

## **BONDS**

The massive expansion of the money supply (on a global basis) is bound to keep interest rates low for the foreseeable future. However, so much money has been created (literally out of thin air) in an effort to bring the economy back to life that it is bound (ultimately) to be inflationary. This means higher interest rates are in our future – likely to begin rising by late 2009 or early 2010. But for now, the stubbornly high Libor rate (that determines many business loans) is finally coming down. Mortgage interest is also dropping. Lower rates will eventually stimulate the flow of credit and begin to revive commerce.

Credit is the lifeblood of the economy. It gives businesses the ability to finance operations and inventories, pay expenses and meet salaries. Without the availability of credit, consumers cannot buy or upgrade homes, buy new or used cars, go on vacation, or finance other big ticket items. The financial panic inspired a flight to cash and short term U.S. Treasuries, pushing yields to extremely low levels. The Federal Reserve announcement that it will be buying long term bonds in the open market is doing the same thing to long term bond yields. At the same time, investors have eschewed corporate bonds (especially the high yield variety) and preferred stocks. The spread between high and low quality fixed income securities is setting records. Bottom line – it is a good time to sell U.S. Treasuries and buy high yield, lower quality bonds, preferred stocks and distressed securities, but broad diversification is imperative.

## **STOCKS**

Chaos, volatility and a vast knowledge vacuum rules the market. But we believe it is the buying opportunity of a generation, possibly a lifetime. Stocks are the next asset class to get inflated – the mass of money created liquidity sitting on the margin will go somewhere and with the dividend yield on the S&P 500 Index higher than that of the long Treasury bond (for the first time since the late 1950's), dollars will again flow into stocks, especially the ones with strong financials, low debt and healthy cash flows. Equities are selling as cheaply relative to other investment alternatives as they have since the crash of 1973 / 1974. The recovery will begin as the credit markets get sorted out. Derivative contracts, especially credit default swaps, the enormous profit makers for banks and hedge funds are going away. This may take several quarters, but it is inevitable – these elaborate synthetic securities were designed to avoid risk and emulate the returns of real investments. They can no longer be produced at a reasonable cost because they were based on assumptions that work in a normal investment environment. We have learned that their sophisticated formulas break down during times of speculative frenzy or bear market fear (just as the concept of "portfolio insurance" broke down in 1987).

You really have to feel sorry for shareholders of quality common stocks and funds. Most have saved frugally, done their homework, picked good companies or funds and bravely invested their hard earned dollars. Yet, despite the fact that most (particularly nonfinancial) companies have maintained strong balance sheets, and have operated efficiently and profitably, their stock values have been decimated. In a way, the equity market is an innocent bystander to this credit debacle – financial panics take no prisoners. Equity investors feel like they are living in an alternative universe – practically every stock index, whether tracking large, mid or small companies is down close to 40% this year (almost 60% at it's worst level) – historically, a market crash similar to 1973 / 1974. What has

made it so difficult is that virtually all other asset classes have been equally hammered – corporate bonds, mortgage bonds, real estate, commodities, international and emerging market stocks – all down even more. The only place to hide (like the '73 / '74 debacle) has been cash, municipal bonds or U.S. Treasuries.

The big question is – have we seen the bottom? Market bottoms are rarely a singular event – they are most often a process – sometimes lasting longer than investors think or expect. Market crashes are panic events – when irrationality plagues normal, calm, more organized thinking. This irrational disconnect can often persist for extended periods of time, but it does come to an end. The good news is that stock valuations (compared with the lows reached in other bear markets) suggest we are in this bottoming process, and unlike many other bear markets, there is a tremendous amount of cash on the sidelines, just waiting to jump in. There is also massive pent up, global demand for all the wonderful products Americans take for granted. Emerging economy consumers have saved; their currencies are strong – exports to emerging countries will eventually establish a base under all western economies, starting with the U.S.

Although (on paper) we are seeing some incredible values right now, it takes real courage to buy. We're well aware of the old adage: "buy low; sell high". Buyers now know what it feels like to buy low and it is not a pleasant feeling. Most investors are frozen in place, unable to act because of the unknowns. The inability to get financing imperils all business activity, especially capital spending. Over the years, merger and acquisition activity (M&A) has provided support for stock prices. When prices have dropped in the past as severely as now, companies with strong balance sheets buy up or merge weaker, troubled companies. But this time, there is no M&A because there is no credit – yet, but that day is coming soon.

Several "log jams" must be freed up before stocks, corporate bonds and preferred stocks begin to recover. First, the "mark to market" rule must be liberalized. This extremely severe accounting rule, emanating from the Enron / Worldcom debacle sets unrealistically low pricing standards on debt securities. Mortgage backed securities (MBS) held mostly by banks are being priced at unrealistically low prices based on liquidity rather than cash flow. An example of this is where, say 70% of the mortgages inside an MBS are paying on a current basis, but the mark to market rule dictates the price of the MBS at \$.20 on the dollar because it can't be sold in the market. The other \$.80 must be written off – charged against earnings and capital.

Second, credit must start flowing again, starting with short term commercial paper. In order for that to happen, there must be some transparency as to the amount of off balance sheet debt companies are shouldering; particularly credit default swaps (CDS - contracts that insure a security against default). CDS were allowed to exist in legal limbo – off-balance sheet. An investor may think he or she has a good understanding of a company's balance sheet, then an unknown CDS can emerge, gutting the healthy assets of the company, making the balance sheet irrelevant. The sheer size of CDS has spooked this market almost more than anything else – the "how many more shoes will drop" syndrome. One of the mitigating factors with CDS is that many companies are mutually liable to one another offering up multi-party CDS cancellation opportunities. All of this will be sorted out in time. Third, housing prices must stop falling with sales of existing homes re-invigorated. This is beginning to

happen in California and Florida – two of the hardest hit areas. Lower mortgage rates and lower gasoline prices will serve to hopefully keep this trend rolling.

