

INVESTMENT STRATEGIES

Neither a Pollyanna nor a Cassandra Be

With apologies to William Shakespeare's Prince Hamlet and the author of Proverbs before him, the title of this newsletter reflects our view that 2009 is shaping up to be yet another trying year for the investment markets. The key to recovering from the stock market crash that caught the investment world unaware is to be able to navigate what will likely be a series of rallies and corrections as the post-crash bottom is formed.

Famed investor Doug Kass has said for months that he is neither a Pollyanna nor a Cassandra on the market for 2009, but rather he views the market as range-bound. I couldn't agree more. 2009 will be the year of the nimble and analytical, with passive index style investors likely to experience little-to-no recovery.

At the end of this newsletter, I will give you our 2009 Investment Strategy, but first I thought it would be helpful to understand what caused the stock market to crash, catching the investment world unaware.

Who Knew Thomas Jefferson Had a Crystal Ball?

"I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around [the banks] will deprive the people of all property until their children wake up homeless on the continent their fathers conquered. The issuing power should be taken from the banks and restored to the people, to whom it properly belongs."

Thomas Jefferson, (1743 - 1826)
3rd President of the United States

It's not exactly what happened during 2008, but his mistrust in the large banking institutions sure seems justified in retrospect.

I wrote in the April 11, 2008 *Investment Strategies* that the financial system was under severe stress due to the housing crisis. The major banks and brokerages had adopted various mathematical models that they relied upon to manage risk. Using these models, they packaged home mortgages into bonds, putting some lower quality loans with some higher quality loans, and the models projected that they were essentially risk-free.

When the managements of the major banks and brokerages realized the extent of the demand for these products from entities that were required to hold AAA-rated paper, they put pressure on their bond departments and sales people to produce ever-higher numbers of these bonds. Couple this with historically low interest rates from Alan Greenspan's Federal Reserve and Congress' pressure on lenders to develop programs that would allow every American to own a home, and you had the makings of a perfect storm. Financial incentives were put in place to generate the loans to package into bonds, interest rates were low, and loan programs with reduced or non-existent underwriting criteria were adopted to encourage consumers to go into debt.

The hedge funds determined that they could borrow money from the U.S. and Japanese banks at very low interest rates and buy these AAA-rated bonds, netting 4% to 5% on the spread. They would leverage themselves 30-to-1 (i.e., take on debt that is 30 times their capital), or even 40-to-1 in Europe, and make a fortune for their investors and themselves.

The major banks and brokerages saw this and copied it, with Lehman Brothers and Bear Stearns assuming 30-to-1 leverage positions. However, the mathematical models were not programmed to anticipate such things as "liars loans" and "ninja loans" (no income, no job, no assets). Loans were packaged into bonds and given AAA ratings based upon the now-flawed mathematical models. As the housing crisis spread across the country and

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the borrowers stopped making their mortgage payments, the bonds stopped paying to the investors.

Hedge funds began to collapse, as they did not have the cash flow coming in to meet the principal and interest payments due on their borrowings. They started to sell whatever assets they could in order to pay down debt. The vortex had begun that would threaten to take down the global financial system.

2008 Redux

Throughout 2008, we had a continuing housing crash, record foreclosures, rising unemployment, the failure/merger of Bear Stearns, the bankruptcy of Lehman Brothers, the nationalization of AIG, various government bailouts, a Wall Street Ponzi scheme, a credit crunch, record-high oil and gas prices, high grain and commodity prices, the nationalization of Fannie Mae and Freddie Mac, record declines in CPI, near failure of the automakers, record-low Consumer Sentiment readings, and a subsequent crash of oil and commodity prices, as well as the stock market crash.

Investment-wise, our clients held up very well for the first eight months of 2008. As commodity and oil prices skyrocketed in the first half of the year, we positioned clients so that they would take advantage of it by owning Ag, Basic Materials, and Energy stocks. As the dollar bear market ensued, our clients owned the industrial manufacturers that exported their products to the foreign markets; the falling dollar increased their sales substantially, and our clients profited from rising share prices. As China's economic renaissance continued, we positioned clients in the global infrastructure companies and Ag companies that were benefiting from the demographic shifts in the third world. Millions of people were moving from subsistence living into the middle class in Asia, South America, and Eastern Europe—with China having the greatest number of people on the move—and demand was increasing for the basics of a middle-class lifestyle: homes, appliances, transportation, and food.

