

THE MARKET OBSERVER

MARCH 2009

After rallying over 24% from its November, 2008 bottom, the market turned down again in January and February. Hope and then skepticism over the \$788B Congressional Stimulus Plan saw prices decline further through the first week of March, with the S&P 500 testing and initially holding its November 20, 2008 intra day low of 741. The market subsequently pushed through this resistance point on 2/27, before closing at 683 on March 6th.

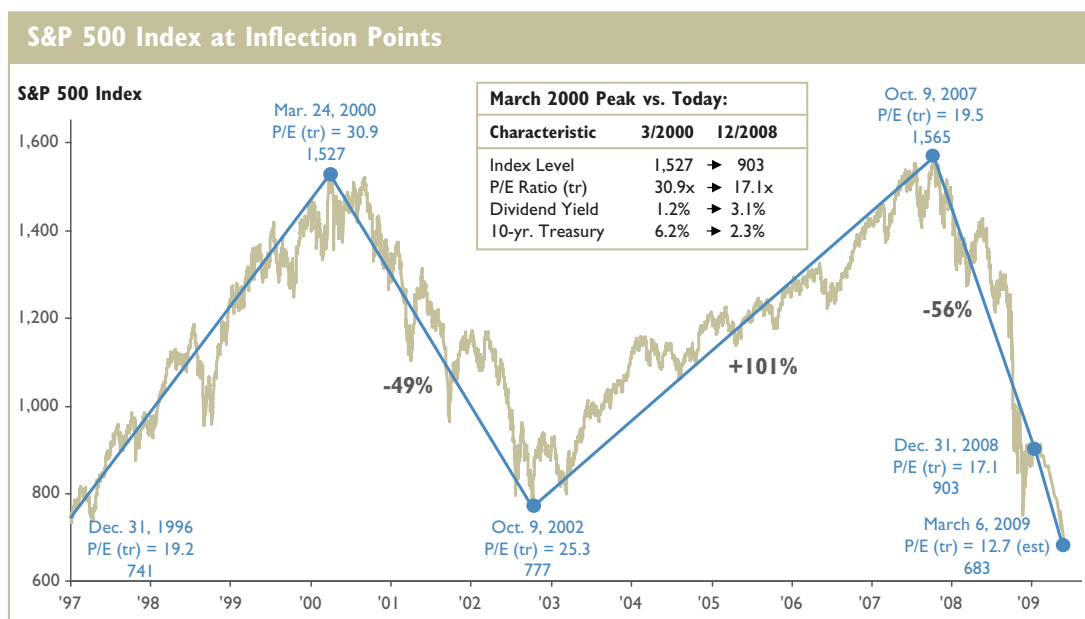
The highly publicized plan that recently passed both the House and Senate includes over \$500B of government spending and \$280B in tax cuts. These actions

follow the \$700B TARP funding approved at the end of 2008 and the massive \$2.4T liquidity injection made by the Federal Reserve into the credit markets since the start of this crisis.

Restoring dysfunctional credit markets to some form of normalcy is widely believed to be a pre-requisite to the success of any “stabilization” plan. Significant improvement has been made since the panic experienced at the end of last year, but we still have a way to go. Bank capital levels are still a concern, as is the excessive financial leverage that still needs to be purged from the system. Finally, the greatest challenge

will be the development of a plan that can effectively price and remove “toxic” mortgage related securities from institutional balance sheets.

Meanwhile, the negative economic news keeps coming at us, deepening our fears and spurring further price declines. The market seems to understand (while most citizens and politicians do not) that the resolution of over 20 years of excessive debt accumulation cannot be fixed overnight and not without experiencing some pain and discomfort. This means some companies should and will fail and that illusory, debt financed growth will disappear.

