



8053 XERXES AV S. ■ BLOOMINGTON, MN 55431 ■ 952.926-3000 ■ Toll Free: 866.926.3022 ■ www.capstratcorp.com ■ e-mail: capstrat@comcast.net

Financial Market Commentary 3rd Quarter 2008

October 21, 2008

Overview

Problems in the mortgage market spilled over into lending markets worldwide, leading to a global credit crisis. Because of this, we have seen panic selling in the bonds and stock markets over the past four weeks. Panic selling is not a term we use lightly, but there has been little if any differentiation recently between selling quality assets and more speculative ones. It has been truly frightening to see how fast prices can fall. On the plus side, some really good opportunities have been created. We hope to be able to profit from the indiscriminate selling in some of these areas.

That said this past quarter was the worst for investors in the last two decades. For stock investors alone, the third quarters of 2001 and 2002 were worse, as was the fourth quarter of 1987. On the bond side, however, this past quarter stands alone. For the most part, treasury securities held their own. Unfortunately, any bond that did not have the explicit backing of the U.S. Government most likely came under serious pressure. The spreading belief that almost no company's bonds were safe, no matter how short the maturity, undermined the entire financial system and forced the government to get involved in a manner that is without precedent. In the commentary, we will discuss what happened and where we go from here.

Summary

Stocks posted big losses during the previous quarter due to the collapse of the world's credit markets. Massive leverage in the bond market, coupled with a fundamentally flawed bond rating system, has led to a wave of forced selling that has affected both high quality and lower quality bonds (because the bond rating system has lost almost all credibility, differentiating safe bonds from more risky ones has never been harder). Making matters worse, the credit crisis has spread overseas. Many foreign banks and governments were buying American mortgage securities (because they were running a trade surplus with the United States and wanted to reinvest that surplus back into the U.S. in order to help us keep our interest rates down¹). The long running depreciation of the dollar made investing overseas very profitable for the last several years.

¹ Without the cooperation of our creditors recycling their surplus back into the U.S., our interest rates would have gone a lot higher, and we wouldn't have been able to buy as many foreign goods.

This came to a screeching halt in July as Europe became caught in the credit crisis when the sudden decline in oil prices meant reduced demand for Euros to hedge their dollar exposure.

The extra currency return American investors got for investing overseas from November 2006 to July 2008 has been almost completely taken away in the last 12 weeks, making international investments even worse over that time period than domestic ones.

For the quarter, U.S. stocks declined an average of -9.96% ². Larger companies tended to lose a little less (the S&P 500 lost only -8.37%) because they tend to be perceived as more financially stable and usually have higher dividends. Mid-size stocks were the weakest area of the market -10.87% ³. Natural resources stocks sank a frightening -32.68% as speculation on that sector of the market absolutely collapsed. Gold stocks fell -30.68% and utilities plunged -20.34% . On the other hand, non-energy sensitive industries did fair well last quarter. Financial services, real estate, and health care managed small gains. It should be noted that no industry whatsoever was spared in the first ten days of October.

International stocks performed terribly in dollar terms, for the reasons mentioned above. The average international stock fund lost more than -21% , as developed markets lost -19.14% and emerging markets tumbled -26.95% ⁴. Emerging market stocks tended to under-perform developed country stocks because they contribute a disproportionate share of natural resources to the world economy, and the long running surge in resources prices came to an abrupt end.

U.S. treasury bonds were about the only port in the storm last quarter. Series I (inflation indexed) bonds declined because inflation expectations fell primarily due to the plunge in oil prices. Municipal bonds, which have a historical default rate of less than one-tenth of one percent, nevertheless declined because investors feared the impact of housing foreclosures on local economies (and because over-leveraged financial institutions were forced to sell everything they could in order to generate cash to avoid insolvency). High quality bonds, be they government, corporate, or municipal, usually rise in value during periods of falling inflation and economic weakness because their interest payments are both safe and worth more in after-inflation terms. The fact that they haven't (for the most part) is testimony to the unprecedented conditions in that market. Bond fund returns ranged from up $+1.70\%$ (U.S. Treasuries) to down -4.29% (inflation-indexed bonds), down -4.55% (municipal bonds), down -5.61% (investment grade corporate bonds), and down -8.10% (high yield corporate bonds).

