JVL Associates, LLC
NEWSLETTER

DECEMBER 2008

As we close the book on 2008 we need to step back and view how historic the year was for investors.

Looking at returns of various asset classes both domestically and internationally we see just how broad based the market declines were.

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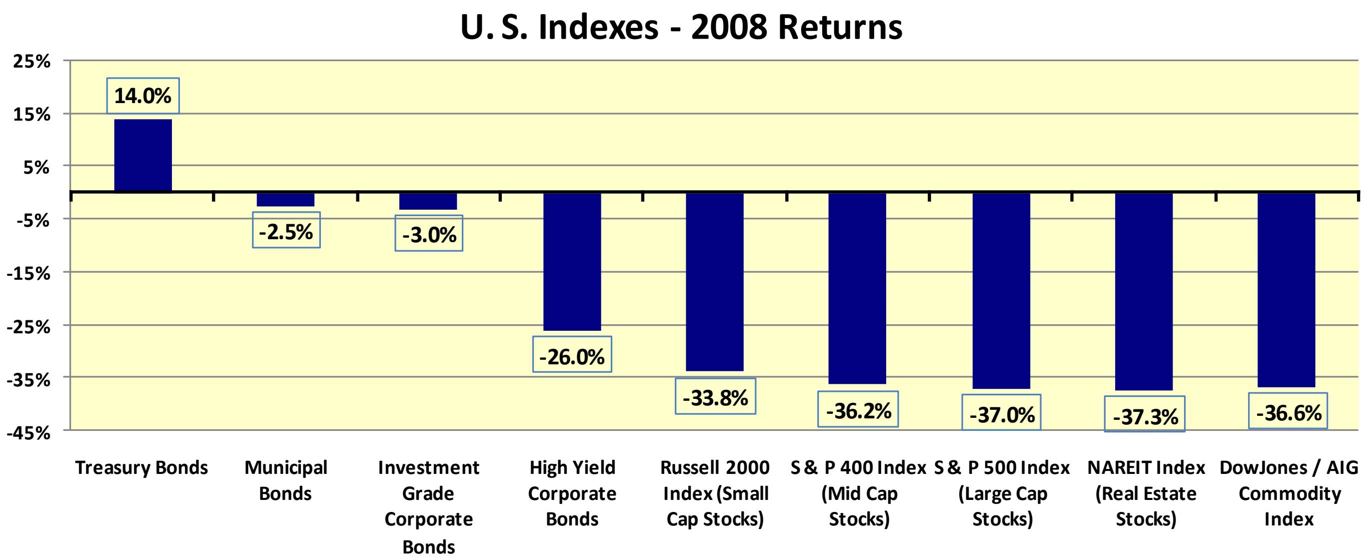

