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Greetings,

What we have at this point in time is the ultimate crises of confidence. The crisis in confidence covers every area that I can think of including; the stock market, the economy and the government. I wouldn't blame you or anyone else for lacking confidence in any of the above. I am totally disgusted with everything that has happened over the past year and a half.

The economy is in bad shape. There is no doubt about that. The unemployment rate of 7.2% is the highest that it has been in 25 years. The labor market will get worse before it gets better. Many of the 93% of the people who are working are concerned about losing their jobs. This fear has caused them to cut back on spending which accounts for 70% of GDP. The financial media as well as the main stream media who are constantly harping about how bad the economy is certainly hasn't helped things.

The fact that the stock market is doing so poorly (at least in my view) has made things worse with the economy. During the bull market of the 1990's, the wealth effect was a positive factor with the economy. When people saw their retirement accounts growing each year, they felt comfortable spending on discretionary items. We now have the reverse wealth effect. Even though the vast majority of wage earners have similar incomes (if not slightly higher) as they had last year; because everyone is so depressed at the rapid devastation of their net worth (including the value of their homes), even though the money is there to spend, they are cutting back. This is having a major effect on small businesses, which are also being hurt by the credit crises.

While listening to the talking heads 45 hours per week, I hear that we are in the worst economy in either 35 years or 70 years, depending on the degree of pessimism of the head doing the chatting. I did grow up in the 1970's, 35 years ago. It was no fun waiting on the gas lines with my parents. It was unpleasant paying more for lunch out of my allowance as the price of food rose each month. Inflation was higher than 10% per year then. The unemployment rate was over 10% and heaven forbid you needed to borrow money; you would have to pay an interest rate of between 16-20%. Unemployment now is just under 7% but will most likely top out between 8-9% within the next few months. There is no inflation. There are no gas lines as gas prices are at four year lows. 10 year Treasury notes will get you a return of just over 2%. If you can get a mortgage (which I hear is possible if you have good credit and are willing to put down 20%, which IMO is the way it should always have been) you will most likely be able to finance your house at a 5% interest rate. Consumer confidence is at an all time low.

Several months ago, when the price of crude oil was on its way down, more than one economist stated that if the price of oil stays at $ 60 per barrel, it would act as a $ 250 billion stimulus to the economy. This is because the consumer in effect will be getting a nice tax cut because of all the money they are saving at the pump + the savings in home heating costs. All I heard last summer was how devastated the consumer was because of the high cost of energy and food. Now that food costs have dropped slightly and energy costs are at four year lows, doesn't it make sense that the consumer should be benefiting from this? The price of crude oil is now just above $ 40 per barrel so you would think the stimulus to the economy would be even greater than $ 250 billion. I read last week that consumer spending in November was up for the first time since May. The reason was because of lower gas prices. I also have been reading about how bad retail sales are. The devil is in the details, not just the bottom line. Gas sales at the pump are included in retail sales. With gas prices at four year lows, of course retail sales will be hurt. Auto sales are also counted in retail sales. Auto sales are down 40% year over year. If you take out gas (the fact that gas is down is a good thing) and auto sales, then the retail sales numbers aren't that bad.

I am in the strong minority in feeling that this recession won't be as deep or as long as the vast majority of people are convinced it will be. One of the many things I have learned as an investor over the last 24 years is that when things are going well, the vast majority of people think that what is working now will continue to work for as long as the eye can see. This was the case with the tech. bubble in early 2000 and the case with Real Estate just a few years ago. Although the extreme pessimism is worse now than it was six years ago at the end of the last bear market, it was pretty bad back then when the vast majority of people were convinced with 100% certainty that the market at best would return high single digit returns over the next few years. The vast majority of people were incorrect in that respect just as they were in early 2000 with tech. stocks and a few years ago with Real Estate. I and my clients who were smart enough to stick it out recouped our losses from the last bear market within a year.

