



Perspective

Economic and Market

2008-Issue 7

"Bringing you national and global economic trends for over 25 years"

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One of the darkest moods ever has engulfed Wall Street, producing a free fall in most asset prices—including stocks, bonds, cash and commodities. A severe loss of confidence in American leadership and in the central operational machinery and solvency of global financial institutions has frozen economic players and seems likely to produce a significant stall in economic activity.

The last few weeks have been a breathtaking reminder of just how dependent capitalism is on confidence! A dollar bill is simply a worthless piece of paper without confidence in the full faith and backing of the U.S. government. The price of any asset (e.g., a stock or bond) without "confidence" becomes dislodged from its value. If faith in the process is lost, asset prices become totally divorced from their future earnings potential (i.e., discounted future cash flows) and are left only to the vagaries of emotional nightmarish scenarios. When this happens, the price of fundamentally sound assets can become worthless nearly overnight simply because nobody will bid at any price if all become convinced the price will still decline further. Without confidence in the process, asset pricing leaves the fundamental ranch, and rather than being based on a careful assessment of future earnings potential and risk-versus-reward analysis, potential bidder considerations are reduced to simply waiting until sanity returns. Of course, when all bidders wait, prices fall further, exacerbating the downward spiral.

The bad news? The U.S. is facing one of its most severe confidence crises in its history and it has little experience in dealing with such a deep and prolonged period of widespread and dominating fear! The economic toolbox has always been full of "fixes" for fundamental economic problems. Tax and interest rate cuts, fiscal spending hikes and monetary accommodations help improve weak balance sheets and speed up slow income statements. But the toolbox is notably empty when it comes to "confidence fixes." In the last year, and particularly in recent weeks, policy officials have been treating fundamental economic problems with stronger and stronger doses of traditional medicines. While these applications have certainly improved fundamental issues, they have done little for the primary problem that has long been facing the economy—worsening fears and a deepening loss of confidence!

The good news? Although the U.S. has some serious fundamental economic problems and is likely headed for a recession, this is a crisis more of confidence than fundamentals. Fear of worsening fundamentals is currently more problematic than actual worsening fundamentals. Why is this good news? Because if the economy was predominately fundamentally challenged, it would take much longer and would be much more difficult to fix. By contrast, although the solution to widespread fears and lack of confidence is still elusive, unlike fundamental problems, an improvement in emotions among economic players could occur quickly.

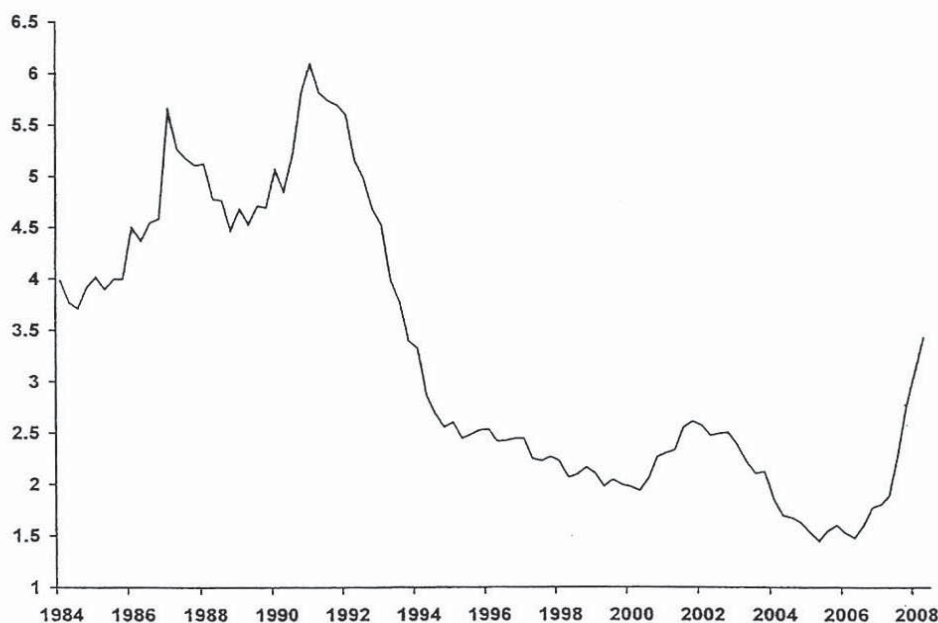
So how bad are the economic fundamentals? Is the U.S. facing a debt Armageddon? Are consumers bankrupt? Banks, too? Is this the worst fundamental recession since the Great Depression? Or, is the "fear" of a massive debt collapse worst than its reality? What about the economic fallout from this "fearsession"? Will the recession be sharp but short, or will it prove prolonged? Is anything good happening in the economy? Any hope the outcome in the next few years will turn out better than widely feared? Won't it take the overleveraged consumer years to get back to solvency? And, what will the economy do while the household is deleveraging? Finally, is it just too volatile and too risky to venture into the stock market now? Or, is a 50 percent retrenchment offering investors one of the greatest opportunities in a lifetime?

Not a Debt Armageddon?!?!

From the beginning, this crisis has been sold as a “bad debt” crisis. While there are certainly some “bad debts,” this crisis is more about “good debts nobody is willing to buy”! Consider the banks. No doubt many subprime mortgage loans are fundamentally unsound and have been written off. Globally, the banking industry has recorded \$600+ billion in losses since this crisis began. However, a significant, if not predominant, portion of these losses does not represent the write-off of fundamentally bad debt. Rather, they represent “write-downs” of fundamentally sound loans that are not credit challenged. There are simply no bidders due to widespread fears and uncertainty, which, when combined with contemporary mark-to-market accounting laws, has forced financial institutions to record good assets at prices woefully below any semblance of true fundamental values. The \$600 billion in losses gives the impression of an apocalyptic banking industry debt implosion even though most of the loans are paying on time and will likely pay in full over time.

So far in 2008, adding to the hysteria were 15 bank failures widely portrayed as evidence of a depression-like contemporary cycle. Although up from recent years when only a handful have failed, 15 failures is virtually nothing compared to the 1980s and 1990s when hundreds of banks failed each year! Indeed, over 500 bank failures occurred in a single year in the late 1980s! Exhibit 1 provides perspective on this debt crisis. The chart below shows the percent of total U.S. bank loans that are currently delinquent. While up from a record low in 2006, the current delinquency rate is only about 3.5 percent. Between 1984 and 1994, the delinquency rate was chronically above today’s level, which is oscillating between four and six percent! Why is the hysteria about bad debt so elevated today compared to a period not long ago when, for a decade, delinquencies were permanently higher? The other charts show delinquencies by loan category. As expected, real estate loans have the most fundamental challenges. But even here, current delinquencies are also less than they were throughout much of the late 1980s and early 1990s. Business loan delinquencies are near record lows and consumer loan and credit card delinquencies are no higher today than they were just three years ago! As they always do, delinquency rates have risen in the last year as the economy has slowed. Even though delinquencies will rise further as the economy recesses, they hardly support a depressionary debt collapse.

It’s Not a Debt Armageddon!!!

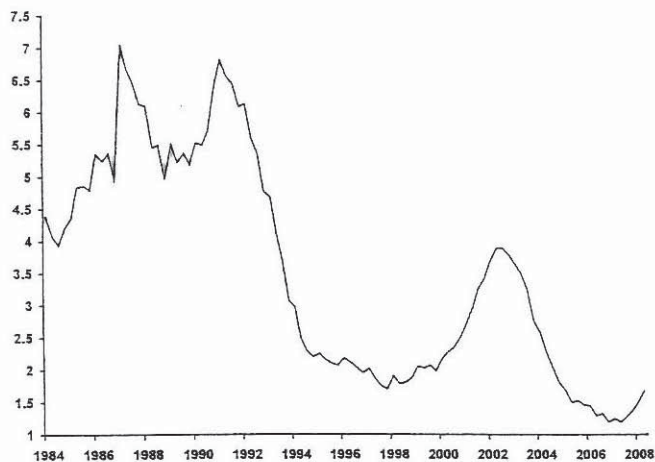


It's Not a Debt Armageddon!!!?