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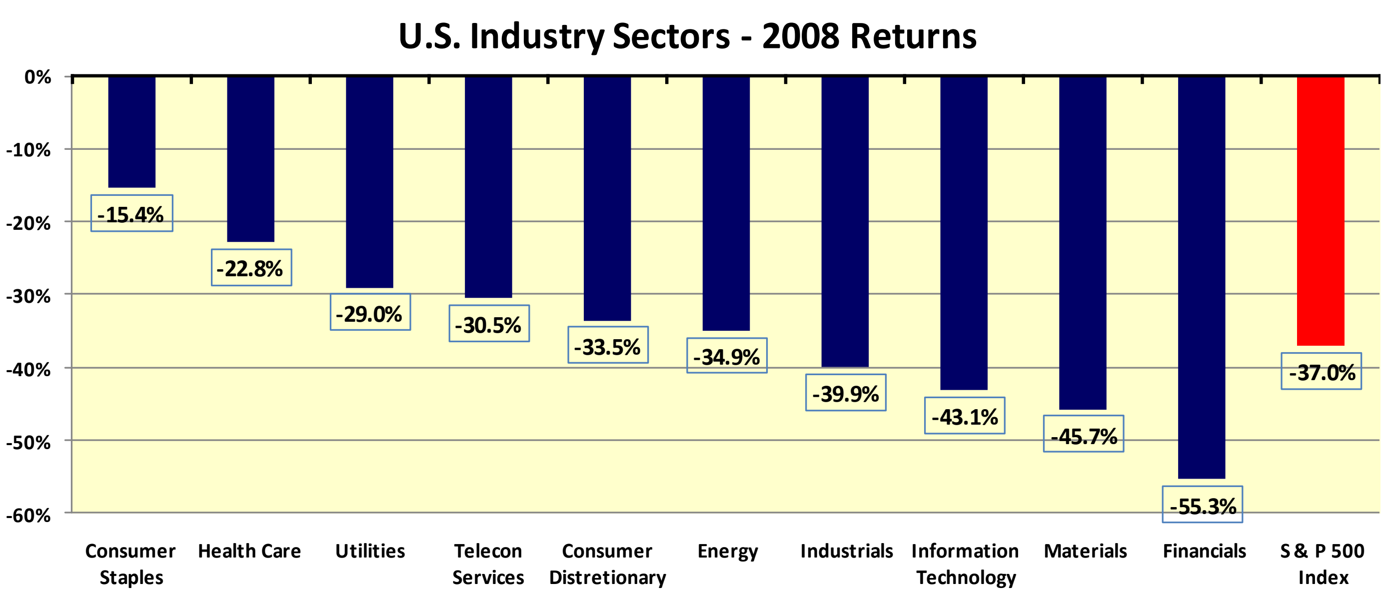

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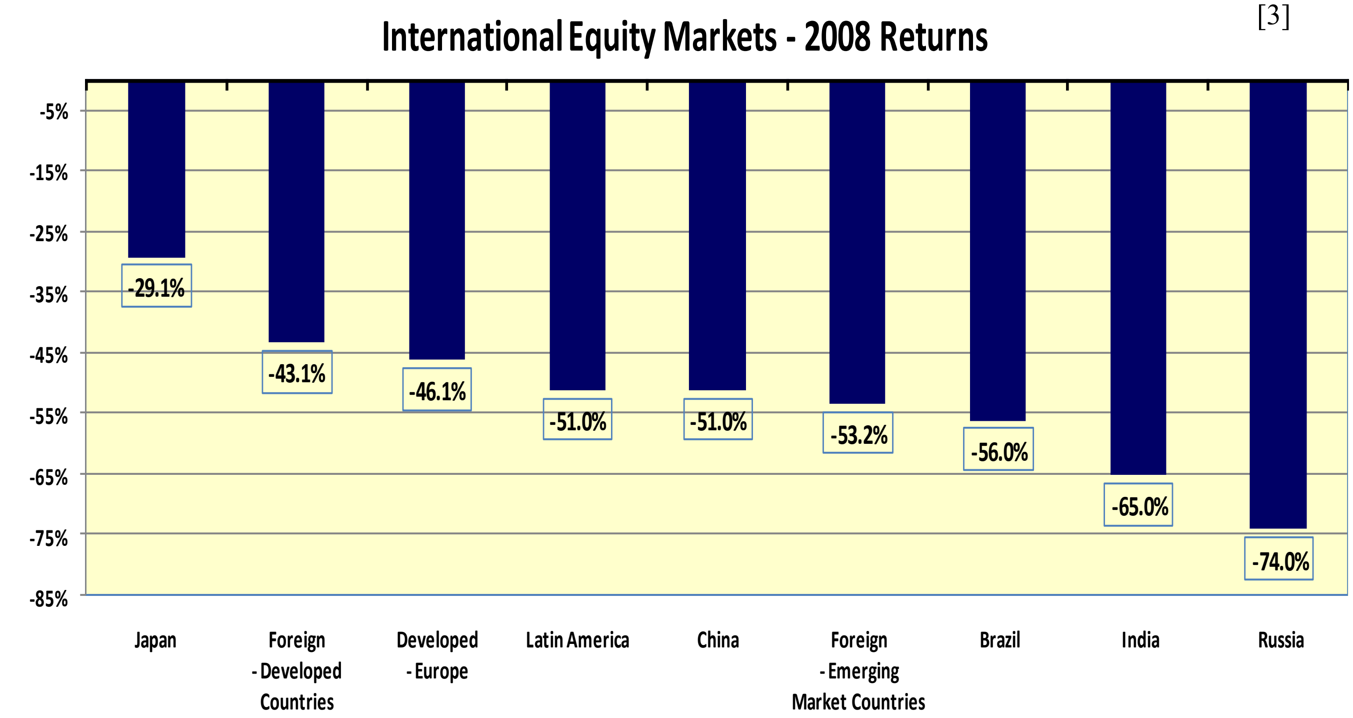


