



EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

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THE MARKET MELTDOWN Is It Too Early To Buy Stocks?

The financial system's inability to cope with the sharp deterioration in the housing sector resulted in an extraordinary collapse of a number of prominent, yet highly leveraged, financial institutions. In just a matter of months, Bear Stearns, Lehman Brothers, AIG Insurance, Merrill Lynch, Washington Mutual, and Wachovia ceased to exist as they were. Freddie Mac and Fannie Mae failed, and the two major remaining investment banks, Goldman Sachs and Morgan Stanley, applied for bank holding company status to facilitate their access to lower cost funds from the Federal Reserve.

As a result, the day-to-day volatility in the Standard & Poor's Index rose to extreme levels as the pendulum of confidence in the Country's financial system swung from fear and despair at one extreme to bouts of hope and relief at the other. The Standard & Poor's Index fell nearly nine percent on Monday, September 29th, when Congress failed to pass what was supposed to be a bi-partisan, \$700 billion bail-out for the financial system.

After the House rejected the first version of the Senate's bail-out package, they finally approved the revised version. Passing of the legislation confirmed to the financial markets the commitment of the government to not let this crisis continue to spiral downward, and allow for a more orderly contraction in the financial system. The implementation of the bail out package and its impact on the economy will, of course, require more time.

Nevertheless, this financial crisis, when combined with the excess housing supply, fragile household balance sheets, and declining employment, is likely to lead to a significant downturn in the economy. Moreover, the seasonal Christmas surge in consumer spending can be expected to be quite disappointing this year as households cut back on discretionary expenditures. The combination of higher mortgage payments, falling home values, shrinking investment values, and sparse savings will undoubtedly dampen the holiday spirit.

TABLE I
Business Cycles in Perspective

Peak	Trough	Prior Expansion Months	Contraction Months	% Economic Decline
Nov-73	Mar-75	36	16	-6.0%
Jan-80	Jul-80	58	6	-2.2%
Jul-81	Nov-82	12	16	-2.9%
Jul-90	Mar-91	92	8	-3.0%
Mar-01	Nov-01	120	8	-1.4%
Nov-07		72	?	?
Average 1973-2001		65	11	-3.1%

How severe will it be and how long could it last? The last five recessions provide some perspective. The average decline in the economy was 3.1% (Table I) and the duration was less than one year. The most severe of the five occurred during 1973-75, in which the economy declined 6% over the course of 16 months.

Because most of the current economic contraction emanates from the housing and financial sectors, it is likely to impact a broad spectrum of the economy. In

this respect, the percent decline could be larger than the 3.1% average. Yet, its duration may be no longer than the average. The passage of the bail-out package was the first step in restoring confidence in the banking system, and credit availability should improve shortly. On this basis, some improvement in the economy could be possible during the second half of next year.

However, a slow and sluggish recovery in the housing, along with a much reduced financial sector will likely make the next business expansion less than vigorous.

INVESTMENT STRATEGY

In a period of seven weeks, the Standard & Poor's Index declined nearly 16% from its intra-day peak on August 11th to its intra-day low on September 29th. From its peak last fall, this bear market declined as much as 30%.

TABLE II
DEPTH AND DURATION OF BEAR MARKETS
1946- 2002

Peak	Dates		Decline	Months
		Trough		
May 29, 1946		May 17, 1947	-29%	10.9
July 15, 1957		October 22, 1957	-21%	3.3
December 12, 1961		June 26, 1962	-28%	6.1
February 11, 1966		October 7, 1966	-22%	8.0
November 29, 1968		May 26, 1970	-36%	17.6
January 11, 1973		October 3, 1974	-48%	20.8
September 21, 1976		March 6, 1978	-19%	17.4
November 28, 1980		August 6, 1982	-27%	20.5
August 21, 1987		December 4, 1987	-34%	3.4
March 24, 2000		October 9, 2002	-49%	30.4
Average Bear Market Decline Since 1946			-31%	13.8
% Bear Markets Ending September-December			50%	

Are we close to a bear market trough? A look back at the previous ten bear markets since World War II provides some perspective. Those bear markets produced an average decline of 31%, and lasted almost 14 months. That average includes the extraordinary 49% decline in 2000-2002 over a period of 30 months, which was preceded by a period of speculation and excessive valuation that elevated the Standard & Poor's price-earnings ratio to 28.9 at the close of 1999.

By way of contrast, the Index was only 18.2 times earnings at last October's peak. In addition, bear markets precipitated by a financial crisis, such as we are currently experiencing, tend to have sharp compact declines. The current contraction may conform to that

norm. Thus, the decline that has occurred so far conforms to the dimensions of prior bear markets in terms of both time and depth. It is also interesting to note that half of the post World War II bear markets ended during the September-December period.

Three other factors also point towards a maturing in this market decline. First, stock market troughs are often reached well before the trough in the economy as investors tend to look "across the valley" and anticipate the subsequent recovery in business conditions. Second, the consensus economic outlook does anticipate improving business conditions during the second half of next year. Third, stocks, relative to historic norms, have become more attractive in terms of dividend yields, price-earnings ratios, and price-to-sales ratios.

For this reason, a program of gradually adding to the equity component may be appropriate. The timing and degree to which this strategy is implemented has to be sensitive to economic conditions as considerable risk still remains. This risk can be mitigated by focusing on better quality large capitalization companies and those with above average cash flow and attractive dividend yields, where the dividends are well covered by earnings.

The 2008 election will have some impact on the economy in 2009 and later years. While each party will be obligated to address our economic problems, each will have a different approach and priorities. Major decisions will be made on taxes, foreign trade, energy policy, and fiscal stimulus.

However, the initial post-election performance of the stock market will be determined more by the economy than the political party occupying the White House. Stabilization in the housing sector, greater liquidity in the banking system, economic growth for our trading partners overseas, and the restoration of confidence in our economy is likely to have more of a near-term impact on stocks than policy changes from Washington, which could take years to influence business conditions.