Exhibit 1 (Cont'd)

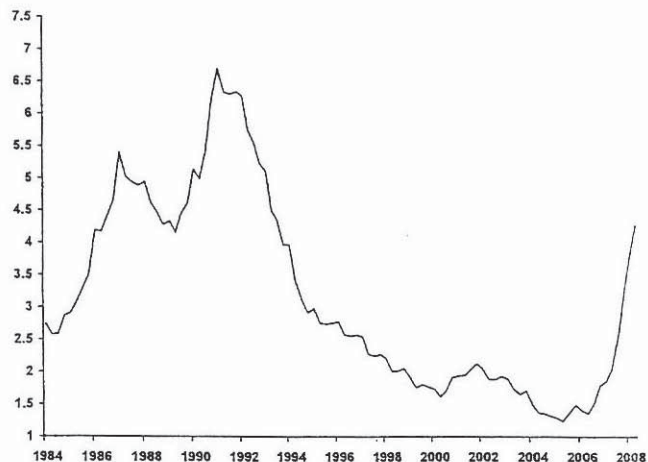
Total Business Loans

Percent of Loans 30+ Days Past Due



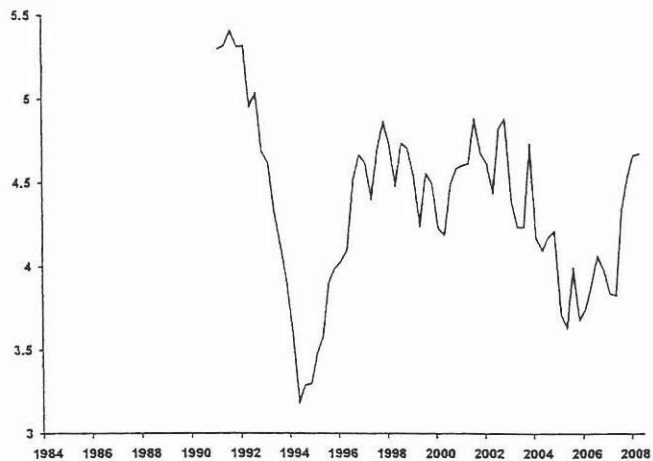
Total Real Estate Loans

Percent of Loans 30+ Days Past Due



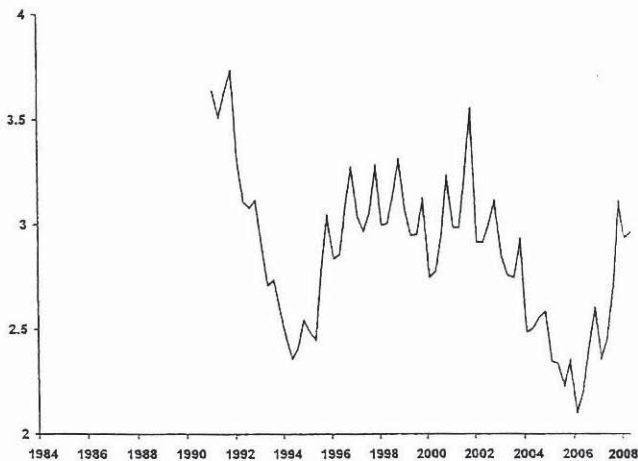
Total Credit Card Loans

Percent of Loans 30+ Days Past Due



Total Other Consumer Loans

Percent of Loans 30+ Days Past Due



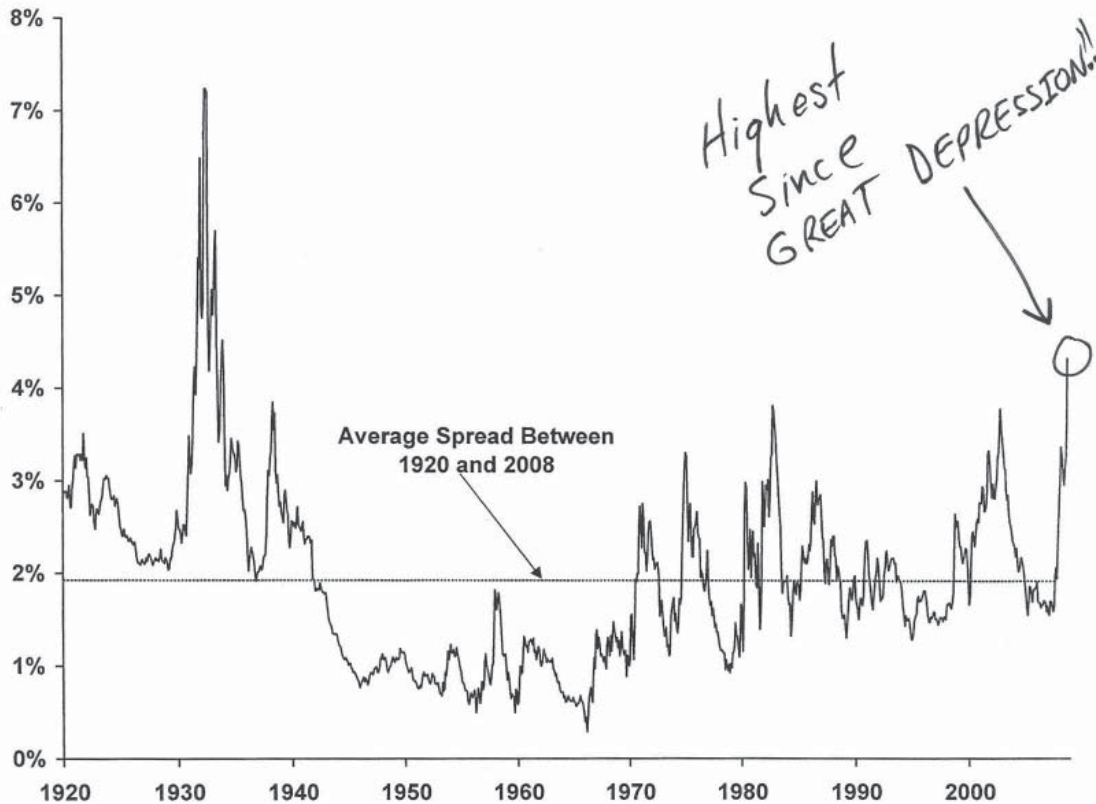
Exhibits 2 and 3 examine whether contemporary debt default fears have become grossly overstated. Exhibit 2 shows the spread of Baa corporate bond yields above the 10-year Treasury yield since 1920. The wider this spread, the greater the market’s estimation of corporate bond default risk. Currently, this spread is at its highest level since the Great Depression! Is corporate credit risk really this dire? Exhibit 3 shows two major balance sheets and two income statement ratios for all U.S. nonfinancial corporations. Currently, the ratio of cash to total debt is close to a 50-year high and the ratio of debt to net worth is as low as it first was in the 1960s! How do balance sheet ratios this strong lead to an estimation of the greatest corporate default risk since the Great Depression? Moreover, for all U.S. corporations, the level of cash flow to capital spending remains at one of its highest levels in the last four decades and profit margins are near post-war record highs. We think the “fear and panic” of potential debt defaults is far greater than the “fundamental” risks of major defaults.

Corporate Credit Risk Rising???

Exhibit 2

Corporate Bond Yield Spread*

*Moody’s BAA Corporate Bond Yield Less 10-Year Treasury Yield

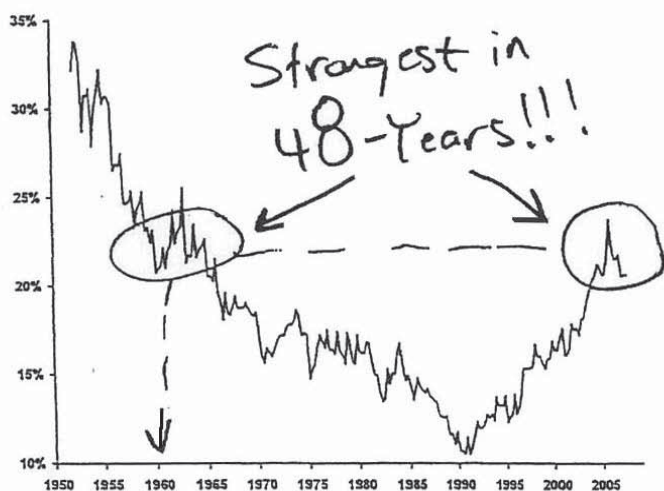


Non-Financial Corporations Have STRONG Income Statements and Balance Sheets!!!