Putting 2008 into perspective with history we find that Real Estate Stocks, Foreign Developed Country Stocks and Foreign Emerging Market Stocks all experienced their largest decline on record. [4] U.S. small cap stocks experienced their worst performance since 1937. [4] And, U.S. large cap stocks recorded their second worst year ever, exceeded only by 1931 as the following chart demonstrates:

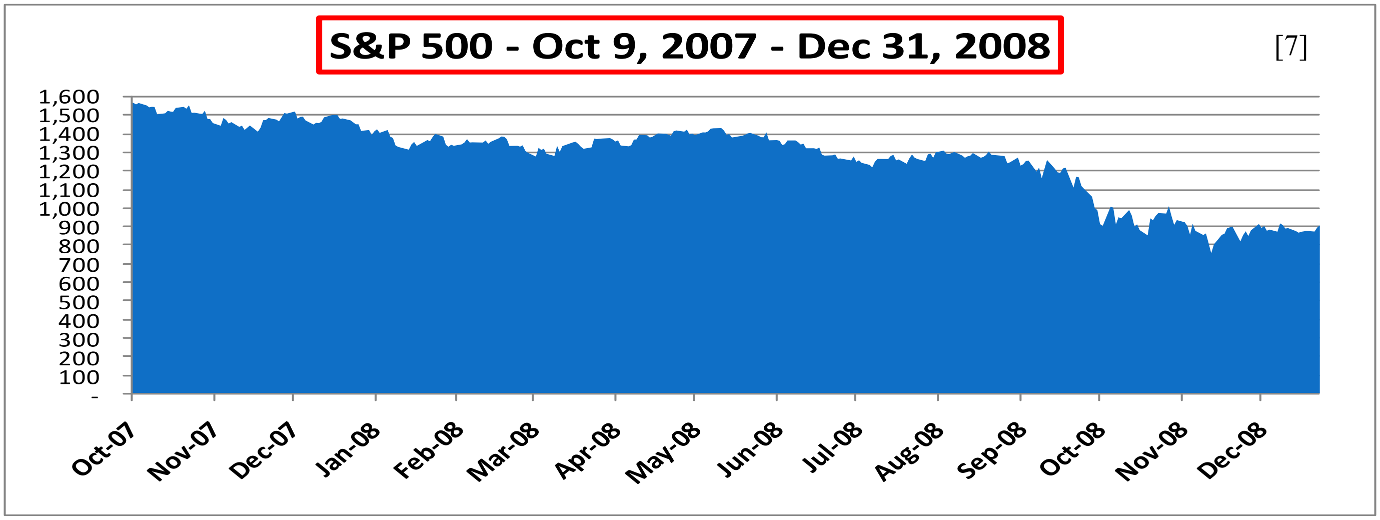
Large Cap Domestic Stocks (S&P 500)

[5]

