



Registered Investment Advisor

## STEIN WHITTINGTON DENIEL INVESTMENT ADVISORS

# Wealth Manager

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## EQUITY MARKETS — WHAT NOW?

We can acknowledge that the original culprit of the current upheaval in the credit markets is the highly leveraged environment we now see unwinding in the residential mortgage sector. Mortgage brokers, realtors, escrow companies, all pursued higher profits and commissions. Banks packaged the loans and sold them to investors earning large underwriting fees. Whether or not borrowers and buyers could make a down payment or had enough income to service debt was ignored. The underlying assumption was that the price of residential real estate would continue to rise thereby supporting higher debt and new borrowings. These experienced professionals who should have known better pushed the general public into new or bigger homes they could not afford, with teaser rates, without regard for the future. The drive to earn more commissions, more fees, more underwriting revenues, overcame common sense. The general public overbought, overspent and over-committed. It is interesting how the public has dubbed the 700 billion rescue legislation as a Wall Street bailout by the taxpayer. If truth were told, other than renters, it looks like everyone, including Main Street was a participant in the problem.

Let's examine where the real estate mortgage market stands currently. There are approximately 80 million homes in the United States. Of these, 25 million have no mortgage. Of the remaining 55 million homes, 51 million homeowners are current and 8%, 4 million are behind on payments. There is a 2% foreclosure rate on the 55 million homes which are tardy. 50% of the foreclosures involve subprime loans that never should have been made. Thus, it is clear the core problem centers around a relatively small group of homeowners who should not have borrowed at the levels they did.

On October 3, 2008, Congress passed comprehensive legislation designed to restore liquidity to the credit markets. It is easy to dispute the wisdom of this legislation or parts of it, particularly in an election year. However, the arguments favoring congressional action are convincing. The markets need calming. Fear which has been rampant hopefully will recede going forward. Rarely, have investors been so negative.

Yet savvy investors such as Warren Buffet, Bank of America and J.P. Morgan Stanley have recently jumped heavily into the equity markets, strongly suggesting a bottom has been reached and prices are cheap. More encouraging is the fact that financial stocks traditionally lead markets out of recession and financials have demonstrated resilience in the past few weeks.

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Another less publicized phenomenon that significantly affects equity prices to the downside is the fact that large number of hedge funds have been forced to liquidate. Liquidation requires these hedge funds to sell blocks of stock holdings regardless of their view of value or timing. In such a hostile market environment, therefore, we have seen significant forced sells so that hedge funds can

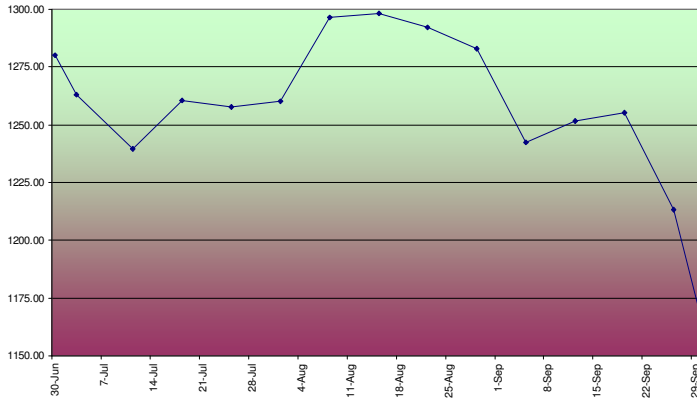
meet redemptions, a phenomenon which has nothing to do with value of the securities.

The evidence suggests the US economy may be in recession or heading there (two successive quarters of negative growth). The Russian markets have been closed; other markets such as China, Brazil and the MSCI EFA have experienced large sell-offs even though their economies appear to be in pretty good shape. Oil and gas, copper, fertilizer, iron ore, and other commodities have experienced sharp sell-offs; they have already sunk to lows indicating a worldwide recession. Is this realistic? We do not think so. However, as has been the case in the past, extremes to the upside, and the down, are typical, driven by the human desire to "follow the herd". While it is true an investor in cash would have been in the best position during 2008, the undisputed facts show that year in, and year out, equities provide a good return and hedge on inflation..

## THE QUARTER IN REVIEW

SP 500 INDEX

July 1 - Sept 30, 2008



The last quarter ending September 30, 2008, represents a period of one of the sharpest quarterly declines in the major indices, -4.4% in the DJIA, -9% in the S&P500 and -8.8% in the Nasdaq. The 777.68 plunge in the DJIA on September 29, 2008, constituted the largest single session decline in the 112 year history of the DOW. By the end of the 3rd quarter most stocks and ETFs, regardless of industry sector, were near or were setting new, 52 week lows. Volatility remains at record highs.

The tight credit conditions which have set the stage for the sharp sell-off resulted in new legislation, the "Troubled Asset Relief Program" or "TARP" on Friday, October 3, 2008. The effects of TARP should become clearer within the next 45 days. This legislation along with the precipitous drop in the cost of basic commodities such as oil, natural gas, copper, iron ore, fertilizer and others, have dramatically changed the outlook for inflation globally; indeed, inflation fears are not even on the radar currently. Rather the focus is now on a worldwide recession; the Fed has been furiously pumping liquidity into the banking system. As pointed out on page 1, savvy investors are looking for bargains and financials appear to have bottomed. These dramatic changes in the financial environment augur well for the future of stock markets even if there will be difficult issues that must be worked through in the near term. It should be noted also that there is discussion and cooperation between the Big Three Central Banks, the Federal Reserve, the European Central Bank, the Bank of Japan (with other banks joining in). This could well lead to an internationally coordinated cut in interest rates which also would prove highly beneficial to the markets.

It cannot be overstated that all of these developments

have taken place in the middle of a Presidential election and other congressional contests. Each party takes every opportunity to blame the other for the current conditions and neither party is motivated to lead or take any measures that might make the economy turn because of the fear that they will be blamed if it does not work out before the elections.

As we write this letter, it is apparent that the credit crisis has spread to Europe and Asia. The growth rate for China was reduced to about 7% per annum, a large reduction from the 10-11% the past few years. Thus, with a globally cooling economy, the price of crude oil has dropped below \$90 a share and the shares of all companies, serving the oil sector, have fallen sharply. Even so, given these developments, we should recognize that (1) governments in Europe have stepped up to support their banking systems, much as TARP; (2) the effects of TARP cannot yet be seen as the legislation has not been implemented; (3) Even with reduced demand, the price of commodities, such as crude, have dropped dramatically, more than supply/demand would dictate; and (4) a slowing of the Chinese economic growth could be favorable, because China has been threatened with inflation.

**Interview on Television:** Rick Stein's interview with Randy Alvarez about Covered Call Writing and our company continues to show on Channel 7 about 10 times a month. Please call if you would like to know the times the interview will air.

**Schwab Alliance:** If you haven't done it yet, please remember to call the Schwab Alliance Team (800) 515-2157, #3 in order to request enrollment in electronic delivery. Please ask to enroll in e-Confirms, electronic delivery of annual reports and 10K's and e-Statements. This will entitle you to receive reduced commissions on equity trades and avoid the clutter in your mail box.

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