Exhibit 3

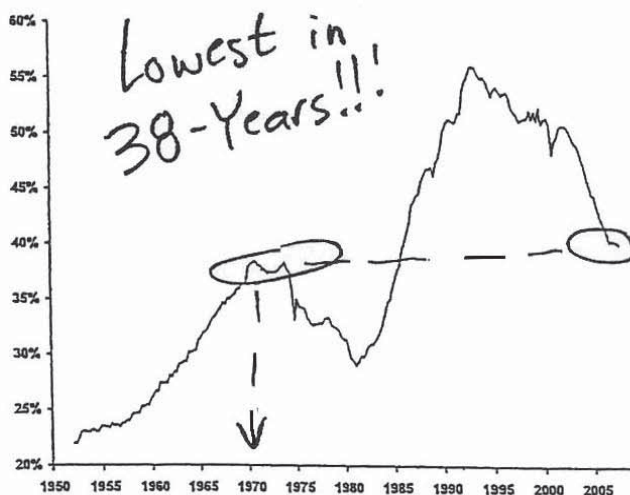
U.S. Non-Financial Corporate Business Ratio of Cash Assets to Total Debt*

*Fed Flow of Funds Table B.102
Sum of Lines 7-12 divided by Line 22



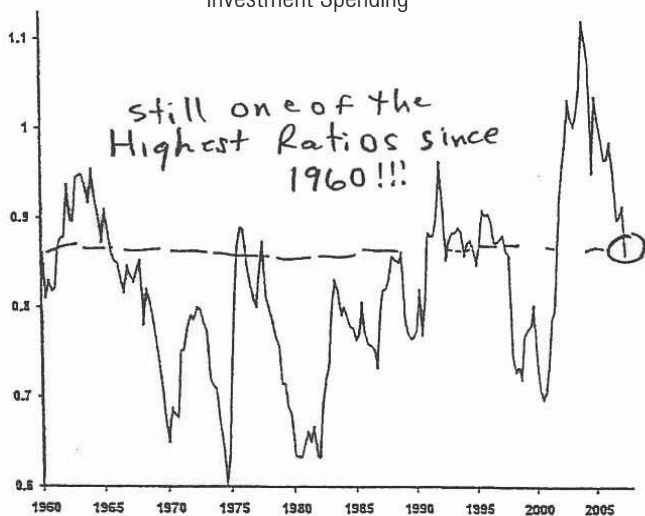
U.S. Non-Financial Corporate Business Ratio of Debt to Net Worth*

*Fed Flow of Funds Table B.102 Line 36



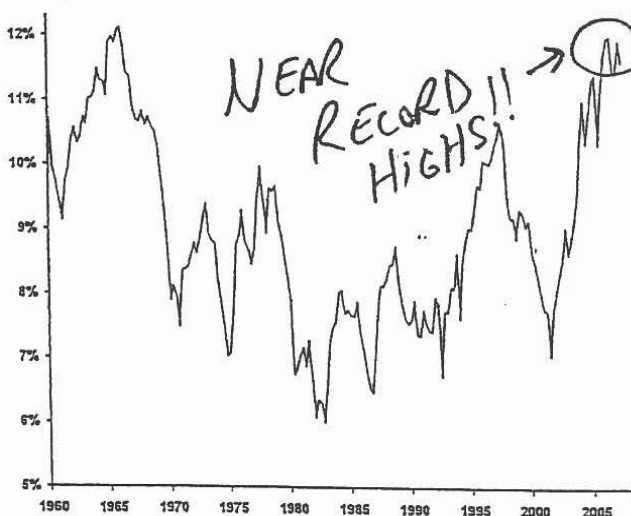
U.S. Corporate Net Cash Flow To Capital Spending Ratio*

*Net Cash Flow divided by Non-residential Investment Spending



U.S. Corporate Profit Margins*

*Corporate Profits with IVA & CCA Adjustments as a percent of nominal GDP

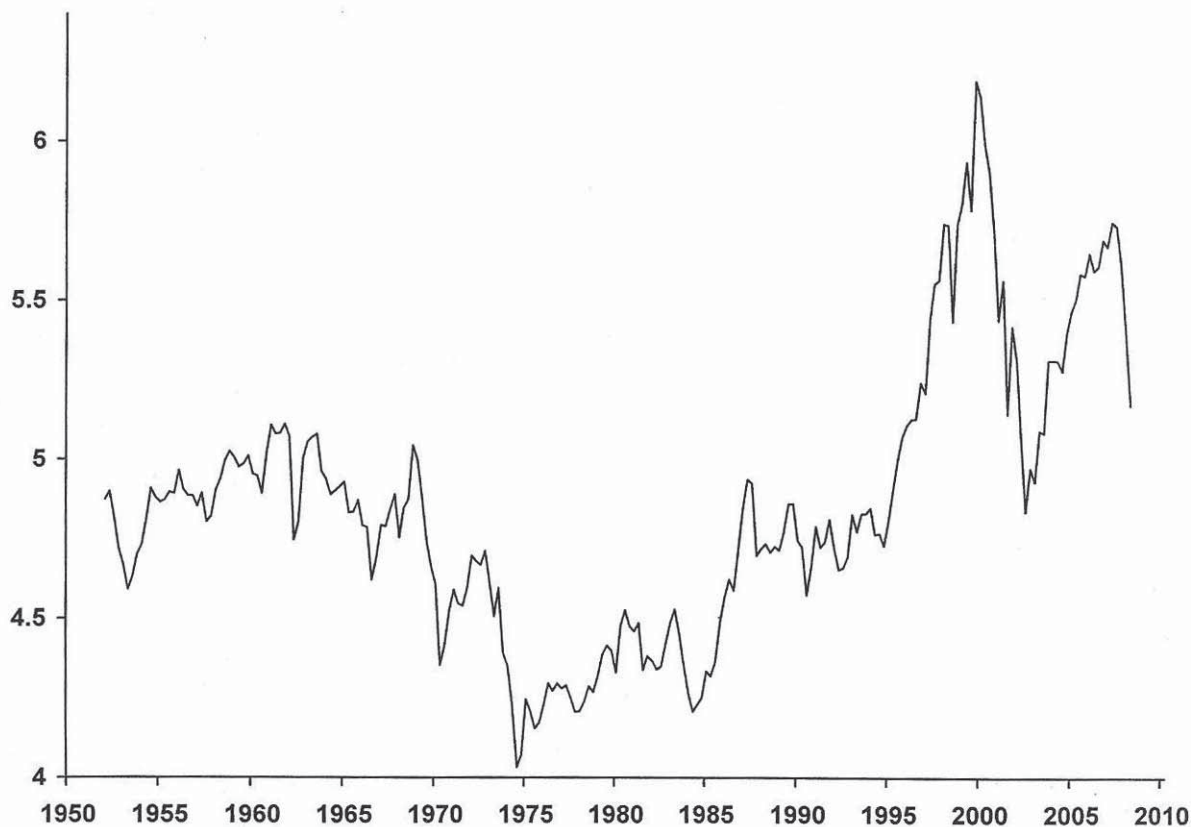


Finally, we agree the household is over-indebted and will likely spend the next several years deleveraging its balance sheet as it has in past post-war economic cycles (e.g., early 1980s and 1990s). However, exhibit 4 is a reminder the consumer is not likely to fall off a cliff into a massive depressionary debt collapse. Total net worth (i.e., after all debts) among U.S. households is near \$56 trillion or more than five times disposable personal income! Tough to bankrupt such an impressively capitalized player!

Household Is Still Fairly Equitized!!?

Exhibit 4

Ratio of Net Worth to Disposable Income
Total U.S. Households



Worst-Ever Crisis????

The contemporary period does represent the worst “confidence crisis” since the Great Depression. However, it is not the worst “economic fundamental situation” the U.S. has faced in the post-war era. Indeed, we believe both the early 1980s and early 1990s were more fundamentally challenging.

Similar to today, back then, the household sector was overdue for a period of liquidation after prolonged spending sprees, which escalated debt to record levels. Also similar to today, the financial community was in poor fundamental shape in both periods. In the early 1980s, banks were loaded with oil, farming and other commodity debts, and with third world insolvencies. In the early 1990s, banks and S&Ls were saddled with a variety of bad debts necessitating an RTC solution. By the way, in neither case did the U.S. have mark-to-market accounting laws, which would have exacerbated the extremely problematic fundamental loan problems that existed at the time. However, unlike today, Third World (now called emerging world) debts and financial stability were far weaker than they are today. Additionally, in both previous cycles and in contrast to today, U.S. nonfinancial corporate balance sheet quality was equally as challenged, as was the financial integrity of the consumer sector.

There are simply less fundamental balance sheet issues today and more areas of financial strength. How bad would today’s confidence crisis be if the emerging world was in the fundamental shape it was in 1980 or if the corporate world was in the shape it was in 1990?

This is also the first major crisis in the “new world,” comprising a much broader array of significant economics than just the old G-7. It is a great advantage in the midst of the contemporary crisis to have so many diverse global economies in various stages of the economic cycle and with varied circumstances. True, all world economies are interconnected. However, it is far better to have diverse pockets of economic growth potential, even if loosely connected to the same forces, than it was in the Old World where seven economies had virtually identical characters. While most of the G-7s face negative growth, many smaller emerging economies will experience only “slower” growth. While the U.S. consumer may be strapped, many emerging world consumers have fresh savings, little debt and growing desires. While banks in the western economies hold mortgage loans which are challenging, many Asian financial institutions seemingly hold far less if, any at all. Essentially, compared to other times, the world faces this crisis with greater global growth opportunities, possessing more diversified situations.