Annual Performance - In 10% increments

									2006				
									2004				
						2000		2007	1988	2003	1997		
						1990		2005	1986	1999	1995		
						1981		1994	1979	1998	1991		
						1977		1993	1972	1996	1989		
						1969		1992	1971	1983	1985		
						1962		1987	1968	1982	1980		
						1953		1984	1965	1976	1975		
						1946		1978	1964	1967	1955		
					2001	1940		1970	1959	1963	1950		
					1973	1939		1960	1952	1961	1945		
				2002	1966	1934		1956	1949	1951	1938	1958	
			2008	1974	1957	1932		1948	1944	1943	1936	1935	1954
		1931	1937	1930	1941	1929		1947	1926	1942	1927	1928	1933
Annual return	*-60%*	*-50%*	*-40%*	*-30%*	*-20%*	*-10%*	*0*	*+10%*	*+20%*	*+30%*	*+40%*	*+50%*	*+60%*
Number of Years	0	1	2	3	5	13		13	15	13	13	3	2

The U.S. stock market (S&P 500) reached its all time high on October 9, 2007. Over the next 13 months, through November 20, 2008, the market experienced a 52% decline. That decline is the 3rd largest decline on record exceeded only by the 1929 – 1932 (34 months) and 1937 – 1942 (61 months) bear markets, both of which occurred over a much longer period of time. [6]



Historical U.S. Stock Bear Markets (1926 - 2008) [6]

Peak	***Trough***	***Duration (Months)***	***Bear Market Magnitude***	***Recession During Bear?***	***1 Yr Return After Trough***
9/3/1929	7/8/1932	34	-86%	Yes	124%
3/10/1937	4/28/1942	61	-60%	Yes	59%
10/9/2007	11/20/2008	14	-52%	Yes	??
3/24/2000	10/9/2002	31	-49%	Yes	34%
1/11/1973	10/3/1974	21	-48%	Yes	38%
11/29/1968	5/26/1970	18	-36%	yes	44%
8/25/1987	12/4/1987	4	-34%	No	23%
5/29/1946	6/13/1949	37	-30%	Yes	42%
12/11/1961	6/26/1962	6	-28%	No	33%
11/28/1980	8/12/1982	21	-27%	Yes	58%
2/9/1966	10/7/1966	8	-22%	No	33%
8/2/1956	10/22/1957	14	-22%	Yes	31%
7/16/1990	10/11/1990	3	-20%	Yes	29%
Average (excluding 2007 - 08):		**22**	**-39%**	**-**	**46%**

Having put 2008 into the history books we have to ask: Now what – where are we today?

The major concern facing world economies is the banking / credit crisis. Banks around the world are making massive write-downs to their loan portfolios, both because of defaulting borrowers and "mark to market" adjustments caused by the lack of a functioning liquid "market" for the loans. Goldman Sachs recently raised its estimates for potential losses from U.S. debt (consisting of residential mortgages, commercial real estate loans, credit card debt, automobile loans and business loans) to over $2 trillion of which only half has currently been recognized. The estimate does not include potential losses from overseas loans. [8]

These write-downs cause banks to need capital which the private market is unwilling to provide. This in turn has caused governments around the world to intervene and provide capital to keep banks afloat. In the last few months the U.K., Germany, France, Spain, Italy and Russia have injected capital directly into their banking institutions in exchange for equity ownership. Ireland nationalized three of its country's largest banks. [9]

The U.S. federal government has had to put huge amounts of capital into trouble banks to provide them the capital they need to continue functioning. These amounts are required to be repaid and were initially deemed loans, preferred stock and / or warrants to purchase common stock if the amounts are not repaid by certain dates. But now, some believe the amounts are not sufficient and the government may have to inject more than the banks can repay over a reasonable time period. We have to ask ourselves if the federal government will begin to nationalize the largest U.S. banks before the crisis ends.

Central banks around the world have dramatically reduced interest rates in an attempt to stimulate borrowing. From August, 2007 to December, 2008 official interest rates have dropped in the U.K. (5.75% to 2.00%), Europe (4.00% to 2.5%), Australia (6.5% to 4.25%), China (7.02% to 5.31%), Hong Kong (6.75% to 0.50%) and the U.S. (5.25% to 0.25%). [10] In addition, many governments have announced guarantee programs to provide protection for bank assets.

