



Market Commentary

The Worst may have Passed

Some signs are emerging that the economy and the financial markets bottomed during the first quarter. Although miserable in absolute terms, the March data for new unemployment claims, existing home sales and new car sales all showed modest improvement over January and February. The ISM index of manufacturing activity likewise showed a slight improvement. Although the equity markets reached a new low in early March, the declines in 2009 concentrated in the financial sector and some level of differentiation between high and low quality companies appeared to be returning. The volatility, as measured by the VIX index, has fallen from the record levels of October and November. Beginning in early March, the equity markets staged a 23% trough-to-peak rally, one of the best short term moves since the Depression. Financials led the rally, followed by the Industrials and Consumer Discretionary sectors.

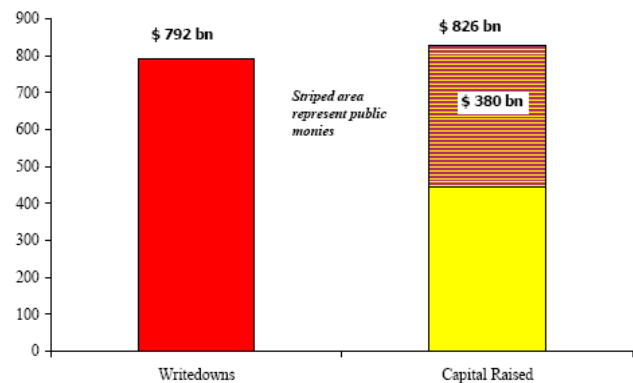
Most importantly, liquidity has returned to the credit markets. The TED spread – the difference between T-Bill rates and intra-bank lending rates – has remained throughout 2009 at the 100 basis point level – higher than historical averages, but well below the post-Lehman high of 450 basis points. The spread on corporate lending rates has likewise narrowed with the yield premium of the average BBB-rated bond over comparable duration Treasuries falling from a high of 620 basis points to current levels of around 550 basis points. Over \$350 billion of new investment-grade corporate bonds were issued in the first quarter as companies scrambled to raise funds to carry them through the recession. Small and mid-sized banks which did not compromise their lending standards during the bubble are able now to make very profitable and conservatively underwritten loans. The stimulus plan looks to add at least a percentage point to GDP growth in the second half of 2009 and throughout 2010.

A Slow Recovery

However, we would caution against becoming overly optimistic. The real issue is not that the economy has

bottomed, but the slope of the recovery. Given that the problems in the banking sector are far from over, the global economy appears to be assured of several years of anemic growth as credit remains tight and highly leveraged borrowers struggle with servicing their debt. While financial stocks led the March rally, there is still a reasonable probability that one or more large banks will have to be “nationalized” (i.e. put into receivership by the government). While losses from subprime mortgage lending, particularly in its securitized form, have largely been reflected on banks’ balance sheets, lenders have just started to recognize losses from commercial real estate, consumer and corporate loans. Estimates by RGE, Nouriel Roubini’s economic research firm, project the US banking system’s potential losses at over \$700 billion between these three categories, comparable in magnitude to what total writedowns from subprime and other loans have been to date (see graph below). The real magnitude of these losses depends, of course, on the depth and length of the recession.

Figure 2. Bank Writedowns and Capital Raised (\$ bns)



Source: Bloomberg; Through January 26, 2009

Source: IMF GFSR Update January 2009

The hope of the stimulus package in regard to the banks is that it will spur economic growth beginning in the second half of 2009 and into 2010 which will mitigate the losses the banks would otherwise have faced on consumer, corporate and commercial mortgage lending as

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well as lead to a speedier return of public funds invested through the TARP program. Given the size of the stimulus, it cannot fail to generate economic growth. The issue is the cost-effectiveness of the plan and the impact of record deficits on inflation and interest rates a few years from now. Between 1929 and 1933 GDP declined in real terms by 27% whereas to date GDP has declined 1.8%. Grant's Interest Rate Observer notes that the stimulus plan calls for expenditures totaling 29% of GDP over the next two years – about equal to the entire output loss of the Depression. This is an unprecedented experiment in Keynesian economics and carries substantial risks; however, the alternative may be a decline in output on the scale of the Depression, which would carry costs of at least a similar magnitude.

