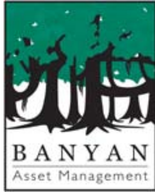

"Bear Market Opportunities"

Market Commentary – February 2008

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The U.S. Bureau of Economic Analysis calculates that Gross Domestic Product (GDP), a measure of the value of goods and services produced in the U.S., grew an annualized 0.6% in the fourth quarter. This represents a significant slowdown from 4.9% growth in the third quarter. Looking at all of 2007, GDP grew by only 2.2%, the slowest rate in five years. The Congressional Budget Office expects 2008 GDP to be 1.7%. In an effort to boost economic growth, Congress is trying to pass a $150 billion fiscal stimulus package which includes tax rebates to individuals and business investment tax credits.

Panicky stock markets worldwide helped drive the U.S. Federal Reserve to aggressively ease monetary policy in January. Making an already weak 2008 even worse, global stock markets plunged on Monday, January 18 and were tanking again on Tuesday due to fears that the U.S. economy is sinking into recession. In a surprise emergency move on the morning of the 19th, the Fed slashed its benchmark Fed Funds rate by 0.75% to 3.5%. This was the first intermeeting rate reduction since the September 11, 2001 terrorist attacks, and the steepest rate cut since 1984. Publicly, the Fed wrote that they "took this action in view of a weakening of the economic outlook and increasing downside risks to growth". Reading between the lines, the Fed was trying to prevent a collapse in the financial markets. Adding to the surprise reduction, the Fed cut the Fed Funds rate by another 0.50% to 3.0% on January 30. Futures markets see the rate dropping to 2.2% by July. A low Fed Funds rate helps to boost economic growth. The next Federal Open Market Committee interest rate decision is scheduled for March 18.

After a lackluster 2007, value stocks are outperforming growth stocks so far in 2008. Year-to-date market returns follow in the format of (entire index, value portion, growth portion): Large Cap S&P 500 (-6.1%, -3.7%, -8.4%); Mid Cap S&P 400 (-6.2%, -5.2%, -7.3%); and Small Cap S&P 600 (-5.0%, -4.0%, -6.1%). Contrary to growth investing, which often relies on stock price momentum, value investing is the attempt to buy a stock for less than what it is believed to be truly worth. For example, a good deal for a value investor would be buying a particular stock for $70 when it is calculated to be worth $100 (called "intrinsic value"). Buying stocks at a discount to intrinsic value provides a margin of safety, since an even lower stock price would likely attract more buyers to a stock which has become too cheap. With the economy on the verge of recession, it is prudent to maintain a margin of safety with stocks.

Technical factors of the market are bearish (more supply than demand), while fundamentals are attractively priced – therefore, we are mildly bearish on the market. The price-to-earnings (P/E) ratio for the S&P 500 has fallen to 17.2 from 18.6 a month ago. A lower P/E ratio implies cheaper valuations. The earnings yield (E/P) of the S&P 500 is 5.82%. Stocks are attractively priced relative to the 10-year Treasury note, which yields 3.64%. Should stocks fall further while earnings grow or stay flat, they would become increasingly attractive. At some point, value provides a floor under stock prices.

Key support levels were violated in January, thus defining the current bear market. According to the media, a market which is down 10% is in correction, while a market down 20% is a bear market. Technicians would say that a downtrend is a series of lower highs and lower lows, and that a bear market is a market in a downtrend. After breaking through support around 1400, the S&P 500 found its next level of support near 1300 (on a closing basis). When old support is broken, it becomes future resistance. Therefore, we expect significant headwinds as the market tries to push higher.

Bear markets do not have to last a long time, and they create excellent opportunities to buy stocks on the cheap. To not get lured into calling a bottom (or conversely a top), portfolios of individual stocks may be tweaked incrementally. With a balanced approach, rather than an "all or nothing" strategy (such as being 100% in cash or 100% invested), planning becomes more important than prediction.