Finally, compared to past crises, the contemporary economic policy response has never been as quick, nor as aggressive! Normally, a crisis hits after policy officials have been tightening. The current crisis blew out a few weeks ago, “a year after widespread economic policy easing” had already been implemented. Historically, the economic fundamental problems associated with a crisis had to wait until the “policy lag” was reached. In this crisis, some early policy medicines applied a year ago are probably already helping fundamental problems. Moreover, in the last six weeks, these lagged policies are also interacting with arguably the most aggressive and widespread set of policies ever employed since the Great Depression.

Let’s Treat Confidence!!!?

It is time to slow down the treatment of fundamental economic problems that are now adequately addressed and give more thought and effort to the treatment of fear and confidence. Indeed, continued panicky policy responses thrown at perceived fundamental economic issues may be making confidence worse. Much of what our policy officials have done has been necessary and appropriate. However, the problem from here is not more liquidity. The problem is building the confidence to use this liquidity. The problem is no longer ensuring further reductions in risk-free interest rates. The problem is convincing lenders and investors that the level of interest rates outside of the Fed’s control is finally high enough in relation to fundamental credit risks.

It is time for U.S. leadership to warn the public less about how bad things are and to ensure the public more that what has already been put in place (e.g., massive policy easings and widespread guarantees) will work. It is time to remind the public more positive force is coming soon (i.e., the TARP in a few weeks), which could raise bond pricing and perhaps produce a series of bank write-ups under mark-to-market rules.

The TARP was a creative idea that we believe is aimed not at taking bad debts off bank balance sheets, but rather at pushing free market pricing of good bonds back closer to underlying fundamental (i.e., discounted future cash flow) values. And we think it has a good chance of working once it is implemented! However, the “selling” of the TARP a few weeks ago contributed significantly to the collapse in confidence from which the U.S. is still trying to recover. For almost two weeks during the attempted passage of TARP, every major leader in the U.S. had to go in front of the American people and essentially say the “economy is going down”! The president gave daily conferences suggesting the possibility of a depression, the Treasury secretary and Fed chairman had to tell Congress how dire it was in the economy, both sides of Congress regularly complained about how “messed up” the economy was and both presidential candidates missed no opportunity to “scare votes” their way. It was, in our view, absolutely disastrous for the American leadership en masse to implement a “fear campaign” in the middle of the worst confidence crisis since the Great Depression. The stock market, businesses and the consumer are now slowly trying to recover from the shock of this campaign.

We admire what our policy officials are attempting to do in this most difficult crisis. We also believe many of the policies enacted to-date were both necessary and often very creative. The liquidity injections, interest rate reductions, backstop guarantees and negotiated international cooperation have largely been excellent. However, we think the almost daily litany of “emergency meeting” economic policies enacted whenever Dow Jones falls by 300 points has to slow down. These panicky policy responses may be doing more bad for confidence than good for fundamental problems. A slower, calmer and more confident approach to economic policy may start to yield better results. Enough has been done to treat fundamentals and more focus should now be shown by our American leadership and policy officials on improving confidence.

How about bringing together 50 CEOs from the largest U.S. nonfinancial corporations to announce a joint program whereby each will buy back \$X billions of their own stock in a show of solidarity for capitalism, a demonstration of confidence in the U.S. economy, an illustration of the financial strength of nonfinancial balance sheets and mostly a statement about how ridiculously cheap they perceive their current stock prices. This would likely do more good than an additional rate cut or liquidity injection.

Confidence boosters are forthcoming. Soon we will have a new president, which should provide a feeling of a fresh start. Soon we will stop talking about TARP and begin to see its tangible benefits. Soon the dramatic collapse in energy prices will be more noticed by hurting consumers. Soon recently lowered mortgage yields should also provide some holiday cheer. Soon, with a bit longer bottoming action and perhaps some decay in its daily volatility, the stock market may start giving an impression the worst is finally over. Finally, even though economic data will worsen in the months ahead, perhaps it will turn out better than most nightmarish scenarios. This crisis will start to mend the day the stock market posts an impressive rally “all on its own without any new public assistance program.”

Economic Crisis Fallout???

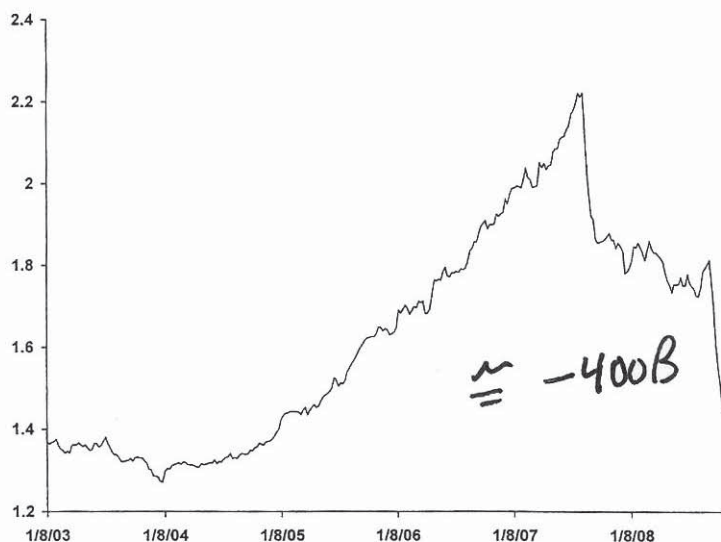
Several negative economic forces have been intensifying in the last year, including the demise of the housing and auto industries; a slow, but steady erosion in jobs; high consumer debt loads; skyrocketing energy prices and an economic slowdown spreading across the globe. Recently, these forces have combined with an intense panic, causing a total freeze in the short-term lending markets. The panic-induced “credit freeze” is the last straw, which probably will push the economy into a sharp recession during the next couple of quarters.

Credit Freeze

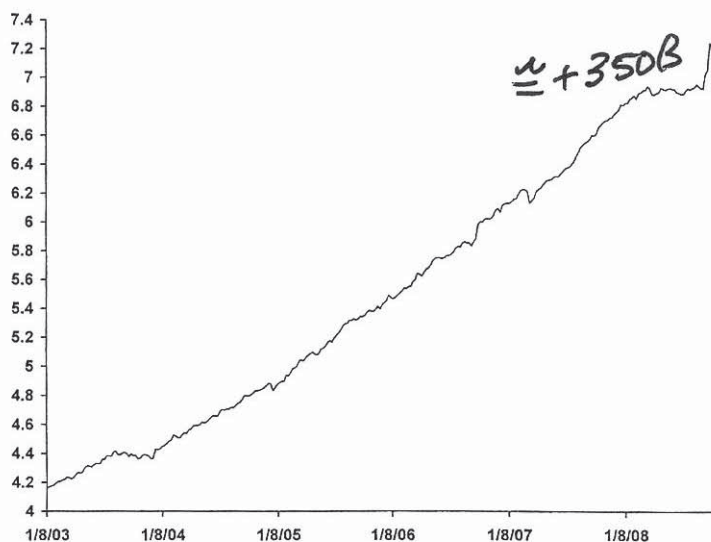
Exhibit 5 shows that commercial paper issuance has collapsed by a larger amount than it did during last year's short-term credit freeze. It is encouraging, however, as commercial paper issuance has collapsed, bank lending has spiked. It might be due mostly to businesses and consumers maxing out credit lines, but nonetheless it helps mitigate the economic fallout from this credit freeze if it can be normalized soon.

"Credit Freeze" Partially Mitigated by Tapping Bank Lines Exhibit 5

Total Commercial Paper Outstanding
Trillions



Total U.S. Commercial Bank Loans & Leases
Trillions



Player Freeze

In our view, what is even more damaging to future economic growth than the credit freeze is what we call the "player freeze." Even healthy economic players that qualify for a loan or have the ability to spend or hire have temporarily "suspended" economic behaviors. All players, whether economically constrained or healthy, are frozen with panic! How many small banks across the country that are in fine shape with ample deposit bases and strong capital ratios are nonetheless restricting lending for awhile "just to be safe" considering all the bad news they are hearing? How many small businesses have enacted a hiring freeze even though their company continues to see growth? Finally, how many consumers that have seen no change in their job status are nonetheless reeling in spending plans "in case it gets bad"? The player freeze is the most damaging force in the economy right now and it is entirely due to confidence!

Intensifying Household Headwinds

Even though both housing and auto activities are already at remarkably low levels, the credit and player freeze probably ensures that these industries worsen still further in the months ahead. Job losses are also set to accelerate. Further weakness in housing prices combined with further job losses will strengthen household debt pressures forcing further consumer spending cuts. Although it appears the economy is in for a rough couple quarters, not all prospective news is bad!

Some Economic Silver Linings!?!?