As we moved toward \$147 oil, our strategy changed. We determined that world growth rates would be negatively impacted by high oil and

commodity prices. China also announced that it was shutting down most of its factories in anticipation of the Olympics in order to clean up the air quality, but that as soon as the Paralympics were over, they would resume production. The equity bear market had begun eight months earlier in the broader stock market, and because our clients avoided most of it, we opted to start raising cash. We sold significant positions in the winning areas detailed above. We assumed that there would be a normal bear market correction to the 20% decline level, and we would then re-deploy the cash reserves into our preferred investment themes.

As we moved through the summer, we experienced the correction as anticipated. In anticipation of China's production coming back on line in a few weeks and demand for oil and basic materials resuming, it appeared to be an opportune time to be a buyer. For new accounts that held all cash and for the accounts where we had raised cash, we started accumulating positions on the theory that this would be a normal correction and that there was a catalyst for increased share prices (resumption of Chinese demand) on the horizon. With energy, Ag, and infrastructure stocks down 15% to 30%, we began to accumulate and add to positions through July, August, and early September.

The Crash

In mid-September, the government acted contrary to its previous practices and allowed Lehman Brothers to go bankrupt. Personally, I believe it was simply a childish reaction to the criticism they had received for rescuing Bear Stearns, AIG, Freddie Mac, and Fannie Mae; they decided to let Lehman fail in a "we'll show you" sort of move. Little did they realize the extent to which Lehman had been counter-party to the various Credit Default Swaps around the globe. Their bankruptcy put severe stress on the financial system and caused a global credit crisis that is just now beginning to be resolved.

This systemic problem—no access to credit—caused wholesale liquidation of assets by the hedge fund industry. They were significant borrowers who used their funds' assets as collateral for the debt. As their loans came due, they could not refinance and had to sell assets to

cover the payments. This sent asset prices down further, making their loans under-collateralized, thereby causing their lenders to force even more asset sales to continue to pay down debt. At the same time, hedge fund investors began to redeem their interests, causing the need for further asset sales to make payouts; winning asset classes were sold first (those happened to be the energy, basic materials, Ag, global exporters, and infrastructure companies) as the funds still had gains in those positions. This, unfortunately, caused our performance for the year to quickly catch up with the broader markets as these winning sectors were negatively impacted by the forced liquidations.



As you can see on the chart, the TED Spread jumped significantly in the days prior to the Lehman Brothers bankruptcy and continued rising as the extent of their counter-party risk was uncovered. We now are monitoring the TED Spread daily and have plans in place to raise cash and increase allocations to gold in client accounts if this indicator again moves to such levels.

The Benefit of Technical Analysis

Technical analysis of the market is really just a way to understand the sentiment that is moving the markets by applying historic relationships to future actions. There are no guarantees that history will repeat itself, but it happens often enough that certain patterns are recognizable and which can assist with investment management decisions. I thought you might find it interesting to see one of those patterns and how we use it in the investment management process.

If you look at the following chart, you will see that I've drawn two lines that form a symmetrical triangle. This is an identifiable chart pattern that usually presages a strong move in the chart. Studies have shown that 75% of the time, the strong move results in a resumption of the previous primary trend (in the case of the S&P 500, that would be down). However, in the other 25%, any major change in investor sentiment can cause a trend reversal that can be very profitable.



As you can see on the chart above of the stock market through the end of 2008, the crash was swift and severe. The S&P 500 Index fell from 1250 to 750, or 40%, in no time at all. It was clear to us that we needed to add an indicator that would act as a warning signal whenever the global financial system was stressed to the breaking point.