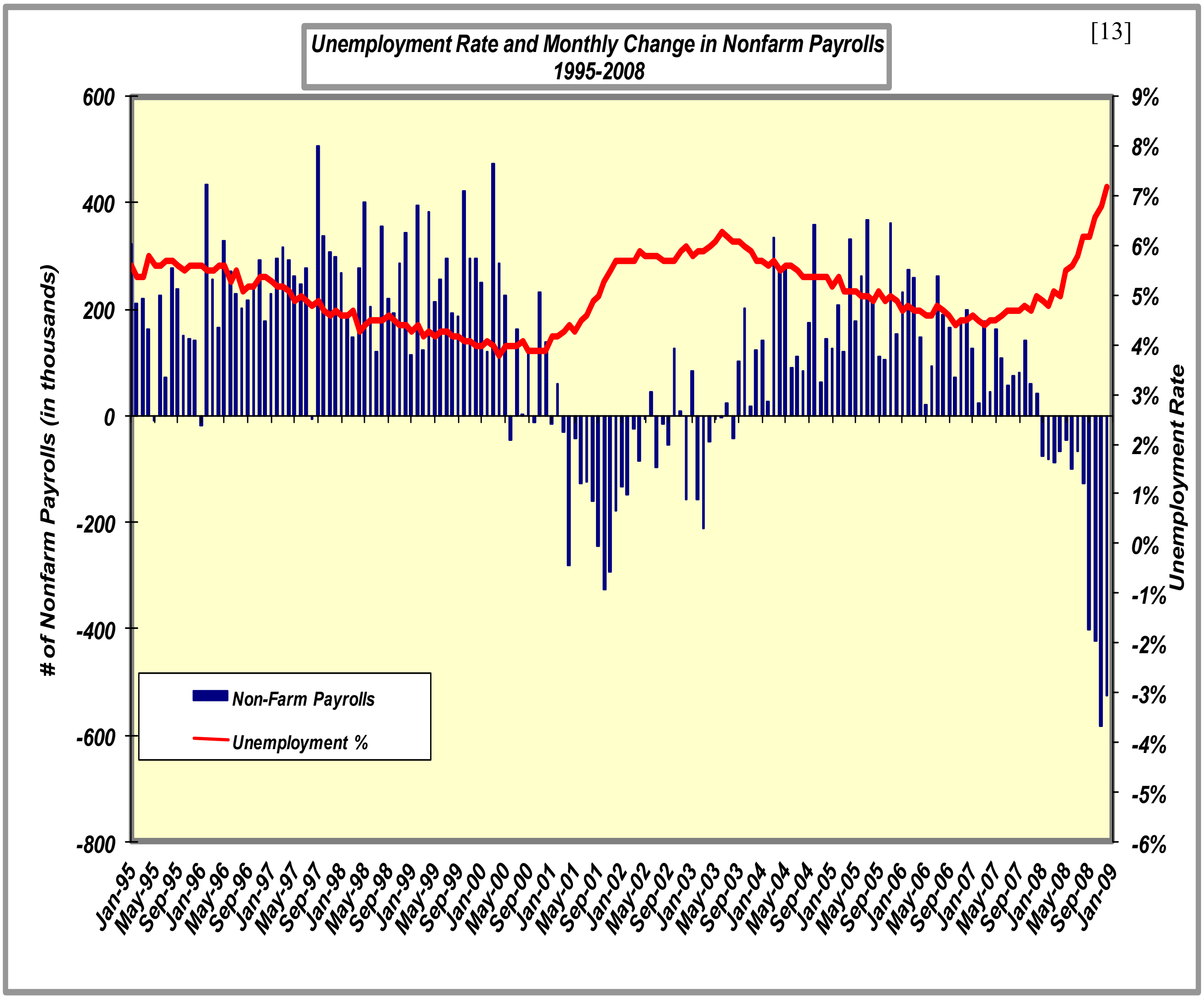
Governments around the world have stepped in with "stimulus packages" in attempts to rescue their economies. China ($586 billion), Japan ($51 billion), Germany ($68 billion), and South Korea ($11 billion) have all announced stimulus plans to keep their economies going. [9] Many economies are either officially in a recession or close to one.