Pipeline Policy Push

Perhaps the most positive aspect of the contemporary crisis compared to any in the past (including the Great Depression) is the “preemptive nature” of economic policy stimulus. Historically, crises emerge “after” prolonged periods of policy tightening. This crisis blew out a few weeks ago “after” considerable economic policy easing (illustrated in Exhibit 6) for almost a year! Since so much policy ease has already been in the pipeline for awhile, it may begin helping fundamental problems much quicker compared to past crises.

Pipeline Policy Push

Exhibit 6

- **MZM Money Supply Growth → 5% to 15%!!**
- **Yield Curve → Inversion to steep**
- **Real Fed Funds Rate → +4% to -4%**
- **Federal Deficit Spending → \$150B to \$400B+**
- **U.S. Dollar → Another 10% drop through July**

Panic Policy Push

In addition to the massive policy stimulus put in place during the last year, additional policies have been enacted in recent weeks. These unprecedented policies were implemented in the panicky environment surrounding the peak intensity of this crisis. No doubt, the amount of “policy push” introduced in this crisis, in terms of duration, speed, size and type has been far greater than any other crisis in the post-war era! This could produce an economic resolution that proves both quicker and stronger than most now anticipate.

Net Exports!!!

Never have net exports (Exhibit 7) contributed this much to overall economic growth (i.e., about 1.5 percent to real GDP growth in the last year), and certainly never during an ongoing crisis. Many believe the global slowdown will rapidly slow export growth and eliminate the net export push the U.S. has enjoyed. We disagree! U.S. trade improvement is not just about export growth. It is “net” exports delivering growth whenever exports grow faster “relative” to imports. While U.S. exports will slow with global growth, so will U.S. imports, perhaps leaving the “net” contribution to overall U.S. real GDP growth at about 1 percent in future quarters. Such a persistent contribution to growth would surprise many and may allow this crisis to surpass worst expectations.

U.S. Trade Will Remain Positive!?!?

Exhibit 7

U.S. Monthly Real Goods Net Exports



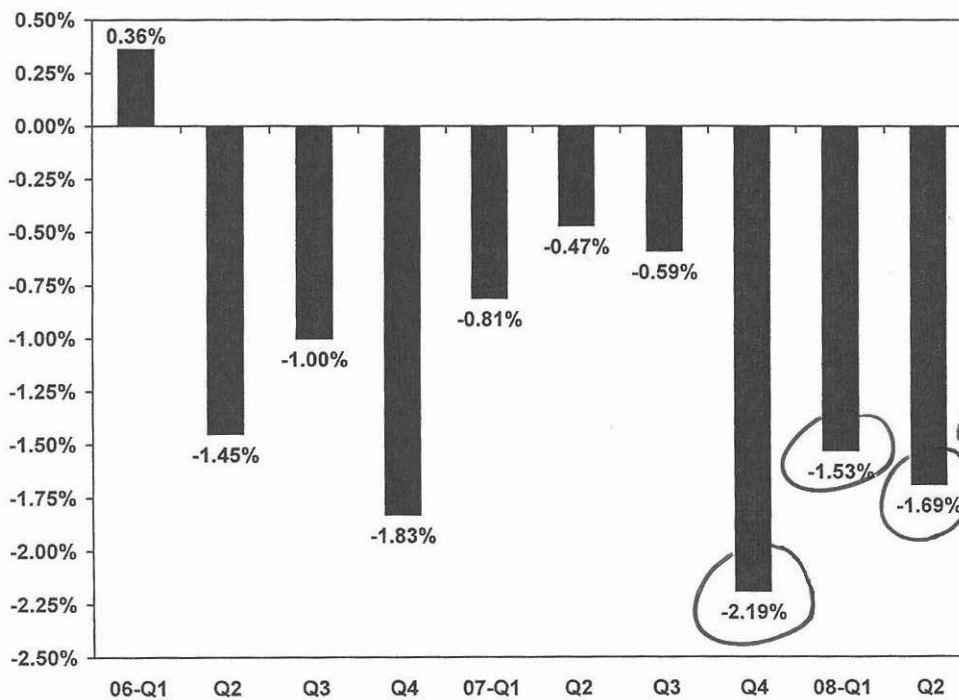
Housing & Auto Burn Rate?!??

Housing and auto activity will remain weak for the foreseeable future. However, most of the ultimate collapse in these two industries has probably past. Exhibit 8 illustrates how much these two industries have reduced real GDP growth for the last few years. Even if the credit/player freeze continues to retard these industries, the overall “burn rate” in the next year may still be less than it has been in the last year. A slower burn rate could “add” to overall growth by addition through less subtraction. Don’t misunderstand. We fully expect housing and autos to remain horrible in the coming year—just not as horrible as they were in the last year.

Housing & Auto Burn to Ease???

Exhibit 8

Contribution to Quarterly Real GDP Growth
Housing & Auto Spending



Will this lessen??!

Massive Buying Power in the Bed Mattresses!!!

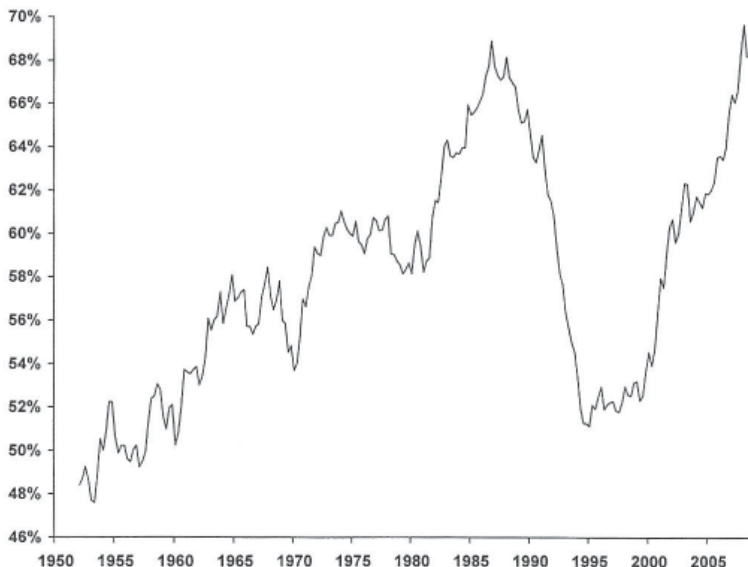
One positive fallout from an economy-wide panic is the buildup of idle power buying on the sidelines. As pessimism has risen over the last year, most economic players have increased and/or hoarded liquidity. This has been accentuated further by the massive additions to liquidity introduced by policy officials. Exhibit 9 shows the ratio of cash assets from both the business and household sectors as a percent of nominal GDP is near an all-time record high! What does this imply? When confidence eventually improves, there is considerable hidden buying power which could rapidly improve economic growth.

Bed Mattress Is FULL!!!

Exhibit 9

U.S.A. Cash to GDP Ratio*

*Sum of Cash holdings from Households, Non-Financial Corporations and Non-Corporate Businesses as a Percent of Nominal GDP. Source: Tables B.100, B.102 and B.103 of Federal Reserve Flow of Funds Report (Z.1)



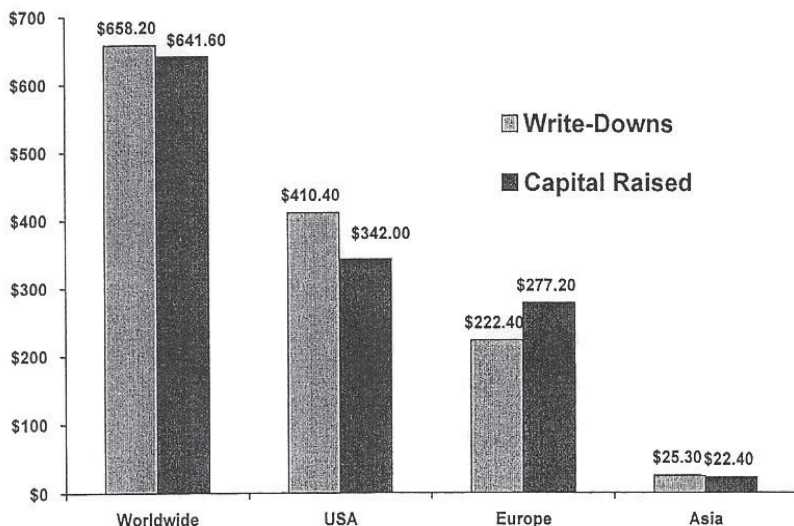
Bank Capital Lies Dormant?!?!

We remain optimistic U.S. bank capital has not been destroyed as much as widely perceived. First, as shown in Exhibit 10, even though global banks have written down/off more than \$600 billion since the middle of 2007, bank capital is almost unchanged. That is, they have raised almost as much additional capital as they have incurred in announced losses. Moreover, total U.S. bank credit (i.e., combination of loans and securities) from the Federal Reserve’s weekly release shows it has recently risen to its highest level of the year! Finally, we are hopeful the TARP, which is nearing implementation, will have a positive impact on overall bank capital. If the auctions for bank mortgage assets can succeed in elevating prices, all banks will be able to announce “write-ups,” and suddenly bank capital, which is lying dormant and undervalued on balance sheets, could reemerge!