The reasons I think that the economy will bounce back quicker than is expected is because of a combination of low energy prices, low interest rates and the expected government stimulus. I don't scare easily. The thought of our elected officials, many of whom are responsible for this recession and our losses from the stock market, now trying to fix things by printing $ 800 billion (give or take a few billion) makes me uncomfortable. After all, it was less than three months ago that Congress authorized the Treasury department to spend $ 700 billion (the total cost was really $ 850 billion because our elected officials wouldn't authorize the program unless an additional $ 150 billion was included to fund certain pet projects and targeted tax cuts) with no accountability. I was all for this at the time because I was under the impression most of the money would be used to purchase illiquid securities from the banks. Treasury secretary Paulson clearly stated (I watched the hearings) to Congress that this was his intention and that once these assets were off the balance sheets of the banks, then the banks capital ratio's would go up and then they would have the capital to lend which would then ease the credit crises. Secretary Paulson also stated that most of these mortgages that were included in the securities were being paid so the government would receive a nice interest rate and then in the future when they would sell the securities, make money on this program once market conditions improved. On the surface, this made perfect sense. What didn't make sense was that Treasury secretary Paulson became Czar Paulson when he changed his mind after receiving authorization to spend $ 350 billion. Instead of taking toxic assets from the banks, he decided that it would be best to inject the government's (our) money into the same financial institutions that caused this mess to begin with! In return, the government received preferred stock. There were also virtually no conditions. Czar Paulson didn't want too many conditions because he wanted to encourage as much participation as possible. He also twisted the arms of some banks (Bank of America being one of them) to participate when they really didn't want the government's money. Czar Paulson did state that the banks couldn't raise its dividends, have stock buyback programs or have golden parachutes for its top executives. In case Czar Paulson didn't realize it, the banks had no cash even with this infusion to increase its dividends or buy back its own stock. So, after infusing $ 350 billion of our money into these financial institutions (to be accurate, I have to mention that a small part of the $350 billion did recently go to the auto companies), not only is the economy in worse shape now than it was two months ago, the stock market is also lower. To add insult to injury, the banks are hording the cash that they received because they aren't doing any lending. They will also most likely have to write off many of these assets that were supposed to be sold to the government which will reduce its capital and make it more difficult to lend.

Can you now see why I am a tad nervous at the thought of this $ 800 billion "stimulus" that is on the way. True; there will be a new administration coming aboard in a few weeks. However, Congress controls the purse strings. I could be wrong but I think that there is a reason why Congress has a 14% approval rating. Most of the people now in Congress (especially the leadership) are the same people who have screwed things up over the past 5-6 years. From what I have read, 60% of the "stimulus" will be on spending, 40% on a combination "middle class" (who knows what their definition of middle class is) and business tax cuts. Personally, and of course this is just my opinion, I prefer as much of the stimulus going to tax cuts as possible since 70% of the GDP is consumer spending. My biggest concern is that much of the tax cuts won't really go to the middle class but instead be "targeted" tax cuts which ultimately won't result in job creation. As far as the $480 billion that will be spent; I have already heard and read from several sources that over 1,000 mayors across the country have lined up to get a piece of this huge pie for their pet projects. I think it is imperative that this huge sum of money be spent wisely. The economy should improve if the money is spent in the right places. I think the new administration does have the right intentions. I just hope that the people in charge are able to say the word NO to the thousands who will have their hands out.

As far as the stock market; I don't blame you for being scared, angry, disgusted or horrified as a result of the rapid destruction of our money. What is imperative is to separate the emotion from the intellect. Believe me, it isn't easy. I can understand how a part of you would like to just sell whatever is left to prevent losing any more money. That would be the worst thing to do. Some people have suggested selling much of what we have and then getting back in once the recession or the bear market is over. That would be market timing, which has proven to be a losing strategy. I am not stating that every single person every single time who has tried to time the market has been unsuccessful. I would estimate that at best one out of fifty people can time the market. I don't like those odds. I even have heard of a few people who wisely sold a significant amount of their assets earlier in the year. The reason why it is at best a 50-1 shot is that unless you know exactly when to get back in, you haven't accomplished much other than to sleep better than we do. A perfect example is that I tried to time the market with a decent amount of our assets last year. I sold just about when the market was at its high and waited patiently as the market dropped. The problem (and why this is a losing strategy) is that I went back in a year and three months early. While not to be cute, there isn't exactly an announcement on TV or in the papers stating that the recession or the bear market is now over. The vast majority of gains in the stock market in one year occur over ten trading days. Warren Buffet has said that if you wait for the Robins to sing, you will miss the spring. Warren Buffet, like me, has put a significant amount of new cash into the market recently. Similar to Mr. Buffet, I was several months early. I don't believe that either of us was several years early. I think that I am in good company.

I read in last week's Wall Street Journal that we have had six major panic sell offs in the stock market since 1900, where the market was down between 40-50%. One of those was during the Great Depression where the market dropped another 45%. That is what almost everyone (other than me) is focusing on. Even though the stock market is behaving like it is the 1930's, the economy is not even remotely as bad as it was then. Anyone who thinks it is will have a pretty tough case to make. The other five times, the market has dropped this much, each time the market recovered 75% of the losses within 18 months.

Jim Paulsen (no relation to Czar Henry) who is one of the smarter talking heads has stated that he thinks the S&P 500 will rise by 45% in 2009. I detest making short term predictions. Everything would have to fall into place with the economy this year for that to happen. More importantly; even if the economy shows some signs of life by the spring (which is what I see) and the market makes a significant move, since so many people are becoming traders with short time frames (attempting to imitate the hedge funds), the rallies could be cut short by the traders (and especially the hedge funds) looking to take their short term profits. Since stocks are so cheap, I do think that the market has a much better chance of increasing by 25% this year than losing 10%.

I think that I gave you quite a bit to digest. I can't thank you enough for your patience and confidence in these difficult times. If you have any questions or have anything that you want to discuss, then please give me a call or send me an email.