### \$6.6 TRIL AND COUNTING

The unfolding financial drama we have witnessed over the last year is worthy of the Keystone Cops – all these supposedly brilliant economists and politicians bumping into one another in an effort to stave off depression and financial crisis. In an effort to avoid one calamity, they are in fact creating others by throwing good money after bad. The irony is that the cure is the same as the disease – caused in large part by the government socializing loss and privatizing gain. Popular media likes to blame greedy Wall Street bankers for their leverage largess, and those excesses are certainly part of the picture. But, the truth is – Wall Street firms had substantial encouragement to lever up.

First, government created GSE's (government sponsored entities - Fannie Mae and Freddie Mac) to liquefy the mortgage market by buying mortgages from banks and implicitly guaranteeing mortgage backed securities (MBS). The government imprimatur earned MBS higher quality status from the various rating agencies than was achievable on their own. Second, government (through the various banking regulators) required banks to increase low income lending via the affordable housing programs. Third, after 9/11, government lowered interest rates (Fed Fund down to 1%) and greatly expanded the money supply to avert recession.

These actions set the groundwork for banks and mortgage companies to originate as many mortgages as possible. They often ignored normal lending standards, knowing these low quality mortgages would not be held in their own portfolios – they could simply be passed off to the GSE's. Wall Street then jumped into the act by packaging mortgages to create MBS, pocketing big fees as they went along. Wall Street firms, banks and hedge funds also bought billions of the GSE backed MBS on margin (borrowed money). Recognizing that the degree of leverage was becoming dangerously high, along with a lack of diversification, Wall Street firms and other investors contracted with insurance companies like AIG to write credit default swaps (insurance against default). They thought they were wearing a "belt and suspenders" – ultra conservative, enabling even more leverage. The credit default swaps themselves, often purchased on margin were very profitable and liquid securities that piled up in portfolios.

Count up all the bailouts - loan guarantees, lines of credit, preferred stock purchases and other rescue programs:

JP Morgan (to purchase Bear Stearns)	\$29 billion
Fannie Mae and Freddie Mac	\$944 billion
AIG	\$152 billion
TARP (Troubled Asset Relief Program)	\$700 billion
Citigroup	\$249 billion
Fed purchase of commercial paper	\$271 billion
Money Market Funding Facility	\$600 billion
FDIC insurance for banks	\$1.9 trillion
Federal Term Auction Facility loans	\$900 billion
Federal Reserve discount window loans	\$297 billion
Auto Industry (proposed)	\$25 billion
Consumer credit card loans	\$200 billion
Treasury purchase of MBS	\$27 billion
Federal Housing Administration	\$300 billion
Local Communities	\$4 billion
Exchange Stability Fund	\$50 billion
<b>Total</b>	<b>\$6.6 trillion</b>

This massive, unprecedented government facility dwarfs the total of all government bailouts going back to 1970 - Penn Central, Lockheed, Franklin National Bank, New York City, Chrysler, Continental Illinois, the Savings & Loan debacle and the airline industry. Added together, prior bailouts totaled \$347 billion, just 5.3% of the current bailout. Some of the \$6.6 trillion new government facility may not be taken down or spent. A portion may be paid back (such as Chrysler) or even make a profit (like Lockheed). However, there are likely more bailouts and big government spending projects yet to be announced (such as infrastructure spending and other entitlement plans of the new administration).

Ultimately, there will be significant money creation - bound to cause inflation in the not too distant future. Total money supply in the U.S. economy (as measured by M2) at the end of October was almost \$7.9 trillion. If just \$3 trillion in new bailout money is created, we would have 38% inflation. Inflation is a monetary event – total money in circulation versus goods and services produced. If money supply doubles and production stays the same, prices will ultimately double. Of course, the government can also raise taxes, mitigating the amount of money creation, but in the end, it doesn't really matter if the dollars are taken from the private sector's front pocket in the form of taxation, or the back pocket in the form of inflation. Remember, government does not produce or sell anything – all this money must come from private businesses and individuals.

By: ECA Investment Group, Inc.

### FEATURED INVESTMENT MANAGER AND MARKET INDICIES:

	1 Year Ending <u>11/30/08</u>	2 Years Ending <u>11/30/08</u>	10 Years Ending <u>11/30/08</u>
<i>This quarter's featured Investment Manager is:</i> <b>Altair All Weather (One of ECA's equity managers)</b>	<b>(22.6)%</b>	<b>(8.8)%</b>	<b>NA</b>
<b>STOCK AND BOND MARKET INDICES:</b>			
S & P 500 Stock Index	(38.1)%	(18.4)%	(0.9)%
Barclays Capital Aggregate Bond Index	1.7%	3.9%	5.3%
Balanced Index	(18.2)%	(7.2)%	2.2%
90 Day U.S. T-Bills	1.6%	3.0%	3.2%
Consumer Price Index	3.0%	3.7%	2.8%

### OUR SERVICES TO YOU

- Investment Management
- Asset Allocation Consulting and Performance Measurement
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- Personal and Institutional Trust Services through Counsel Trust Company

- Investment Manager Search and Selection
- 401(k) / Employee Benefit Plans
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