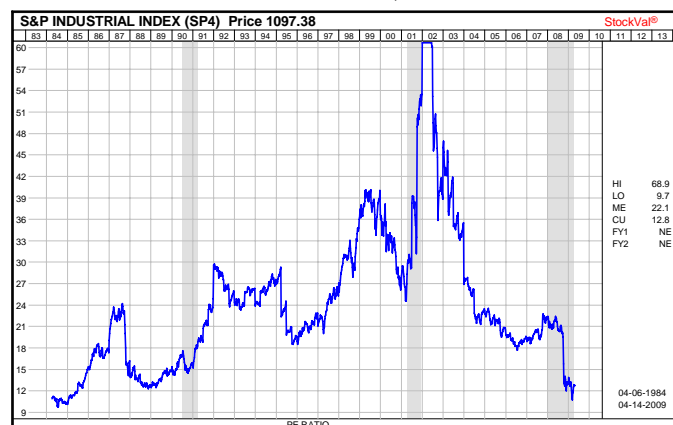
This level of government spending carries significant risks of inflation. However, this will not be a problem until the overhang of bad debt and insolvent banks has passed, likely 3-5 years from now. Throughout the announced stimulus the world has maintained its basic confidence in the dollar which makes the nightmare hyperinflation case increasingly an insignificant risk. The real risk would be a multi-year period of mid to high single digit inflation combined with weak economic growth similar to the 1970s. More likely, in our opinion, is a short recovery followed by another, albeit smaller, recession. Once the global economy recovers, private credit growth resumes and the US starts to grow at the 2.5%-3.0% rate, the Fed may have to raise interest rates sooner than it would otherwise to stem inflation.

S&P Trading at 57 Times Earnings?

Thanks to the massive losses in the financial sector, the S&P 500 earned in aggregate \$14.89 for 2008. A few pundits seized on this to claim stocks are still expensive and predict further declines. Pricing the S&P 500 at a 20x multiple on these earnings would lead to a level of around 300 – a 65% decline from current levels. However the current high P/E ratio is a function of the massive losses in the financial sector. Standard & Poors accounts for the earnings as if the index were a single conglomerate. While correct in historical terms, it is misleading in regard to future earnings. AIG, for example, ended the year with a 99 billion dollar loss against a market capitalization of only 3 billion. The losses in AIG and other companies in the Financial sector are of course already reflected in the share prices of the stocks. Investors cannot lose more than their investment in the company and reported losses by one company in the index does not count against the income of another – so in this regard the S&P 500 is definitely not like a con-

glomerate. Examining the S&P, Industrials, which excludes the Financial, Transportation and Utilities sectors, show even after the recent rally that they are trading at levels not seen since the early 1980s, at 12.8 times trailing earnings and 7.8 times trailing cash flow.

S&P Industrials: PE Ratio, 1984 - 2009



No magic bullet exists for dealing with the current environment. Stocks remain priced for attractive returns once the economy fully recovers, but the time this will take is uncertain. Opportunities exist in the credit markets for equity-type returns, but pitfalls abound. Safe investments are certain losers once spending needs and potential inflation are accounted for. The emerging debacle in commercial real estate looks to offer values comparable to the early 1990s, but patience and willingness to sacrifice liquidity will be required. Finally, technology has been the core driver of economic expansion and over the long term there are enough promising opportunities, particularly in the confluence of nanotechnology and biotechnology, to drive decades of real wealth creation. The only real option is diversification and making sure that portfolio liquidity matches distribution needs. Investors should know what they own and why they own it and make sure it can survive a longer than expected downturn. One wins in a market like this by merely surviving and participating in the eventual recovery.



Commentary by
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Smart Investing Monthly Conference Calls

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Past Conference Call Highlights

Fiduciary Responsibility Post Madoff

Paul Comstock, Chairman, Peter Chadwick, Partner, Day Pitney, and Karla Valas, Chief Compliance Officer, Fidelity, discuss whether the definition of diversification has changed for Trustees after Madoff.

A few of the points mentioned during the call that trustees should consider:

- Under UPMIFA & UPIA the requirement to diversify has been generally interpreted to be in regard to the number of securities held within the portfolio.
- Requirements of Fiduciaries under UPMIFA that go beyond the diversification issue:
 - Act in good faith, with the care an ordinary prudent person would exercise
 - Make a reasonable effort to verify relevant facts
 - Make decisions about each asset in the context of the portfolio of investments as part of an overall strategy
 - In general, develop an investment strategy appropriate for the (trust) or the charity
 - In managing and investing, the following factors, if relevant, must be considered: general economic conditions, the possible effect of inflation and deflation, the role that each investment or “course of action” plays within the overall investment portfolio of the fund (trust), management and investment decisions should be made...as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust or institution.

Portfolio Modeling, Does it Work?

During our Smart Investing Conference Call in March, Steve Browne, CFA, discussed key areas investors need to focus on during this tumultuous investing period.

How do you control risk in today’s environment?

Keeping these key factors in mind will help investors stay focused on a long term investment strategy that will keep you on track with your financial goals.

- Portfolio losses are difficult to recover from when required distributions are being taken from the portfolio. Be sure to maintain adequate liquidity (cash and high quality fixed income) to cover 5+ years of distributions.
- Volatility is at record levels. This means that investors should expand rebalancing targets to acknowledge that a 50/50 portfolio today is more volatile than a 70/30 portfolio was three years ago.
- Risk cannot be expressed by statistics alone so it is important that you know what you own and how it is financed.
- Traditional investment models often underestimate potential losses. To account for the true potential of loss, model fat-tails into projections of possible future returns.
- Comstock portfolios are structured to avoid any potential for catastrophic loss.

For complete handouts and recordings of these calls, be sure to go to our website:

www.paulcomstockpartners.com under Smart Investing Resources/conference calls.



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