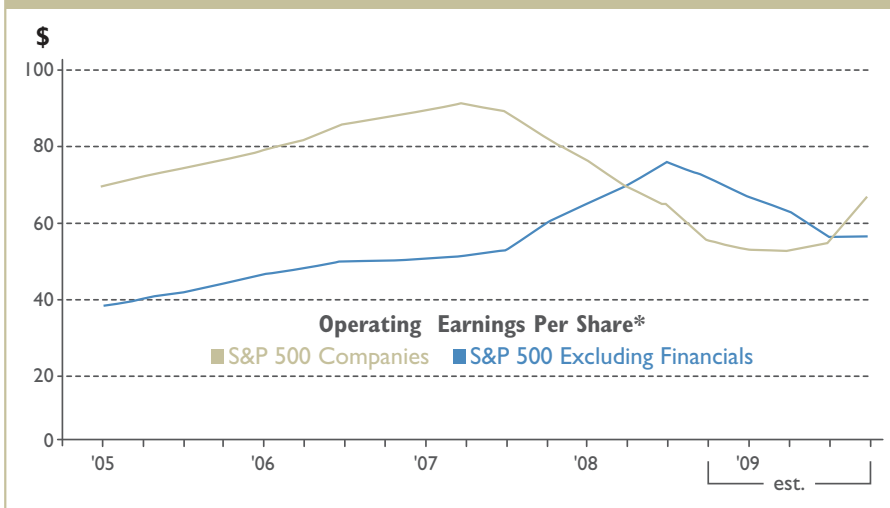


Source: Standard & Poor's, First Call, Compustat, FactSet, JPMorgan Asset Management.

The stock market's behavior since November also seems to indicate uncertainty over how much of the earnings growth over the past 12 years is sustainable going forward. At the end of 1996, the S&P 500 closed at a price of 741 and had composite operating earnings per share of approxi-

US Earnings

Profits of non financial companies, down in Q4 2008 are still above their 2007 level.



*Rolling four quarters; as of Feb. 12; Source: Standard & Poor's Index Services

mately \$40. After the piercing of the “tech bubble” in 2000, the market bottomed at 777 on 10/10/02 with trough earnings, once again, of approximately \$40-\$45. After experiencing peak “debt/housing bubble” earnings of over \$90 in 2007 (and surpassing the 1,500 price level last experienced in 2000) the market closed at 683 on March 6th, with earnings estimates ranging from \$40 on the pessimistic side, \$50 to \$60 in the moderate camp, and \$70+ on the optimistic side.

The moderate “trading range” camp sees massive worldwide government intervention gradually leading a return to some degree of normalcy over the next 6 to 18 months. They see retrenchment, deleveraging, and increased savings followed by renewed investment, innovation and risk taking setting the foundation for positive growth in 2010. The optimistic “recovery” camp sees a quicker turn around not only due to global governmental intervention, but also due to

the emergence of evidence of a higher level of sustainable earnings. The pessimistic camp sees a more prolonged period of pain before we are able to rise from the leveraged, toxic assets sink hole we are experiencing. Most prognosticators in this group suspect some yet to be discovered negative economic news to come to light in the months ahead which could push stock prices down to a price level of 600 or even lower.

The S&P 500 was last at the 600 level in 1995 and at that time had an operating earnings per share of approximately \$36 per share.

The US economy’s GDP in 2008 was approximately \$14T while US GDP in 1995 was \$7.4T.

To be sure, a good chunk of the market’s earnings over the past few years was induced by debt and speculation. We would hope that some of this earnings power can be regained in an eventual recovery going forward.

A Historical Perspective

World War II expenditures were estimated at \$341 billion (in 1940’s dollars) which represented approximately 47% of total GDP on an averaged annualized basis spanning December 1941 – August 1945 (or approximately 3.7 years).

Note: Annual GDP (in Billions) between 1942-1945 was \$161.9 (1942), \$198.6 (1943), \$219.8 (1944) and \$223.2 (1945)

\$2.7 trillion in 2008 rescue spending represents approximately 20% of 2007’s GDP (\$13.8 trillion).

Note: \$2.7 trillion includes new Federal Reserve open market activities and new US Treasury investments and expenditures (including 2008 tax rebates).

In order to match World War II’s spending rate (as a percent of GDP), we would need to spend approximately **\$6.5 trillion per year over the next 3 years** on stimulus and/or rescues.

Source: DiMeo Schneider & Associates, LLC



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2700 Patriot Blvd., Suite 440, Glenview, IL 60026 | 847 441-5644 | www.coyleasset.com