

INSIGHTS ON FRONT STREET



BY JOHN W. GUDRITZ, CFA
FRONT STREET INVESTMENT MANAGEMENT LLC

LIVING IN A DE-LEVERAGING WORLD

JANUARY 2009

With the stock market down almost 40% in 2008, one would think that 2009 has got to be a good year for equity investors. Historically speaking, that would be a reasonable assumption. However, the world is in the midst of an economic recession, the likes of which we have not seen since the early 1980's at best or the 1930's at worst. Life as we have known it over the past 20 years has changed. We don't think that the November lows in the stock market reflected the near term or long term consequences of living in a de-leveraging world.

We would like to be bullish for 2009 and aggressively investing in the stock market but our analysis of the economic data and our conversations with people in the real world keep us very cautious as we enter the New Year. While the stock market has rallied over 20% in the face of bad economic news, we think investors' optimism for a second half economic recovery in 2009 will be proven to be premature and the lows will at least be tested again.

Most economists and investment advisors are pinning their hopes for a 2009 recovery on their belief that these massive government stimulus programs and bailouts will have the desired affects and all will soon be right with the world. We just don't believe it is quite that simple.

We think that future economic growth will be based on a different set of priorities and less ability and desire among the people of the developed world to take risk. We think we are entering a new era of conservatism in investment and consumption like we last saw in the 1940's and 50's.

The combination of the destruction of wealth that we have witnessed over the past year and the

demographic reality facing the United States, Japan, and many European countries have dramatically changed how most people will be able to live their lives in the years to come. With rapidly growing percentages of the populations in these parts of the world facing retirement and the physical challenges of getting older, we think saving will trump borrowing and spending going forward.

We all know how we got into this mess; many years of easy access to credit, especially mortgage loans and credit cards. Bankers were falling all over each other to offer credit cards and loans with little or no money down to any breathing human being with real estate. The belief that real estate prices never go down overtook sensible lending standards.

As with any asset bubble, home prices finally got too high to be supported by the income levels used to finance them and the bubble burst. We all discovered that real estate prices could come down hard and fast and wipe out wealth and borrowing capacities (and bank capital) even faster than they created them when they were rising.

And now as we enter 2009 we find ourselves in the midst of a serious global recession that we believe will be deeper and longer than most people expect despite the declining interest rates and the trillions of dollars of monetary and fiscal stimulus programs that have already been implemented. The wealth destruction in this cycle is being felt by everyone as evidenced by the falling sales at Tiffany's and Neiman Marcus. That is why we believe that corporate earnings will be much below consensus thinking.

Even when the foreign and U.S. economies get back on their respective growth paths, the actual recoveries will pale in comparison with economic recoveries of the past 25 years. The rules that we have lived by have changed as we transition to a de-leveraging world.

Debt is now a dirty word. It helped destroy many trillions of dollars of wealth and it is not finished yet. We believe that many people will be more cautious about using credit cards or loans in the future. But even those people who are not inclined to change their ways will probably find they have a lot less credit available to them.

We see a much more conservative way of living for most Americans in 2009 that will probably continue on in future years. The days of conspicuous consumption are over for a while even for people who still have money to spend. Consumer spending will depend much more on wages and salaries as debt will be more difficult to obtain.

We will continue to see manufacturing plants and retail businesses closing as the supply of goods and services adjusts to the lower demand. Needless to say, commercial real estate loans will be another concern for the banks going forward.

Because of this new economic reality, we think that the potential growth rates for the developed and developing economies have been significantly reduced for the next few years along with potential investment returns from stocks. We see no growth at best for most if not all developed countries in 2009.

We will probably continue to see bear market rallies in the weeks and maybe months to come. However, we also believe it is very possible that the stock market could hit a new low like 6500 and 650 on the Dow Jones Industrial Average and the S&P 500 Index, respectively, before the bear market is over. We say this because the "economic reset" that we see happening should

produce lower than expected earnings in 2009 and lower longer-term growth rates. This combination of events should cause price/earnings ratios to be lower than one would expect in this low interest rate environment.

With all of the economic stimulation that has been put into place and that is still expected to come, we expect to see signs of positive economic growth by early 2010 and, therefore, an end to this bear market by summer of this year. That is why we would begin to increase our exposure to stocks carefully and slowly on market weakness and more aggressively if our downside targets are reached. If we are right about the economic reset and not a typical recovery, we expect long-term average annual equity returns in the 7-9% range when this bear market is over and dividend yields will be more of a contributor to those results.

U.S. Treasury yields are unsustainably low, in our opinion, as investors hide in them for safety. Corporate bonds and tax-free municipal bonds still offer attractive returns but they need to be handled with care because of higher risks of default. We are limiting the average duration of our clients' bond portfolios to about 3 to 4 years because of our concerns about inflation pressures popping up down the road. But that is another worry for another year.

There is a possibility that we are too pessimistic about the economy and corporate earnings. However, because we see the risk of another 30% decline in the stock market we believe that we are obligated to our clients to maintain our protective strategy until we begin to see signs of an economic bottom or much cheaper stock prices than we have today.



FRONT STREET
INVESTMENT MANAGEMENT