. While the current purging of excessive leverage and the derivative house of cards constructed over the last decade is painful, it is necessary and ultimately healthy for the U.S. and the global financial system going forward.