One of the things that I noticed prior to the crash was a jump in the TED Spread. Prior to the 1987 crash, the TED Spread also jumped in a significant manner. The TED Spread measures the difference between the yields on Treasury Bills and Euro Dollar deposits. Generally, they maintain a difference within a fairly narrow range around 50 to 75 basis points (1/2 to 3/4 of 1%). The pattern that has emerged is that, before a crisis, the difference more than triples. It is an indication that there is something critically wrong within the global financial system that will lead to a liquidity and credit crisis, presaging a market crash.



A reversal of the previous trend, whether permanent or intermediate, can occur if there is enough positive momentum to push the graph above the upper-trend line. If that happens, you can generally anticipate that there will be a move higher in the market.

For us to know if we are headed higher, there are a few things that we would want to see happen:

1. The market would have to close above the upper-trend line, not just have an intraday move above it and close below it.
2. The market would have to remain above the upper-trend line for three consecutive days or maintain a 3% move above the line.
3. The chart would show an increase in trading volume accompanying the reversal.

If we do get a sustainable reversal with the three factors noted above, the next step is to determine how large the move might be. In order to get a price target for the move, you take the difference between the high and the low on the chart at the wide end of the triangle and add that difference to the point of the breakout. In the case of the S&P 500, that is roughly a 250-point upward move if we get and sustain the breakout (1000 – 750 = 250). So, if we get a breakout around 900 on the S&P, we should have an upside target somewhere around 1150. 1150 is coincidentally near the 200-day moving average, another key technical level.

If the pattern does in fact show a reversal, this would be a great time to take cash off the sidelines

and add to some of our favored areas as described in the 2009 Investment Strategy that follows. It is common for stock prices to move up as people jump into the market and start buying, then pull back to the trend line (or even the apex of the triangle, which may be a lower reading on the S&P than the breakout area) as other investors decide to book profits. However, a reversal pattern graphically depicts a major change in sentiment and any move back to the upper-trend line to retest the breakout can also be a profitable buying opportunity, absent some major event or news that shifts investor sentiment negatively.

There seems to be the beginning of a shift in market sentiment at the moment, whether it's due to the potential for Congress to pass a stimulus bill or whether it's that people are seeing the positive impact that China's own stimulus plan is having.

I do not know if the current sentiment shift can be sustained and gather enough momentum to break above the upper-trend line or not. If it is sustained, then this reversal pattern may just come into play and provide an opportunity to recoup some of the negative impact of the stock market crash.

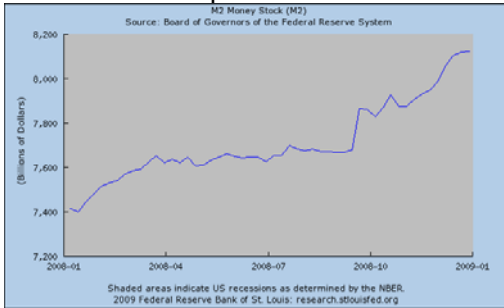
If we get the reversal, we will need to analyze the move as we approach the target and either book profits in anticipation of a return to the primary downtrend or maintain portfolio positions in anticipation of further upside. We certainly hope for the breakout so that we have the opportunity to perform this analysis.

2009: The Healing Begins

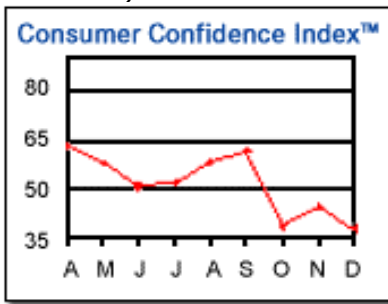
At the present time, we are in a battle against the deflationary impact of the current economic crisis. The recession that is now more than a year old and the impact of the bursting of the housing bubble and the debt bubble are significant issues that must be addressed. For the global economy to pull out of the deflationary cycle it has entered, we must see the following things happen:

- An increase in global money supply
- An increase in the velocity of money
- A resumption of economic activity in China
- A bottom in the housing crisis
- Household, business, and investment leverage decrease to manageable levels