The U.S. has officially been in a recession since December, 2007. This is the 15th official recession since 1926. Only three, 1929 - 1933 (43 months) 1973 - 1975 (16 months) and 1981 – 1982 (16 months) have lasted longer than 13 months. [11]

During the past year the U.S. has witnessed the end of the investment banking industry, a bailout of one of the country's largest insurance companies (AIG), the takeover of the two largest residential mortgage companies in the country, the injection of capital ownership into numerous banking institutions and the attempted "rescue" of the automotive industry.

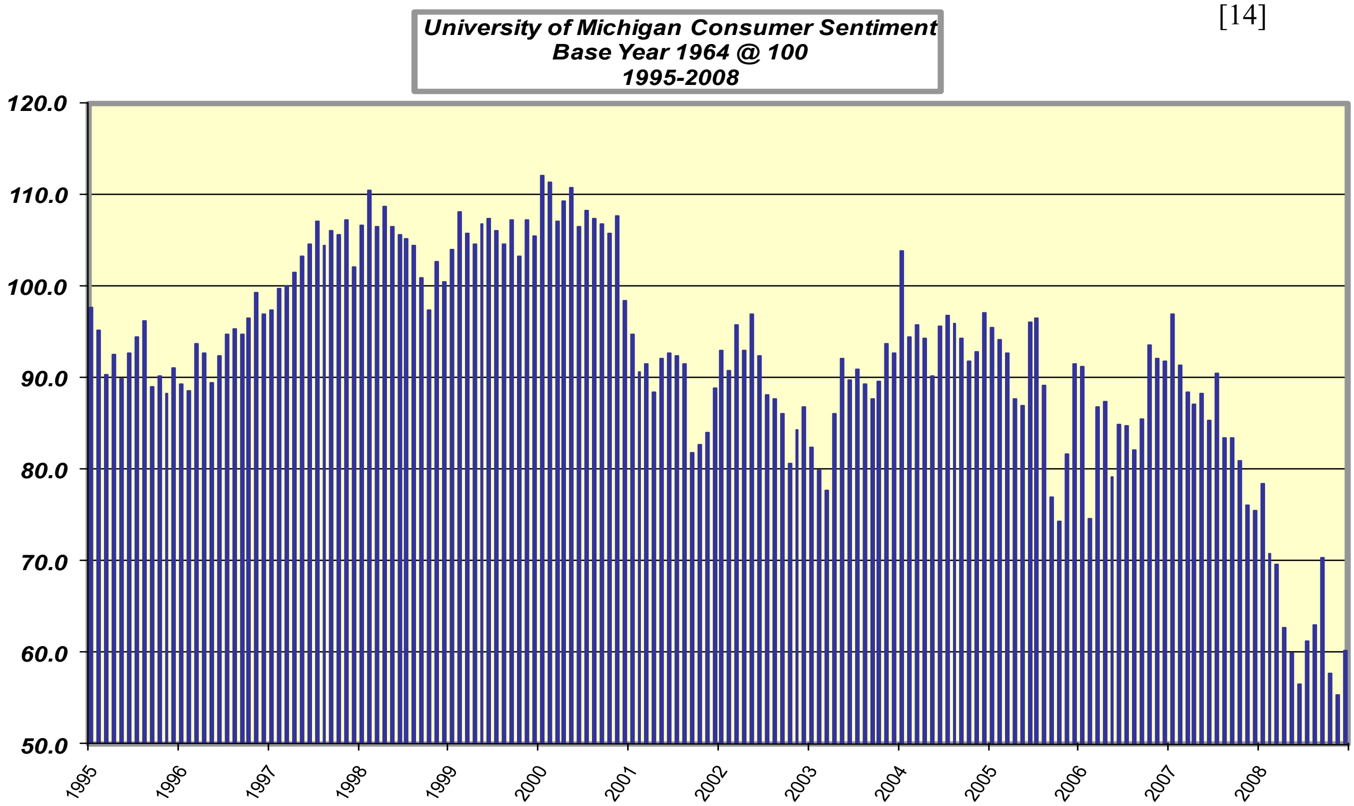
The U.S. government has already committed over $8 trillion in new funding / guarantee programs. In addition, they have taken explicit responsibility for over $5 trillion in Fannie Mae & Freddie Mac loans. And, Congress is currently working on a stimulus package which could reach $800 billion to $1 trillion before it is signed by the new administration. All told that combines to over $14 trillion in new commitments, guarantees and / or spending. [12]