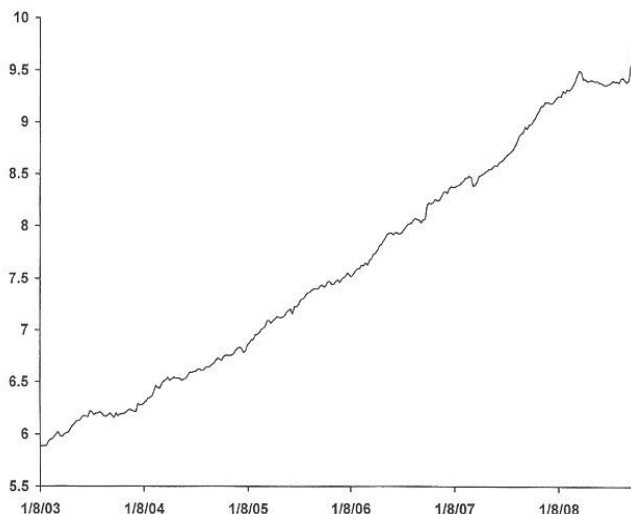
Dormant Bank Capital???

Exhibit 10

Cumulative Global Bank Write-Downs vs. Capital Raised Since Crisis Began (June 2007)



Total U.S. Commercial Bank Credit (Assets)
Trillions



Some Strong Balance Sheets!??

A slowing economy will surely worsen balance sheet pressures throughout the globe. However, compared to past crises, the balance sheet health of at least two major sectors (i.e., nonfinancial U.S. corporations and emerging economies) are far stronger today compared to many historic crises.

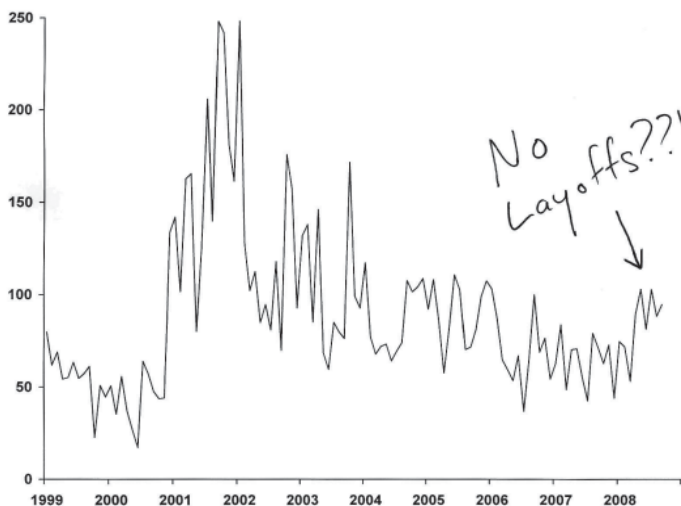
No Excess Inventories, Capital Spending or Labor!!?

Pessimism is nothing new to this cycle. Indeed, U.S. optimism never really returned despite the economic recovery after the dot-com and 9/11 episodes. While lack of confidence probably held back the recovery, it may also mitigate the severity of the current recession. Why? Because chronic pessimism during this recovery kept businesses from overspending (e.g., there has not been a significant capital spending cycle since the 1990s), and from over hiring (e.g., job growth barely rose above 2 percent at its peak in this recovery), and forced an early and aggressive inventory purge during the last year (e.g., the inventory drawdown in the last year is greater than it was during the 1990 recession). Due to chronic pessimism, there simply are fewer business excesses, which normally need to be

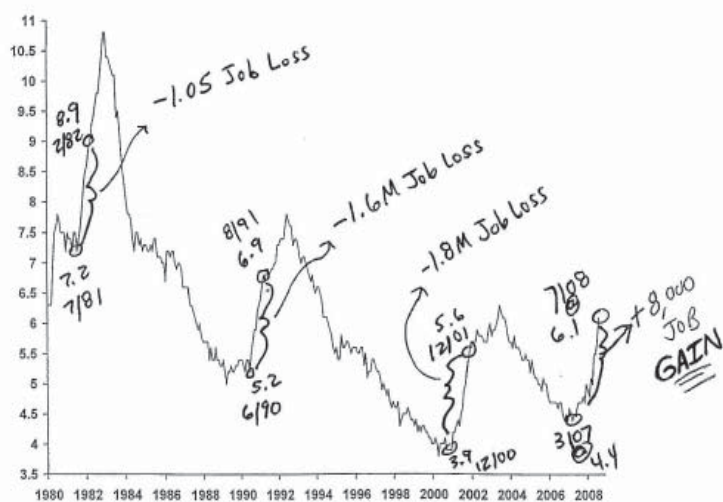
A specific example of the role played by irregularly elevated pessimism and fear is shown in Exhibit 11. It shows charts of the U.S. unemployment rate and layoff announcements. Even though the U.S. unemployment rate has risen by 1.7 percent from its low in March 2007, the level of nonfarm payroll jobs is actually 8,000 “higher” today than it was when the unemployment rate was at cycle lows. A rise in the unemployment rate of this magnitude without a net loss of jobs is unprecedented. In the 1982 recession, by the time the unemployment rate had risen by 1.7 percent, 1.05 million jobs had been lost. Similarly, by the time the unemployment rate had risen by this much during both the 1990 and 2001 recessions, close to two million jobs were lost. Why has the unemployment rate, thus far, risen without a net job loss? We believe, beginning in early 2007, businesses essentially stop hiring in the face of chronically scary economic news. However, most could not afford to lay off workers since business was still too good. Payrolls were held constant since economic growth was still good, but hiring freezes were implemented because of such dire predictions. The result? The unemployment rate rose, not because of higher layoffs—they have not changed much thus far but because of new entrants combined with hiring freezes or business fears! This is now about to change. Companies will escalate layoffs in the next couple quarters as the economy fades, but perhaps job loss will not prove as bad as expected since hiring practices have been conservative for some time.

More Jobs with Higher Unemployment??! Exhibit 11

Challenger Monthly Announced Corporate Layoffs
Thousands



U.S. Unemployment Rate



Strong Productivity Implies Income Growth Somewhere!??

Productivity growth has remained remarkably strong, even though the economy has slowed. Healthy productivity gains translate into income generation for someone—either business or households. It appears household income continues to weaken, but perhaps profits will prove stronger than feared in the next several quarters—even though they will decline with the recession because of above-average productivity growth.

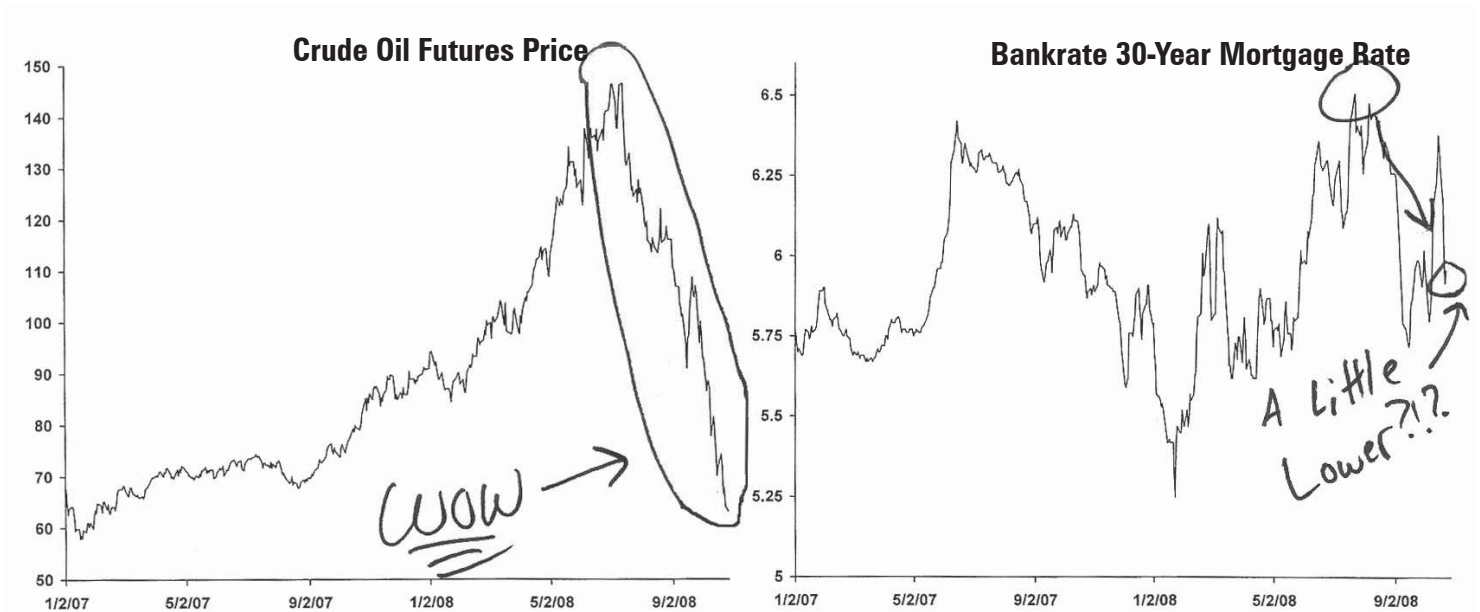
Help for Households ... Oil and Mortgage Yields!?!?

Exhibit 12 illustrates two major positives, which should help mitigate the many negatives facing consumers during the next few quarters—significantly lower energy prices and mildly lower mortgage yields. Households not only will benefit from a lower energy bite, but also indirectly from much lower headline inflation, which will augment real (e.g., inflation-adjusted) income trends. Somewhat lower mortgage yields will mitigate rate reset pressures and could stimulate refinancing activity.

Although the economy is headed for recession, due to many potentially underestimated positive forces, our expectation is for a recession that probably proves very sharp and deep, but perhaps relatively short.

Help for the Household!?!?

Exhibit 12



Consumer Deleveraging????

Households have begun what will prove to be a prolonged period of deleveraging and a slow, but steady return to financial health. This does not, in our view, necessarily sentence the U.S. to a decade-long cold winter economy. The adjustment process that lies ahead may be less about a consumer collapse than it is about a change in the “composition” of U.S. economic growth.

For much of the last couple of decades, the U.S. consumer has chronically spent in excess of its income. This was primarily because a sizable portion of household outlays leaked through the import window and stimulated the GDPs, income and employment growth of foreign economies rather than creating an equal amount of income domestically. Exhibit 13 provides an illustration. It shows the trailing four-quarter contribution to real GDP growth from real consumption growth and net exports. In the late 1990s, consumption growth contributed about 3.5 percent to real GDP growth while net exports subtracted 1 percent from domestic growth. That is, 3.5 percent consumption growth produced only 2.5 percent income growth. Domestic consumption growth without commensurate income generation forced households to reduce savings and escalate debt.

Years of persistent import leakage has left the household sector in poor financial shape—without savings and over-indebted. Many consider this situation and conclude the only solution is a prolonged period of U.S. economic retrenchment. We believe a far more optimistic outcome is possible and indeed is already underway. Consider the last year. The contribution of consumption growth to real GDP has slowed to only about a 1 percent, but net exports have switched from a drag to a positive contribution of about 1.5 percent! In 1998, consumption provided 3.5 percent growth offset by a trade loss of 1 percent, resulting in a net contribution of 2.5 percent. Today, even though consumption is providing much less growth, trade is offering more. Although its composition is very different, today's net contribution of about 2.5 percent (i.e., 1 percent consumption and 1.5 percent trade) is essentially the same as it was in 1998!

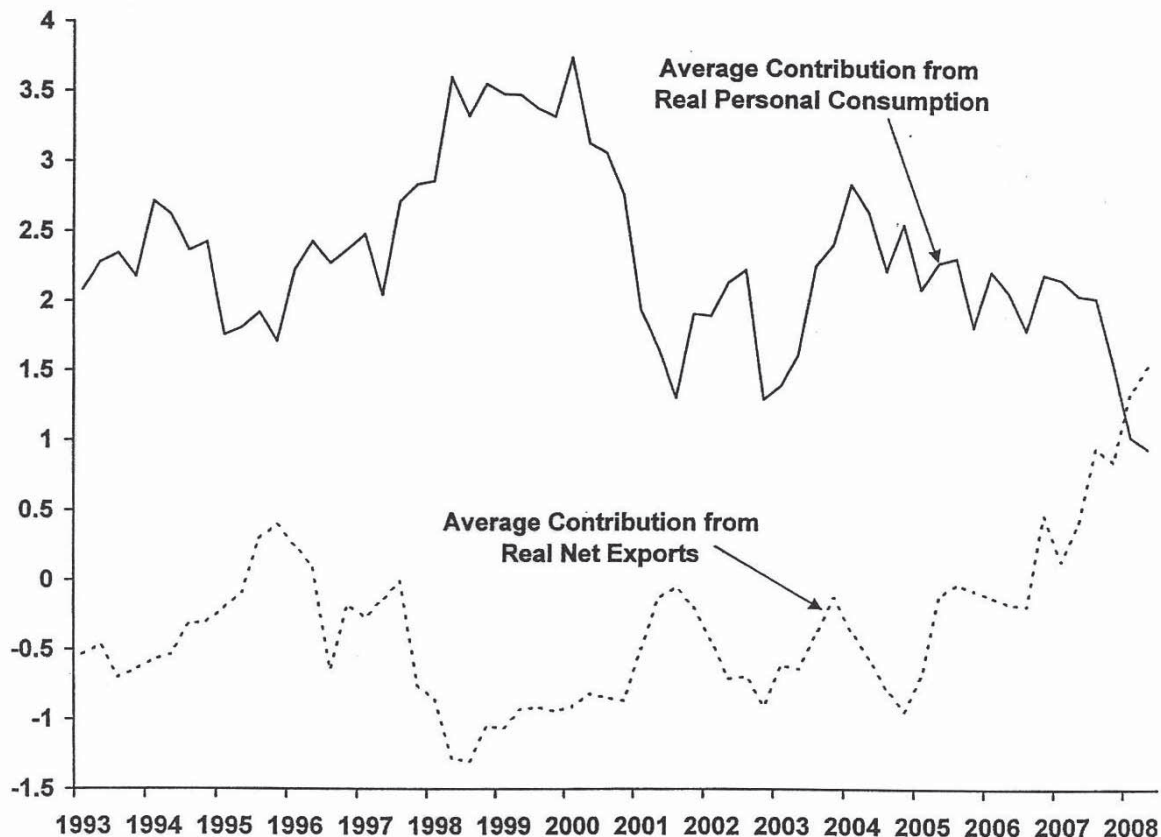
Like many others, we expect consumer deleveraging to continue for several more years. However, we also anticipate a persistent trend of U.S. trade improvement, which should help mitigate, if not offset, household deleveraging. For the last 10 to 20 years, the U.S. has been spending in excess of its means, “building out” or investing in the emerging world. Now, primarily because of its prolonged U.S. investment, the emerging world is slowly becoming a set of self-sufficient capitalist economies that possess young demographics with growing desires and strong savings. Essentially, just what the U.S. economy needs to help it through a period of consumer deleveraging. In the next 10 to 20 years, as U.S. households reliquify, the country stands to finally reap a “return on its emerging world investments” of recent years. U.S. net export growth is, and will likely continue to be, helping finance the deleveraging of the U.S. consumer.

This secular change in the U.S. economy from a consumption-driven net importer to a trade-driven net exporter will not allow the U.S. to avoid recession in the coming year. It does, however, suggest a shorter recession than most fear and a much more favorable U.S. economic future than most currently anticipate after the coming recession.

Collapse or Compositional Shift????

Exhibit 13

U.S. Real Personal Consumption vs. Real Net Exports
4-Quarter Average Contribution to Real GDP Growth