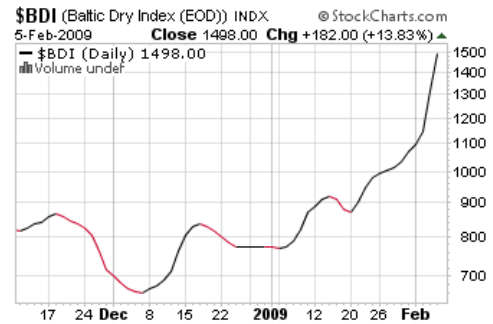
Global Money Supply: We have already seen a significant increase in the money supply in the United States. The graph below is of M2 and you can see how the Federal Reserve furiously increased liquidity following the Lehman Brothers bankruptcy in September. If you were to look at other graphs from central banks around the world, you would see similar patterns.



Velocity of Money: We have not yet seen an increase in the velocity of money. This is really a synonym for economic activity. I like to look at the Consumer Confidence Index to get a feel for when consumers will start to spend again. As you can see, we are at a historic low and should not anticipate an increase in velocity anytime until consumer balance sheets stabilize (debt is paid down, home prices stop falling, and 401(k)s begin to move up in value).



Economic Activity in China: The stimulus package that was implemented in China in November, coupled with China's own monetary stimulus, is beginning to have an impact. China has started to import base metals and Ag chemicals again as its industry and infrastructure building has resumed. The chart below is of the Baltic Dry Index and represents shipping rates. We use it as a proxy for emerging market demand for commodities, and as you can see, it has turned decisively up in concert with China's stimulus plan taking effect.



Housing Crisis: There are a number of indicators that show things may be starting to improve in the housing crisis: the drop in home prices is starting to moderate; the total supply of homes for sale is dropping; mortgage rates are low and are anticipated to decline further; the Senate is proposing an up to \$15,000 tax credit to purchase a home; and with the drop in home prices and mortgage rates, it is becoming financially viable to buy a home compared to renting a home. Per the Case Shiller survey in some markets hit hardest by the housing crisis, it is cheaper to buy than rent.

Offsetting these positives is increasing unemployment. However, not everyone will lose their jobs, and there are a significant number of renters who will remain employed and who have been waiting for an opportunity to buy a home. We are probably not at the bottom of the housing crisis yet, but finding a bottom in the coming months may be the financial surprise of the year.

Deleveraging: Consumers, businesses and investors assumed way too much debt.

"Owners of capital will stimulate the working class to buy more and more expensive goods, houses, and technology, pushing them to take more and more expensive credits, until their debt becomes unbearable. The unpaid debt will lead to bankruptcy of banks, which will have to be nationalized, and the State will have to take the road which will eventually lead to communism."

Karl Marx, *Das Kapital*, 1867

Consumers used their rising home equity presuming ever-increasing home prices like an ATM machine, buying cars, flat-screen TVs, computers, vacations, vacation homes, expensive restaurant meals, designer clothes, and other less-than-necessary items. However, in the third quarter

2008, Federal Reserve data shows that household and mortgage debt outstanding dropped by the largest amount in 40 years. Consumers are deleveraging.

Businesses capitalized upon debt-fueled consumer demand to expand through low-cost debt instead of equity capital. The world has significantly overbuilt, and now capacity utilization is falling. Worldwide, we have the capacity to build 92 million cars, but sales will be lucky to reach 60 million. Many manufacturing facilities—auto and otherwise, around the world—will have to be closed. Businesses are deleveraging and reducing capacity.

Hedge funds and brokerages acquired debt to buy investments while individual investors margined their portfolios to buy investments. Investors are deleveraging as assets have been liquidated to pay down debt.

Karl Marx was correct in so far as his analysis of major change coming from economic turmoil, although ours will not result in communism but rather government policy changes. Overcapacity, unemployment, a credit crisis, lack of consumer confidence, and business bankruptcies are all components to a deflationary economy. Deflation will be fought by governments around the world with major policy changes: increased money supply (see the chart of M2 above) and Keynesian government spending through stimulus programs.

