



EARL M. FOSTER ASSOCIATES

INVESTMENT MANAGEMENT

NEWSLETTER

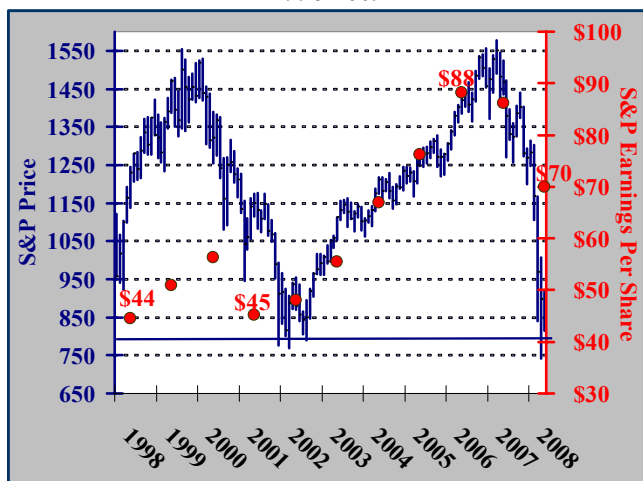
January 2009

THE MARKET MELTDOWN- PART II Is It Over?

The last ten years have been frustrating for investors. It started with the Standard & Poor's Index rising toward a March 2000 speculative peak, which was then followed by a prolonged and precipitous bear market decline of 50% to an October 2002 trough. Over the course of the subsequent five years, stocks rebounded to their former peak supported by a substantial rise in earnings and dividends. But, that recovery faltered during 2007's fourth quarter, and stocks then dropped 52% – registering the worst bear market decline in three-quarters of a century (Chart I).

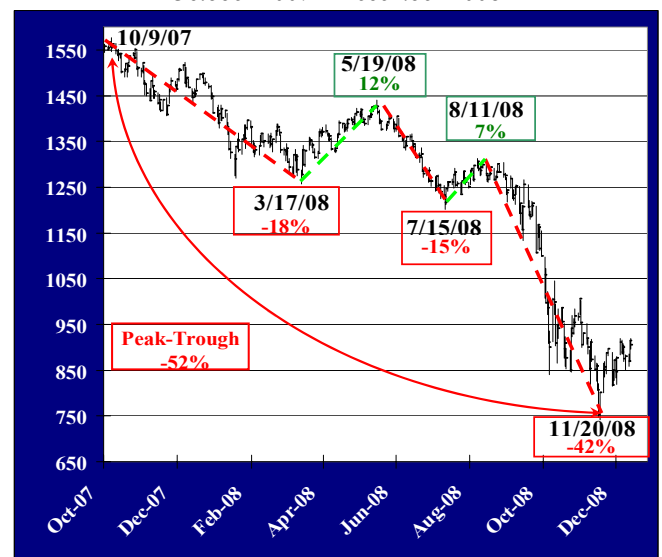
and 15%, respectively, and each was followed of by a rise of more modest proportions. The third, and most severe, saw stock prices plunge 42% in just over a three months. Investors reacted with extreme pessimism to the severity of the recession, perhaps the worst since the 1930's, as well as the ineffectiveness, to date, of government programs designed to re-ignite the economy.

CHART I
The Standard & Poor's Index
Price vs. Earnings Growth
1998-2009



The recent bear market occurred in three declining waves (Chart II). The first two were drops of 18%

CHART II
The Standard & Poor's Index
Price Performance
October 2007 – December 2008



The near-term outlook is by no means sanguine. In the recently completed fourth quarter, the economy is expected to have declined 4% - 6%. Weak business conditions are likely to persist during the

first half of this year as re-setting adjustable rate mortgages continue to force more home foreclosures, further lay-offs bring the unemployment rate to the highest level in several decades, and consumers, ill-prepared for this economic environment due to inadequate household savings, curtail spending, especially for discretionary items.

As mid-year approaches, the economy should exhibit some signs of stabilization. First, excess housing inventory is gradually being absorbed by the sharp drop in new home construction. Second, the funds that the Treasury and the Federal Reserve put into the financial system should eventually emerge in the form of mortgage loans and credit for businesses. Third, proposed fiscal programs, if enacted, could moderate the deterioration in the employment picture. On this basis, economic conditions in the second half of the year should show improvement over the first.

INVESTMENT STRATEGY

The stock market is a discounting mechanism that normally, although not always, anticipates economic news and adjusts market values accordingly. Thus, a good part of the expected 20% profit decline in the Standard & Poor's Index for 2008 and another 20% decline for 2009 may have already been discounted.

While it may be pre-mature to declare last November's low as the bear market trough, the combination of the depth of the recent decline, current valuation levels, and the aggressive application of fiscal and monetary policy to stimulate the economy, suggest that the risk in stocks is substantially reduced. Moreover, 2009's depressed earnings will still likely be 10% - 20% higher than during the last bear market while dividends are likely to be more than 60% higher. This, by no means, precludes stocks from re-visiting recent lows. After all, investors still face another 3 - 6 months of discouraging economic news, and stock prices could retreat periodically.

Table I looks at the most severe bear market declines - those exceeding 30%, since 1940. There were five such instances. Except for the 1970-73 recovery, each rose to a new high. The average gain in the first year was 36.3%; although, the last two bear market recoveries gained about 23% within the first 12 months. However, the recoveries extended over a considerable period of time (6.1 years on average) and the compound annual price gain averaged 18.5% during the life of the recovery. From a long-term perspective, therefore, it is important to have significant stock market exposure following bear market troughs to be able to recoup from the prior bear market.

TABLE I
Bear Markets and the Recovery
Standard & Poor's Index

| Date of Peak | Date of Trough | % Decline** | % Gain** Within One Year | Length Of Recovery (Years) | Compound Annual % Gain |
|----------------|----------------|---------------|--------------------------|----------------------------|------------------------|
| 11/9/40 | 4/28/42 | -34.5% | 53.7% | 4.1 | 26.1% |
| 11/29/68 | 5/26/70 | -36.1% | 43.7% | 2.6 | 23.3% |
| 1/11/73 | 10/3/74 | -48.2% | 38.0% | 6.2 | 14.1% |
| 8/25/87 | 12/4/87 | -33.5% | 22.8% | 12.4 | 16.5% |
| 3/24/00 | 10/9/02 | -49.2% | 23.2% | 5.0 | 12.4% |
| 10/12/07 | 11/20/08* | -52.0% | | | |
| Average | | -42.3% | 36.3% | 6.1 | 18.5% |

*Possible Trough

** Price Change Only

Since its November low, the Standard & Poor's Index already advanced 20%, and history suggests additional gains are likely. For those willing to tolerate the volatility, further additions to the equity portion of the portfolio for the next recovery in the economy is appropriate. However, the business environment remains challenging and such acquisitions should be undertaken with caution and confined to the strongest companies. In the event of a delayed economic recovery, small capitalization firms with narrow profit margins could be particularly vulnerable during the final stages of this recession.