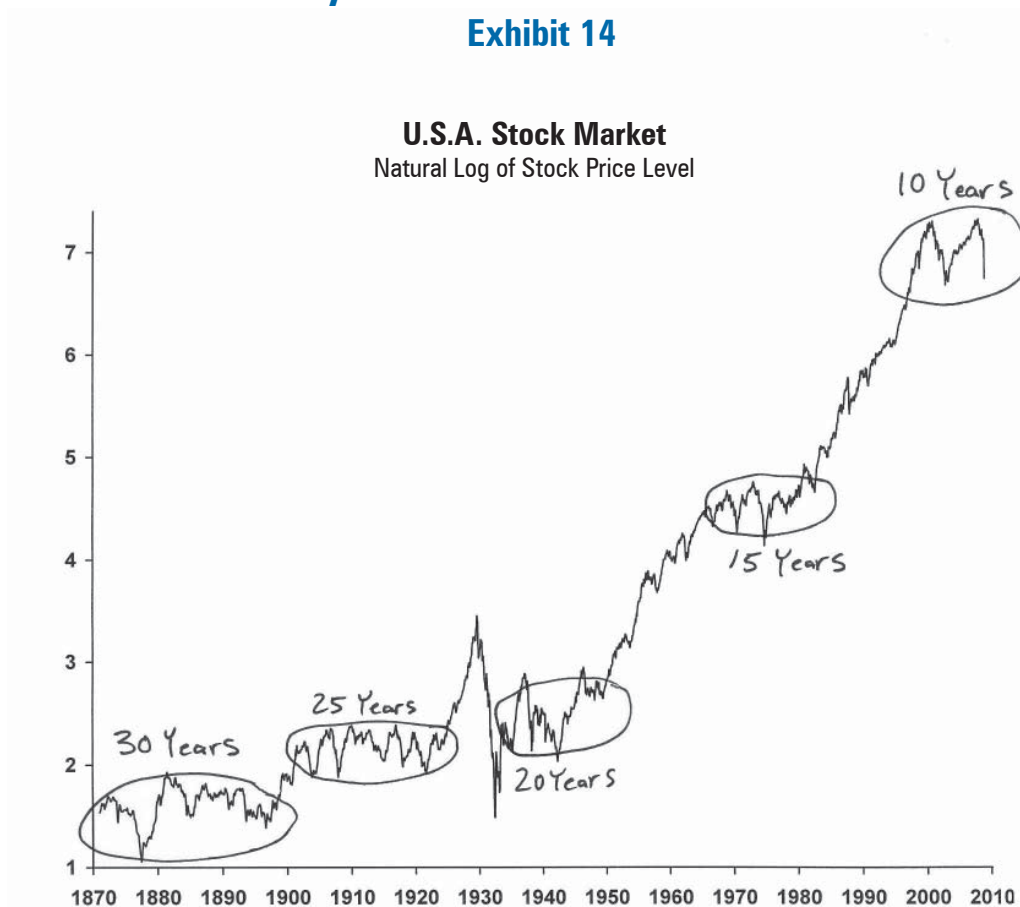


Investment Implications!?!?

We first published the chart in Exhibit 14 in the late 1990s. Among the widespread optimism of the day, we wanted to illustrate that historically, sideways stock markets tended to be much more prevalent than bullish periods. Indeed, of the 140 years of market history shown, only about 40 of those years experienced a sustained rise in stock prices. Today, however, we believe the popular notion that the U.S. stock market is stuck in a prolonged trading range similar to the 1970s is more a description of what has happened in the last decade rather than a forecast of the future. Moreover, as illustrated, trade-range stock markets have become progressively shorter through time, and at 10-years, the current trade-range market appears to be nearing its limit. We don't know when the stock market will finally bottom, but we do believe when it does, it can embark on a fresh sustainable bull run after being revalued during the last decade.

Sideways Stock Market ... No More!?!?

Exhibit 14



It may take several more months of tests and retests of recent market bottoms. The stock market may even break to new lower lows, but a bottom is nearing and the upside potential when it turns is more than sufficient to warrant riding through whatever bottoming process is still left. Although investors will have to endure ongoing incredible volatility in the near-term, we think a trio of positives has significantly improved the stock market outlook.

First is the restoration of value! Exhibit 15 shows the median company, S&P 500, price to forward one-year earnings estimate has almost declined to single digits! Even if earnings estimates are lowered, valuations still look compelling. Also shown is the ratio of total U.S. market capitalization to nominal GDP. This ratio recently declined to about 0.66, its lowest level in about 20 years, and is equal with where it was in 1974! Relative valuation is even more compelling. While absolute valuation is about the same as it was in the early 1990s, both the core inflation rate and long-term Treasury yields are only about one-half what they were 20 years ago!

Stock Market VALUE + FEAR + Policy Push = BUY Exhibit 15

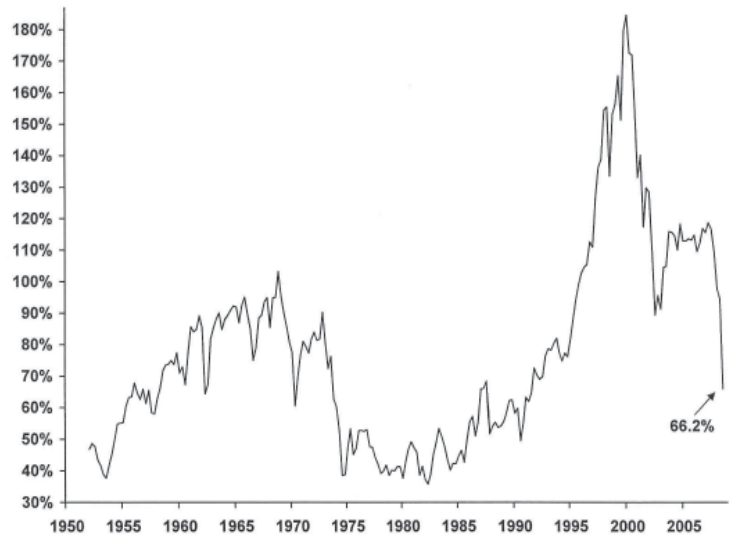
S&P 500 Price-Earnings Multiple*

*Median Company Price to Forward 1-Year IBES Mean Earnings Estimate



U.S. Equity Market Capitalization as a Percent of Nominal GDP*

*Last data point based on actual nominal GDP data through Q2 2008 and an estimated Market Capitalization adjusted for the total return of the Dow Jones Wilshire 5000 since the end of Q2 2008



Second, is Fear! The VIX stock market volatility index is persisting at record highs. Investors seem content in giving away assets at any value as the buzz says you should focus on “return of capital” rather than “return on capital.” When this defines the consensus attitude, you can bet there are some real “fire sales” available in the stock market. Fear and panic have seldom been higher, and for equities, this implies all the “nervous Nellies” have sold and there is massive buying power sitting safely on the sidelines waiting for the second coming of the Great Depression. If things turn out better than feared, which won’t be hard since popular nightmarish scenarios are all the rage, think of how many dollars will be coming back into the stock market, chasing the return of optimism higher.

Third, and the best of all, is every economic policy official about the globe is working 24/7 with a single myopic focus—how to lift the value of your equity portfolio. Seldom do stock investors enjoy such a favorable backdrop of value, fear and policy push. Our advice? The government is going to win—you ought to bet on it!

In times like today, it is also good for investors to recall that the stock market is a leading animal. Even though the economy is headed for recession, much, if not all, of this economic outcome is already embedded in equity prices. And before long, depending on the length of the recession, the stock market will begin reflecting an expected recovery. In most post-war recessions, the stock market has begun to rally six to nine months “prior” to the peak in the unemployment rate. Can’t wait until the “economic waters” feel safe again. By that time, stock prices will have already recognized most of its current undervalued status. Rather, investors should take confidence in the “lack of confidence about you;” should become emboldened by the recent speed and depth of stock price declines and how ridiculous they appear against a multiple-year, if not decade-long investment horizon; and be comforted by your gregarious, motherly government, which seems bent on ensuring nobody gets hurt.

Investors should not confuse volatility with risk. For investors, volatility is a temporary irritant that should mostly be ignored. Certainly, it should not force investors out of the market nor keep additional cash on the sidelines. Traders may need to carefully orchestrate volatility, which could wipe them out if incorrectly positioned. For investors with adequate diversification parameters and with sufficiently long horizons, however, volatility should not be that concerning. Better to hold your nose about volatility and stay focused on the real risk/reward ratio. On a sustained basis (i.e., not just for a volatile bad week or few months,) how much lower can market values fall versus how high could equity prices rise should confidence begin to mend?

We believe a lot of bad news is already priced into this stock market. Indeed, perhaps nearly everything but the second coming of the Great Depression. Assume, for example, the economy is headed for the worst post-war recession ever—a deep and prolonged four-year debacle. Under such a scenario, assume earnings levels would fall by about 50 percent from previous cycle peaks. With stock prices already off by about 50 percent in the last year, this worst-case recession scenario is already priced. If another depression is actually coming, then more downside in the stock market still exists—the stock market fell about 90 percent during the Great Depression. But this seems like a bad bet! It may happen, but it has only occurred once in entire history of the U.S. It seems comparable to betting on winning the Lotto! Could happen, does happen, but its probability is so low it is hardly worthy of any consideration.

Irrational Exuberance to Irrational Pessimism!?!?

In the late 1990s, it was difficult to convince many that, in the “new-era,” stock prices wouldn’t continue on to the moon forever! The economy gave every sign of strength and health and there were just too many antidotal stories of success. Today, it is equally hard to believe the stock market will ever stop falling, let alone ever rise again. There is just too much evidence of economic malaise and too many horror stories.

We have gone full circle, which markets often do, time and time again. Of all the unique features evident in this crisis—all the “worst evers since the Great Depression”—one commonality is noticeable and has been around for as long as man! Fear and Greed! In the late 1990s, we experienced Human Greed at its maximum and the thing to do was to bet against it. Today, we are experiencing maximum Human Fear and again investors will be best served betting against it!

*Thanks for taking a look!!
JWP*

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