As I write this, the Senate has just approved its version of an \$820 billion stimulus bill. It differs from the version that the House of Representatives passed in several ways, but I have not seen any independent analysis as to the exact extent of its stimulative impact. On our blog, I have posted stories from the *New York Times*, the *Wall Street Journal*, and the Congressional Budget Office analyzing the shortcomings of the House stimulus bill. In essence, their criticisms can be summed up as there just is not much stimulus in the bill.

The stimulus package being implemented in China appears to be properly conceived. China is using the money to build infrastructure that will increase economic activity in areas of the country that are currently economically undeveloped. It is, in essence, an investment in the country's future. The *New York Times* ran an article this week that

documented the failure of Keynesian stimulus in Japan to get that country out of its 20-year financial crisis; the Japanese built in a significant way, but the plan was not targeted to increase economic activity. The construction of museums, aquariums, and bridges to nowhere in Japan created a temporary boost to employment, but once the building was completed, there were no jobs created from the resulting projects. It was the economic equivalent of digging holes and filling them up again.

Unfortunately, much of our Keynesian stimulus bill looks like the Japanese version instead of the Chinese version. With billions of dollars slotted for remodeling government buildings and other programs that will give a temporary boost to employment, it may not have the necessary permanent impact on our economy. However, combined with the significantly increased money supply, we will eventually stop worrying about deflation and begin to worry about inflation once again.

2009 Investment Strategy

• Cash Equivalents

- Maintain above-average cash levels as a hedge against further equity or fixed-income market problems
- Invest cash equivalents when market sentiment turns positive and take profits and build cash positions when market sentiment turns negative

• Fixed Income

- Continue to rely on insured Certificates of Deposits in accounts that require fixed-income exposure
 - Eliminate the credit-risk aspect of fixed-income investing
 - CDs are paying higher yields than Treasury Bonds
 - Laddered portfolio provides reinvestment opportunities when rates begin to rise
- When interest rates begin to rise in anticipation of a return to inflation, review adding Treasury Inflation Protected Securities (TIPS)

- Add convertible securities that outperform in this economic stage

- **Equity**

- **Gold:** maintain overweight position— gold will anticipate inflation well in advance and increase in value, and it acts as insurance against further systemic financial crises.
- **Agriculture:** maintain overweight position—we always viewed Ag as a play on increased demand for meat and dairy in the rising middle class in the developing world; it was never an ethanol or biofuel issue for us.
- **Global Infrastructure:** maintain overweight position—the stimulus plans being enacted around the world will increase the earnings for the premier providers of infrastructure.
- **Health Care/Biotech:** maintain market weight position, but overweight Biotech within Health Care sector—the growing earnings of Biotech plus anticipated mergers with pharmaceutical companies should provide attractive returns.
- **Technology/Telecommunications:** move to market weight, but emphasize companies that have catalysts for growth—much of traditional tech investing relied upon companies whose products have now become commoditized (e.g., PC manufacturers); unique products and business lines will be catalysts to growth.
- **Financials:** underweight, but begin to add some selected exposure—asset managers/mutual fund providers will take the place of hedge funds as investors begin to reassess their portfolios; REITs that invest in mortgages will benefit from the government guarantees.
- **Consumer Goods:** continue to underweight—the housing ATM will not be available to promote spending; consumers will need to live within their means and move to a normalized level of spending.
- **Energy:** maintain market weight—we are likely in a trading range for oil between \$35 and \$80 per barrel. Energy companies will see their share prices trade in line with oil for the foreseeable future. The Chinese

stimulus plan may impact oil prices faster and push them higher than current earnings estimates anticipate.

