**IMCA**

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# Industry Spotlight Series
# State of the Markets, Part 2—the Global Impact

## Jonathan Golub, CFA®

# Outline of Discussion

- Recap and update from last call
- What's new since last call
  - The conversation has shifted
  - Coordinated government action
- Implications of increased volatility


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# Conclusions – what to think

- Stock prices value companies; Short-term credit markets fund them.

  **Takeaway: Stocks may be down but credit markets are choking the real economy.**

- We are swamped with conjecture because traditional analysis doesn’t work in this environment.

  **Takeaway: Turn off the TV and stop listening to the pundits.**

- The Fed and foreign central banks are flooding the market with liquidity.

  **Takeaway: The Fed has the tools to help resolve the current crisis. The question is one of timing. The longer it takes the more collateral damage.**


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# Conclusions – what to do

- Current market uncertainty will likely be with us for some time. Establish a framework for evaluating the crisis. Share this with clients.
    - leading indicators - credit, volatility, housing, manufacturing
    - lagging indicators - market returns, employment, profits

    **Takeaway: Communicate. Not knowing the future outcome is okay. Sharing your process demonstrates your expertise and will put you on the same side of the table as your clients.**

- Investors should resist the temptation to go to cash. Review plans to ensure client needs are met in light of diminished assets and returns.

    **Takeaway: Going to cash is not a strategy; it's a tactic.**

    **Takeaway: Given diminished asset levels and cash returns, a cash portfolio will not likely meet client needs.**


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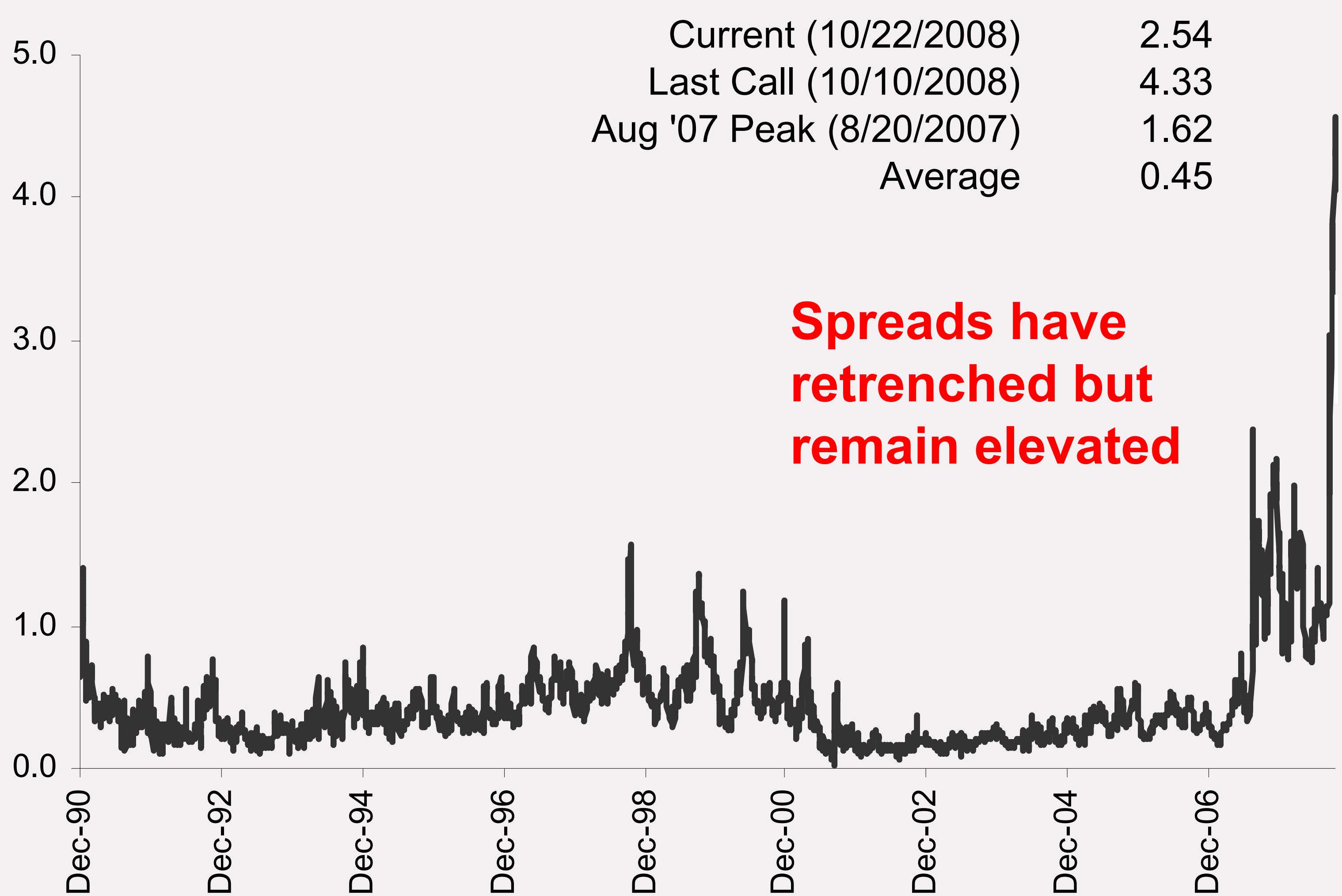
# TED Spread




