

2009 Preview—Will Darwinism Return to the Markets?

December 30, 2008 Newsletter

“It is not the strongest of the species that survives, or the most intelligent that survives. It is the one that is most adaptable to change.” – Charles Darwin

2008 in Review—Has the Easy Market Call Come and Gone?

As regular readers know, I have had a cautious, even bearish view, towards equities and credit over the past couple of years. The handwriting was on the wall and both equities and credit seemed woefully overvalued. That being said, our long-standing target for the S&P 500 of 750-800 was reached this autumn, a level that has held even in the face of awful economic news. I do believe an ultimate low of 500-600 is possible, but most of the pain (in terms of price, not time) has been faced.

Some people will tell you that the bad news is now ‘priced in’ for the S&P 500, but I strongly disagree. According to S&P, their ‘top down/macro’ earnings estimate for 2009 has fallen all the way to \$42 per share. This is in direct contrast to the cumulative ‘bottom up/stock-by-stock’ estimate of \$70 or so from Wall Street analysts. The Wall Street folks have been overly optimistic for 20 years or more while the S&P has a habit of being on the mark as they don’t have an axe to grind.

My point is that while the S&P 500 has moved from nearly 1,600 to a recent 860 (a 45%+ decline) it remains at a healthy 22 times S&P’s earnings estimate for 2009. Bulls will tell you that the market is cheap because even if the \$42 earnings number is correct, these are ‘trough’ earnings or the low point for the cycle. I will concede that even if the \$42 IS a trough number, the market is not cheap on any other metric, price to book, dividend yields, etc. In addition, P/E ratios based on trough estimates assume that earnings will rebound sharply once the bear market is over, but this is certainly not our outlook.

I must concede that the easy call, being out of stocks or underweight stocks in general, has been made. For 2009 and forward, a general call on the overall market will be not as easy, but good money can be made in company selection and sector rotation.

While equities in the US suffered 40% losses for 2008, corporate bonds and other credit sensitive securities got killed (some ‘core’ fixed income managers were down as much as 25% for the year). The pity about 2008 for most investors is that they were let down by what was supposed to save them-DIVERSIFICATION. The year 2008 will be remembered as the year of the ‘1 beta event’, a year where there was nowhere to hide, except in Treasury notes and bonds.

We fully expected the ‘1 beta event’ which explains why we were nearly void of equities (for clients that allow us to go to a 0% weighting) from April until our buy in the 750-775 area in the S&P in November. While we are not close to being bullish about stocks in general or even credit in general, I believe that pockets of value are beginning to develop in some risky asset classes. I also believe that we will enter a period of Darwinism where the best managed companies pick up the pieces of poorly managed companies that will likely fail. I believe that Darwinism will occur at the national, corporate, municipal and individual level.

What Might Darwinism Look Like?

Despite the constant government intervention by the Federal Reserve, Treasury Department and Congress, many companies still went by the wayside this year. Some were outright failures/bankruptcies, some were forced marriages, some were bailouts and others were just given

taxpayer money to just stay alive. It is a long list, many of which we wrote about prior to their demise and well ahead of time. They include AIG, Fannie Mae, Freddie Mac, Bear Stearns, Lehman Brothers, Merrill Lynch, Citigroup, National City,

General Motors, Ford, Countrywide, Wachovia, UBS, and Washington Mutual and now tonight we add GMAC to that list after receiving \$5 billion from TARP.

Losses stemming from the Credit Crisis have now crossed the trillion dollar threshold as you can see in the table below:

Losses to date due to Credit Crisis courtesy of Bloomberg LP – WDCI <GO>

1) Job Cuts		2) Related		3) Bailouts		Writedowns & Credit Losses vs. Capital Raised							
Base Currency: Billions		USD		More Periods								5) >>	
		Total		4Q08		3Q08		2Q08		1Q08		4Q07	
		Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital	Loss	Capital
6) All Financial													
7) Worldwide		1005.4	925.2	78.9	462.0	250.2	99.7	167.0	195.7	223.8	89.3	217.7	64.1
8) Americas		678.1	552.8	76.6	292.5	190.7	44.1	108.4	103.4	129.4	62.6	124.2	47.1
9) Europe		296.5	317.9	2.3	141.4	56.5	46.8	54.7	78.7	83.1	22.8	81.5	17.0
10) Asia		30.8	54.4	.0	28.2	3.0	8.8	3.9	13.6	11.3	3.9	12.0	.0
11) Banks/Brokers													
12) Worldwide		744.9	795.9	77.9	395.4	175.1	98.1	124.4	161.0	156.8	86.1	163.6	46.0
13) Wachovia Corporation		96.5	11.0	44.9	.0	29.1	.0	13.0	7.5	4.4	3.5	3.2	.0
14) Citigroup Inc.		67.2	113.8	.0	64.8	12.3	4.0	12.0	13.9	19.0	19.4	18.2	11.8
15) Merrill Lynch & Co.		55.9	29.9	.0	.0	12.0	11.7	8.9	4.3	7.6	7.2	18.0	5.9
16) UBS AG		48.6	34.5	.0	5.7	4.4	.0	6.0	16.6	19.2	.0	14.4	12.3
17) Washington Mutual Inc.		45.6	12.1	.0	.0	30.9	.0	5.5	.0	4.1	8.1	3.5	4.0
18) HSBC Holdings Plc		33.1	4.9	.0	.0	5.7	.9	9.5	3.9	4.2	.0	10.0	.0
19) Insurers													
20) Worldwide		146.0	92.9	1.0	52.8	36.7	1.6	13.7	27.6	42.4	3.2	42.8	4.6
21) American International...		60.9	65.8	.0	40.7	12.7	.0	8.7	25.1	19.9	.0	19.3	.0
22) Ambac Financial Group...		10.6	1.4	.0	.0	2.2	.0	-.6	.0	2.7	1.4	5.6	.0
23) Hartford Financial SVC...		7.9	3.0	1.0	2.5	3.1	.0	.3	.5	1.9	.0	.8	.0
24) Metlife Inc		7.2	2.3	.0	2.3	3.3	.0	1.0	.0	2.1	.0	.2	.0
25) Allianz SE		4.5	2.0	.0	.0	.7	.0	.9	2.0	1.3	.0	1.0	.0
GSE													
26) Freddie Mac		58.4	20.8	.0	13.8	17.8	.0	12.7	.0	15.1	.0	6.1	6.0
27) Fannie Mae		56.0	15.6	.0	.0	20.5	.0	16.3	7.1	9.5	.0	5.2	7.5

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Worse yet, 242,273 job cuts have been announced in just the public world of financial companies since

the Crisis began. Please reference the chart below.

Job Losses announced to date due to Credit Crisis (courtesy of Bloomberg LP)