- **Energy Efficiency and Clean Energy:** initiate positions—under the proposed stimulus plan, there are incentives to promote clean energy (they will be better outlined by the government later in 2009) and upgrades to the power grid. Also under the *Energy Independence and Security Act (EISA)*, the government has begun awarding a series of contracts totaling \$80 billion to a range of firms involved in boosting energy efficiency.
- **Industrial Metals:** maintain current positions and reevaluate once stimulus package impact becomes known—again, Chinese demand due to its stimulus package may impact share prices more than current earnings estimates anticipate.
- **Utilities:** market weight—there will be a trade-off here between the negative impact of rising interest rates (whenever that may be) and the positive impact of the stimulus package and the EISA. Both of these will positively impact the utilities that are involved in promoting energy efficiency and upgrading the power grid.
- **China/Brazil:** overweight—The developing world will come out of the global recession first because they are now the world's lenders, and the G7 are the world's debtors. China will lead the way, and Brazil (being a primary supplier of coal, metals and oil to China) will follow closely behind.

2009 Forecast

We may very well be on the verge of a rally in the broader markets and potentially a new bull market in industries that will benefit from the Chinese stimulus plan—and maybe even our own. However, I see 2009 as a series of rallies and corrections within a broad trading range of the bottoming process as we work through the economic issues facing us.

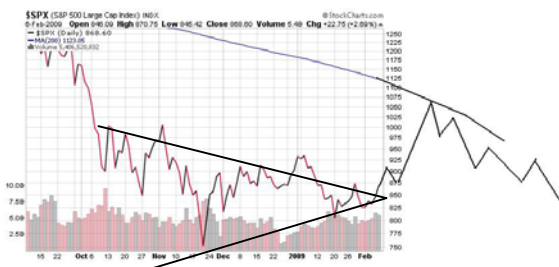
One of the things that I have learned over the years, is that you cannot have a new bull market in stocks without the banks participating. Until we see the bank index begin to outperform the

broader S&P 500 index for at least six weeks, any rally in the broad index should be viewed skeptically.



The graph above is one of the primary indicators that we monitor. It is a graphical representation of the relationship of the bank index (BKX) to the S&P 500 Index. You can see that this past summer, the banks began to outperform the S&P until mid-September. The positive strides that banks made in dealing with the housing and financial crisis were crushed in September with the bankruptcy of Lehman Brothers. The credit crisis, the risks from banks' undetermined exposure to the credit default swap market, and the decimated balance sheets from devalued assets and reduced capital, all will require additional time to heal. It will not be easy to fix such a huge and important piece of our economy, and its continued negative impact on the fortunes of the stock market is virtually guaranteed.

On the graph below, I've drawn in what I think the stock market will likely look like during 2009. You can see that I anticipate that we will in fact have a reversal out of the symmetrical triangle pattern discussed earlier and move up toward the 1150 level on the S&P 500 and the 200-day moving average.



However, until the banking system is healthier than it is currently and the housing crisis finds a bottom and turns up, I seriously doubt that we will see a sustained move beyond the rally to the 200-

day moving average. Over the course of the year, the broader average will likely return to current levels.

This does not mean that we anticipate our clients' portfolios languishing all year long. On the contrary, as of the close of business on Friday, our average portfolio had moved into a slightly positive return for the year. This is due to the companies that benefit from the Chinese stimulus plan performing quite well, our allocation to gold outperforming most of the market, and our deploying some cash into the areas covered in the 2009 Investment Strategy.

2009 will be a year when professional investment management will yield a significant advantage over passive investment management. A well-diversified buy-and-hold strategy will likely not provide adequate returns for the average investor. Rather, a targeted investment management style that capitalizes upon anticipated catalysts and that protects and realizes gains as incurred will provide winning results.

In Summary

You cannot be an overly optimistic Pollyanna nor an overly negative Cassandra in 2009 and expect to have acceptable performance. Being nimble and analytical and being prepared to act upon whatever the market gives you will be critical to success this year.

At BankChampaign, we will follow the strategy as outlined in this *Investment Strategies* newsletter and work to provide the best return possible for our clients.

If you are one of our clients reading this, we thank you for your business and look forward to our continued relationship. Increasing your wealth is important to us, and we appreciate the opportunity to work with you.

If you are not currently a client and would like to discuss how we might positively impact your investment portfolio, please call either Mark Ballard or John Clausen at (217) 351-2870 to schedule a time to meet.

Here's wishing you all the best in 2009!