The crisis has spilled over into the business world. Companies need fewer workers, putting more and more people out of work. The U.S. lost jobs every month during 2008 totaling over 2.5 million jobs.



And in the meantime, U.S. consumer sentiment continues to erode hitting historical lows during the year as demonstrated by the following chart:

[14]



If after all this you are still reading you are either totally depressed or waiting for that "happily ever after" ending that we all know is coming in great literature. Well, I don't make predictions but I do plan for what we know. So, what do we know that can give us hope?

As we go to print, the U.S. stock market (S&P 500) has remained above its November 20, 2008 low. If the low were to hold the bear market would be over. But, since we cannot predict if the low will hold, we should focus on the following:

First, stock markets are forward looking. Much of the above news has already been priced into the equity markets. On average, stock markets begin to rise six to twelve months before the economy turns. Given that we are already into the 3rd longest recession in history we should see positive signs in the market at some point.

Second, by many valuation measures the stock market is "cheap" compared to historical valuations. While there are many ways to compute PE (price earnings) ratios, Fidelity Investments claims that the S&P 500 is trading at a PE ratio below 14 compared to its long term trend (1930-2008) of 17 and short term trend (1980-2008) of 25. [15] Fidelity Investments also claims that International Developed Country stocks are trading at a PE ratio of 8.5 compared to a 20 year trend of 16 while International Emerging Country stocks are trading at a PE ratio of 9 compared to a 20 year trend of 19. [16] In addition, Morningstar, a major independent investment research firm, claims that their universe of 2,000 plus companies are trading at a 25% discount to their fair value computations even after factoring in the latest revised downward earnings estimates. [17]

Third, there is currently over $4 trillion dollars of cash equivalents sitting on the side lines. [18] A good portion of that may be committed to equity markets as investors gain confidence that the end is in site. The funds are in cash because of fear, not for the return cash provides. At some point investors may begin to put money back into the stock market creating an increase in demand and thus driving prices upward.

Americans adapt, they innovate, they create, and they endure. We created this mess by too much leverage and the deleveraging process has and will cause pain. The world may look much different by the time we come out of this but we have always survived. The world was far different in 1950 than it was in 1930, it was far different in 1980 than it was in 1950 and it was far different in 2000 than it was in 1980. Let us put 2008 into the history books believing better days are ahead.

By: Jerry VanderLugt CPA CFP®

References

1 Information obtained from the following sources:
Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 6
Morningstar Pricipia Pro, December 31, 2008
Wall Street Journal, January 2, 2009

2 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 26

3 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - pages 32 and 33

4 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 6

5 Information obtained from the following sources:
Ibbotson SBBI 2008 Classic Yearbook- pages 294 - 299
Morningstar Pricipia Pro, December 31, 2008

6 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 30

7 http://finance.yahoo.com/q?s=%5EGSPC

8 Wall Street Journal - January 15, 2009 page A8

9 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 12

10 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 13

11 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 45

12 http://www.ritholtz.com/blog/2008/12/calculating-the-total-bailout-costs/

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14 http://data.bls.gov/cgi-bin/srgate
http://www.bls.gov/web/empsit.supp.toc.htm#household_m

15 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 28

16 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 34

17 Our Outlook for the Market, by Bill Bergman 12-24-2008
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18 Fidelity Investments, Market Analysis, Research & Education - 2008 Market Update - page 14