Source: Bloomberg



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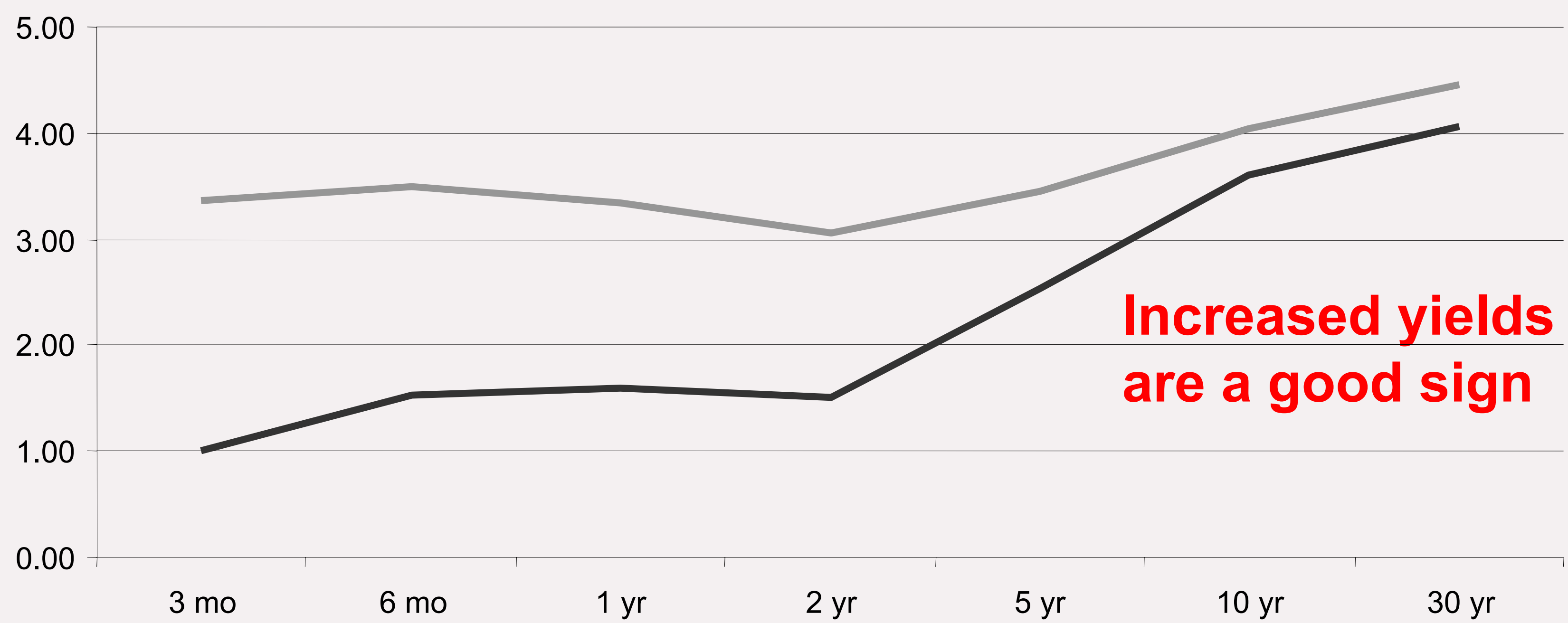
# Yield Curve




| | 3 mo | 6 mo | 1 yr | 2 yr | 5 yr | 10 yr | 30 yr |
|---|---|---|---|---|---|---|---|
| 22-Oct-08 | 1.01 | 1.52 | 1.60 | 1.50 | 2.52 | 3.60 | 4.06 |
| 10-Oct-08 | 0.25 | 0.84 | 1.08 | 1.62 | 2.77 | 3.89 | 4.15 |
| 31-Dec-07 | 3.36 | 3.49 | 3.34 | 3.05 | 3.45 | 4.04 | 4.45 |

Source: Bloomberg



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# Globally Coordinated Intervention

**Actions over words**

**Europe shows leadership**

- Broader insurance on bank deposits
- Insurance on money funds
- Congress passes $700 billion rescue plan
  - Injections of capital into troubled and healthy banks
- Lend directly to companies by intervening in commercial paper market
- Lower policy rates by central banks
  - Aggressive open market activities
- Discussion of further fiscal stimulus and foreclosure relief
- *While lower energy (50%) and commodity prices aren't a policy response, they act as a huge tax cut*


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# Economic Security Alert – From Red to Orange

Economic Security Alert: High

- Disorderly credit markets create a significant disruption for the broader economy resulting in a negative feedback loop.

  ***Lack of available credit hurts businesses. Businesses lay off workers. