

THE MARKET OBSERVER

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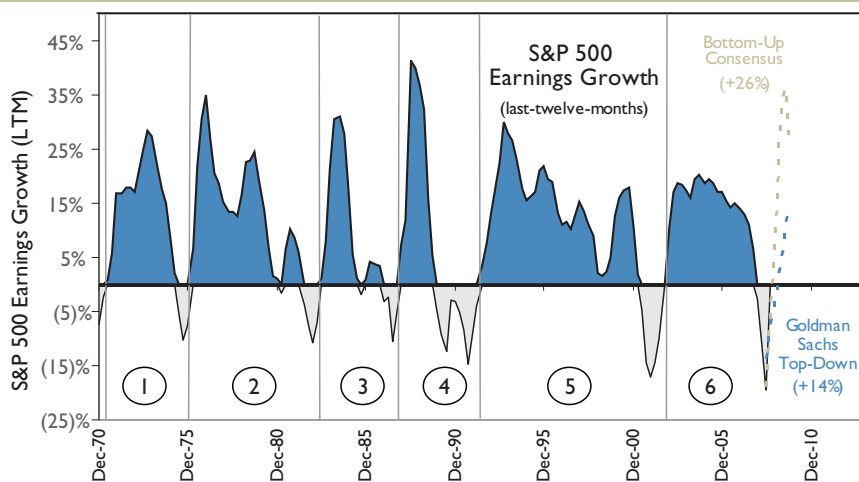
The third quarter was not a good one for stocks, with the S&P 500 declining 8.4%. The decline gained momentum at the end of September, followed by one of the worst Octobers for stocks since 1938 (down 17%). As of the end of October, stocks are down 34% for the year and 38% from their October, 2007 peak. The year to date declines in International (EFA down 43%) and Emerging Markets stocks (EEM down 49%) were even more severe. Stock prices are now at levels last reached in 2003 in the aftermath of the tech bubble, and before that in 1997, preceding the S&P 500's previous peak above the 1500 level in March of 2000. The decline in October would have been much worse, save for the 12% advance realized during the last week of the month, which included an 11% advance on Tuesday, October 28th.

At its trough on 10/27/08, the market's decline of 46% from its October, 2007 high fell just short of the 49% decline experienced between 2001-2002, and the 48% decline endured between 1973-1975. While the mainstream media continues to ponder the culprits

in this crisis (easy credit, over-leveraged balance sheets, excessive risk taking, etc) investors search for signals on how they could have predicted the mass liquidations, margin calls, mark-to-market hits, additional forced liquidations, and the ensuing shutdown of global credit markets that followed the September 15th Lehman Brothers bankruptcy filing. For those investors who

have guarded their liquidity, they now have the opportunity to buy stocks at 1997 prices. They are hesitant, however, because they fear prices may get cheaper. They are struggling with the question of whether a recovery will take as long as the post 2001-2002 period (55 months), the 1973-1975 period (69 months), or the less severe downturns of 1981-1982 (3 months), 1987 (19 months), or

S&P 500 is currently in its 6th profit cycle since 1970



Cycle Peak Date Trough Date	EXPANSION		CONTRACTION	
	Length of Expansion phase (mths)	EPS Growth from prior Trough	Length of Contraction phase (mths)	Earnings decline from Peak
(1) 30-Sep-74 30-Sep-75	45	91 %	12	(10)%
(2) 31-Dec-81 31-Dec-82	75	143	12	(11)
(3) 30-Jun-86 30-Jun-87	42	45	12	(11)
(4) 30-Jun-89 30-Sep-91	24	64	27	(22)
(5) 30-Sep-00 31-Mar-02	108	243	18	(19)
(6) 30-Jun-07 30-Jun-08	63	115	12	(21)
Average Cycle	59	117	16	(14)%

Source: Compustat, FirstCall via FactSet, and Goldman Sachs Research.

1990-1992 (4 months). They are pondering whether a PE of 12 times is a safe entry point in light of the markets 15 to 16 PE average since World War II. They may even see hope in the fact that the earnings of the S&P 500 have doubled over the past 10 years, while stock prices have failed to hold on to their advances and have gained no net yardage. Meanwhile, stock pickers are puzzling over the carnage in their portfolios even though initial third quarter earnings reports (excluding financials) project an advance of 12%. They still see living, breathing, healthy corporations with stable cash flows and conservative balance sheets (not all were leveraged 40:1) and are sticking to their convictions and riding this out. They are

ignoring (with considerable intestinal fortitude) the negative yields investors were accepting for the safety of T-Bills versus higher absolute yields which munis offer over Treasuries, all due to an indiscriminate sale of risk assets in a flight to safety. When viewed from a historical perspective (despite the unprecedented characteristics of the current decline) they see market and economic patterns that resemble past experience, providing at least some hope and confidence for the future.

It will take a while, one would assume, to recover from such an unprecedented loss of confidence. It would also seem, once again from a historical perspective, the risk of significant further declines from here would be remote. One would

hope that the coordinated, worldwide government action taken in response to this crisis would help to prevent a repeat of the panic selling experienced during the past two months. As investors pause at this decisional crossroad, pondering whether to participate in the final capitulation, they should consider one question:

Do they truly want to cast their lot with the “end of the world” constituency, or rather the “this too shall pass” camp? Taken to a deeper level of reflection, taking the first option and proving to be wrong may prove to be a greater risk. They should prepare themselves, however, for continued volatility, as a sustained recovery may take a while.

Performance: S&P 500 Price Performance Similar to Past Recessions

S&P 500 Price Performance below average and median compared to other recession periods

S&P 500 Peak	Start of Recession	S&P 500 Trough	End of Recession	Recession Duration (months)	Acknowledgement		Capitulation		Full Impact		Recovery
					Peak to Start of Recession (months)	Peak to Start of Recession (%)	Start of Recession to Trough (months)	Start of Recession to Trough (%)	Peak to Trough (months)	Peak to Trough (%)	Trough to End of Recession (%)
1/5/53	7/31/53	9/14/53	5/28/54	10	7	-7.1%	2	-8.2%	8	-14.8%	28.5%
7/15/57	8/30/57	10/22/57	4/30/58	8	2	-8.0%	2	-13/8%	3	-20.7%	11.4%
1/5/60	4/29/60	10/25/60	2/28/60	10	4	-10.0%	6	-3.8%	10	-13.4%	21.3%
5/16/69	12/31/69	5/26/70	11/30/70	11	8	-13.1%	5	-24.7%	13	-34.6%	25.8%
2/13/80	1/31/80	3/27/80	7/31/80	6	-	-3.6%	2	-14.0%	1	-17.1%	23.9%
11/28/80	7/31/81	8/12/82	11/30/82	16	8	-6.8%	13	-21.8%	21	-27.1%	35.3%
7/17/90	7/31/90	10/11/90	3/28/91	8	0.5	-3.1%	2	-17.0%	3	-19.6%	27.0%
3/27/00	3/30/01	9/21/01	11/30/01	8	12	-23.9%	6	-16.8%	18	-36.6%	18.0%
19/9/07		9/17/08							11	-26.1%	
			Average	11	6	-9.5%	5	-18.1%	11	-24.4%	25.0%
			Median	10	7	-8.0%	5	-16.8%	10	-20.7%	25.8%
10/9/07		9/30/08							11	-25.5%	
10/9/07		10/31/08	Most Recent						12	-38.1%	
10/9/07		10/27/08	Low so far						12	-45.8%	

Source: Morgan Stanley, Great Lakes Advisors



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