² As measured by Lipper Analytical Services

³ The S&P 400 Midcap Average

⁴ Morgan Stanley's EAFE and EM dollar-based indices.

Activity

We reduced your portfolios' exposure to the stock market, both domestic and international, several quarter ago. Having extra cash in the portfolios helped cushion them from the sell-off in stocks. However, the bond market has declined to a degree not seen in decades (if ever).

We just did not foresee high quality corporate and municipal bonds declining as much as they have. We are looking to make changes now that will incorporate exchange traded funds and some individual stocks (approx. 20% of balanced portfolios) in order to reduce overall exposure to economic conditions that are, to put it politely, not favorable.

Outlook

As always, the near term is very hard to predict. A very knowledgeable investor once told me that "the stock market is a voting machine in the short term and a weighing machine in the long-term". In other words, in the short-term the market will go wherever fear or greed take it (and fear definitely has control right now), but in the long run good value will be sifted out and rewarded. If this were a normal year, we would feel confident that seasonal factors would help lift the market⁵. Right now it is just too hard to say.

We believe that we will get a nice rally at some point, but when and from what level is just too hard to say. Earnings estimates for the fourth quarter of 2008 and all of 2009 have been falling sharply in recent weeks, so even though we are going to get a relief rally, we are a long way from being out of the woods.

Commentary – How Did This Happen?

The economic crisis we find ourselves in is very complicated, but we believe it is important to first answer how we got into this mess. There are a number of culprits:

- A belief system that home ownership was the ticket for the middle class, and therefore anything that could be done to facilitate home ownership was desirable. Fannie Mae and Freddie Mac were encouraged to expand their balance sheets even though it was known that their accounting was poor;
- A rival belief system that held that the private sector was efficient and government incompetent, such that government regulations should never be allowed to interfere with the operations of a free market;

⁵ November through January has traditionally been the best three month period for stocks. Moreover, there is a strong historical tendency for stocks to rally once investors determine which presidential candidate is going to win.

- A Federal Reserve chairman (Alan Greenspan) who believed that derivatives helped mitigate risk in the financial world, such that the more derivatives there were, the safer the market was;
- Derivatives were used to the extreme; credit default swaps (CDS), collateralized debt swaps (CDO) and other variations just continue to magnify the problem;
- The amount of leverage of these financial instruments being used is dramatic. Goldman Sachs a well known and respected investment banking firm recently had a Trillion dollars in assets and only 43 Billion of assets! This type of astounding leverage is now coming back to haunt all of us;
- Financial company executives who profited greatly from the expansion of credit but did not understand all of their implications. When times were good, they argued that their savvy merited the huge bonuses they received. When those same instruments went bad, they begged for a bailout saying “who could have known?” (And they did not offer to return any of the bonus money);
- Individuals who bought homes at low rates and/or with little or no money down, who did not allow for the possibility that the house would not appreciate and therefore they would not be able to refinance once the “teaser” terms expired;
- Hedge fund managers, who didn’t understand the concept that if a particular trade was profitable, leveraging that same trade ten times or more wouldn’t necessarily give you ten times the profits, especially if everyone else was trying to unwind the same trade at the same time;
- Mortgage rating agencies, because despite the greed and/or incompetence of the above, the whole crisis may never have happened if these people had done what they were paid to do (certainly, it would not have gotten this bad).

Few of you have probably ever heard of Nassim Nicholas Taleb. He is a finance professor and author of several books, including *Fooled by Randomness*, in which he introduced the concept of “black swans” or very unlikely random events. He argues that mathematical models of markets are wrong because they assume that market returns are normally distributed (in other words, they can be plotted on a bell curve). For example, human height is normally distributed. If average height is five feet nine inches, many fewer people will be either 4’9” or 6’9”, and magnitudes fewer than that will be 3’9” or 7’9”. Taleb’s argument is that markets have “fat tails”, meaning extreme events (negative and positive) happen more frequently than the bell curve would suggest.