1) Capital Raised	2) Related			3) Bailouts			Writedowns & Credit Losses vs. Job Cuts						
Base Currency: Billions		USD		More Periods									5) >>
	Total			4Q08			3Q08			2Q08			
6) All Financial	Loss	Cuts	% cut	Loss	Cuts	% cut	Loss	Cuts	% cut	Loss	Cuts	% cut	
7) Worldwide	1005.4	242273	4.4	78.9	106008	1.9	250.2	38706	0.7	167.0	52328	1.0	
8) Americas	678.1	166802	7.9	76.6	71677	3.5	190.7	24397	1.1	108.4	35993	1.7	
9) Europe	296.5	71051	2.4	2.3	30701	1.1	56.5	14219	0.5	54.7	16035	0.6	
10) Asia	30.8	4420	0.4	.0	3630	0.3	3.0	90	<0.1	3.9	300	<0.1	
11) Banks/Brokers													
12) Worldwide	744.9	232924	5.2	77.9	103058	2.3	175.1	35415	0.8	124.4	50794	1.2	
13) Wachovia Corporation	96.5	8393	6.9	44.9	0	0	29.1	6950	5.7	13.0	1000	0.8	
14) Citigroup Inc.	67.2	35200	9.4	.0	12200	3.3	12.3	9100	2.4	12.0	7700	2.1	
15) Merrill Lynch & Co.	55.9	6120	9.5	.0	900	1.4	12.0	0	0	8.9	3000	4.7	
16) UBS AG	48.6	9000	10.8	.0	2000	2.4	4.4	0	0	6.0	5500	6.6	
17) Washington Mutual Inc.	45.6	9200	18.6	.0	5000	10.1	30.9	0	0	5.5	1600	3.2	
18) HSBC Holdings Plc	33.1	4598	1.4	.0	1818	0.6	5.7	1130	0.4	9.5	0	0	
19) Bank of America Corp.	27.4	46150	22.0	.0	35000	16.7	6.2	0	0	5.2	7500	3.6	
20) National City Corp.	26.2	4900	15.3	19.9	4000	12.5	.8	0	0	2.5	0	0	
21) Insurers													
22) Worldwide	146.0	9349	0.8	1.0	2950	0.3	36.7	3291	0.2	13.7	1534	0.1	
23) American Internationa...	60.9	980	0.8	.0	380	0.3	12.7	0	0	8.7	0	0	
24) Ambac Financial Group...	10.6	0	0	.0	0	0	2.2	0	0	-.6	0	0	
25) Hartford Financial SVC...	7.9	500	1.6	1.0	500	1.6	3.1	0	0	.3	0	0	
26) Metlife Inc	7.2	0	0	.0	0	0	3.3	0	0	1.0	0	0	
27) Allianz SE	4.5	500	0.3	.0	0	0	.7	0	0	.9	0	0	
28) Swiss Re	4.5	134	1.1	.0	120	1.0	1.4	14	0.1	.6	0	0	
Last Update:	12/29/08 11:45:08						Totals reflect figures before rounding.						

If that weren't bad enough, Bloomberg now actually has a 'Bailouts' tab on this part of their analytics.

Truthfully, had I not witnessed all of this first hand, I would not have believed it to be possible.

Bailouts to date via TARP (Troubled Asset Relief Program) –(courtesy of Bloomberg LP)

1) NEWS	2) Writedowns/Losses		Government Capital Investments in Financial Firms				
Base Currency: Billions		USD		3) All Capital		4) TARP	
Investor Government	UNITED STATES						
Firm	Total	Appropriated	Approved	Pending			
5) Citigroup Inc.	64.5	25.0	39.5	.0			
6) American International Group	40.0	40.0	.0	.0			
7) Wells Fargo & Company	25.0	25.0	.0	.0			
8) Bank of America Corp.	25.0	15.0	10.0	.0			
9) JPMorgan Chase & Co.	25.0	25.0	.0	.0			
10) Freddie Mac	13.8	13.8	.0	.0			
11) Morgan Stanley	10.0	10.0	.0	.0			
12) Goldman Sachs Group Inc.	10.0	10.0	.0	.0			
13) PNC Financial Services Group	7.7	.0	7.7	.0			
14) U.S. Bancorp	6.6	6.6	.0	.0			
15) SunTrust Banks Inc	4.9	3.5	1.4	.0			
16) Capital One Financial	3,555	3,555	.0	.0			
17) Regions Financial Corp	3.5	3.5	.0	.0			
18) Fifth Third Bancorp	3.46	.0	3.46	.0			
19) Hartford Financial SVCS GRP	3.4	.0	.0	3.4			
20) American Express Co.	3.39	.0	3.39	.0			
21) BB&T Corp	3,134	3,134	.0	.0			
22) Bank of New York Mellon	3.0	3.0	.0	.0			
23) KeyCorp	2.5	2.5	.0	.0			
24) CIT Group	2.5	.0	.0	2.5			
25) Comerica Inc	2.25	2.25	.0	.0			
Total Amount	293,708	212,3344	71,706	9,6676			

This may be the list of companies that doesn't emerge from this period of Darwinism. They may

emerge, but only as a shadow of its prior self, run by the Government or broken into pieces rendering

them unrecognizable. Companies that will not survive are likely those that are not able to finance themselves in a profitable manner. Let's face it—if your name is on these lists, it is because you needed the money—plain and simple. There are actually others like American Express and General Electric Credit Corporation that are indirectly on this list as they have used the Fed's Commercial Paper lifeline to finance themselves. They are not on this list - not yet anyway... But look for others including other insurance companies, Real Estate Investment Trusts, other finance companies like GMAC, CIT, and Capital One among others. When we are all said and done with this bailout process, many trillions of dollars of taxpayer money will be thrown at the mess that the Fed helped start in the first place.

What kind of company will survive the test of Darwinism? Those that can finance themselves, have pristine balance sheets and management teams that saw the economic mess coming, tightened their belt and rode out the storm. These might include companies like Johnson and Johnson, Exxon Mobil, Pfizer and Proctor & Gamble. These companies do not need to come to the debt market to finance themselves all the time.

What was more pitiful than the auto industry hearings in Washington where a bunch of grown men who sat there and said, "we recklessly managed our companies, we are almost bankrupt, please bail me out?" Darwinism suggests that these companies should fail. In fact, they should fail to make way for better run companies with stronger balance sheets and more adaptable management, even if they are from another country.

As I travel around the country on both business and pleasure, I have noticed that most people, whether Democrat or Republican, young or old, wealthy or not, are tired of the bailouts. The refrain I hear most often is, "why give money to GM if they ran their company into the ground?" Or, "why bail out Citigroup if they were so fiscally irresponsible when I am running a small business and making a profit—where is MY bailout?" Amen to that!

Who will be the Winners and Losers in a World of Darwinism?

The short and simple answer to the question of survival is that those companies, who were prudent with their finances and took the time to understand the impact of a global unwinding of the largest

Credit Bubble in history, will be around to operate in the next phase. Whether you are running a Fortune 100 company, a hedge fund, a small business, or simply an investment portfolio, those that were prudent with their capital and were not greedy will likely survive. And whether we are talking about running a brokerage firm into the ground due to excessive leverage and greed or an investment portfolio with excessive leverage, the sad truth is that you won't be around to take advantage of the wonderful opportunities that exist after an asset class gets carved in half. Whether the asset is stocks, real estate, a company, distressed securities, or corporate debt, the answer is the same. If you were prudent, managed to hold on to the vast majority or all of your capital, you have won the game—the game of Darwinism. The wasteland called Wall Street is littered with those whose greed got in the way of common sense.

Referring to war, Andrew Jackson borrowed the phrase, "to the victors belong the spoils". The victors, in this case and in this war of investing, are those that did not lose much of their capital during this recent rout. The biggest difference as I see it, from 2008's global rout and 2009 is that I believe we will separate the winners and losers in 2009. I believe we will separate them geographically, by asset class, by balance sheets and by the ability to finance yourself on your own without Government intervention/assistance.

Summary—What to Own During 2009

Note that I wrote what to own DURING 2009, not for ALL OF 2009. Below I will offer up what themes I believe will work next year, and possibly into 2010.

1. Large cap over small cap.
2. High quality bonds versus junk bonds.
3. Developed Markets over Emerging Markets.
4. Mortgage Backed Securities over Treasuries.
5. Defense over Offense.
6. Good Balance Sheets over Poor Balance Sheets.
7. Self Financing Entities over those that need help from the Government.
8. Sector rotation versus Market Timing.
9. Trading versus Investing.
10. Absolute return investing versus Benchmark targeted investing.

In summation:

- a. I continue to believe that the consumer should be left alone to rebuild their balance sheets and not force-fed risk. With Treasury rates near zero, the incentive is to take undue risk rather than opt for safety.
- b. I believe the Government is playing far too great a role in the public markets and should stay out of the way, even if it means an awful recession.

- c. I also believe that prudence will be rewarded and that patience will be a virtue.

And as always, if we are too cautious then all we will have lost is opportunity, but not capital.

Bennet Sedacca,
President

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