In 1998, the bond market conditions that brought down Long Term Capital Management and drove many banks to the brink were said to have been once in a century events. Unfortunately, it only took 9 years for another statistically highly improbable event to occur. Perhaps we've been unusually unlucky. More probably, Taleb is right and the statistics the financial markets use to estimate risk are dangerously flawed.

All of this has led us to a place that we have never been before. Economies all over the globe are being affected by financial instruments that did not exist during the last major global economic downturn (in the late 1970s). Compounding the problem is the fact that so much of the daily volume in the financial markets is coming from traders (as opposed to investors). Trades that work attract similar trades, until so much is wagered on a particular position that the unwinding of that trade is destabilizing to markets. For example, oil prices rose sharply from June 2007 until the end of this past June.

The rise was sharpest in the last three months as both speculators and hedgers got in. The rise in oil prices coincided with an increase in the value of the Euro, as oil is paid for in dollars and oil producers were concerned about having too much exposure to a deteriorating currency. In July, oil prices peaked as global economic growth slowed. As investors anticipated declining worldwide demand for oil, there was a mad rush to get out of oil and energy stocks. That also meant a lot less demand for Euros, which also began to plunge.

In recent years we have seen many situations where the volumes of trades in a particular position swamp the market. We in the financial sector have done an amazing job of creating trading vehicles this decade. What we haven't done is create a system to regulate trading. There are specialists on the New York Stock Exchange. These are people who manage the trading in NYSE listed stocks. In a crisis, they are buyers when nobody else wants to buy and sellers when there are no sell orders. Unfortunately, there are too many things being traded that have a major impact on world economies where the dollar value of the trades exceed anyone's ability to function as a specialist. In essence that is the role that Treasury Secretary Hank Paulson is trying to play now in the credit markets. Business to business lending has almost ceased today because there is nobody but the U.S. Government big enough to buy the debt obligations that nobody else will buy (because they are afraid the borrower will not be able to pay).

We hope that we have done a good job explaining how several separate but inter-related problems have all come together to create the biggest worldwide financial crisis since the 1930s. That does not mean that we are destined to repeat the Depression. Our financial authorities are very cognizant of the mistakes that were made seventy years ago. They may make mistakes, but they won't make the same mistakes that Hoover did.

The current Federal Reserve chairman, Ben Bernanke, after receiving his PhD from MIT made a study of the Depression. He concluded that the major contributing factors in causing the Depression were the Hoover Administration's actions: allowing one third of the nation's banks to fail; keeping interest rates high; and raising taxes (which also reduced spending and the money supply to the economy).

It is going to take time to work our way through this. Unemployment could well rise well above 7% next year. Certainly more companies will fail. However, stock markets have a way of anticipating things. In the 35% decline from last year's peak, markets have been signaling that the economy is going to contract. Long before the economy begins to recover the stock market will have begun its next upward run. We don't know when or at what level this bear market will make its ultimate low. We just know there has been a tremendous decline in prices across the board – no industry has been spared – and that declines like this create a lot of opportunity. If we can gut it out, history suggests the long-term returns can be substantial. There is a reason Warren Buffett is buying now!

To conclude this very long commentary, we are in an unprecedented financial crisis due to a number of factors. Some of these occur to some degree or other in every financial crisis, while others (such as exotic mortgage derivatives and credit default swaps) are unique to this one. There are many parties that bear responsibility, because risks were ignored or downplayed at every stage.

We believe we just have to tough this out, because there are still very many excellent companies out there whose bonds and stocks are fundamentally sound and their prices will eventually reflect that. We will need to continue to make adjustments in your portfolios as we go from economic weakness (short to intermediate term) to inflationary concerns (intermediate to longer term), as we deal with all of the debt the government is going to have to create to help the financial sector get to the point where it is ready to make loans again.

We are currently making major changes to better position your portfolios for these difficult conditions and we expect to continue doing so in the next few months as market conditions and the economy warrant.

Capital Strategies Financial Corporation

Mark A. Carlton, CFA Eric C. Graber, President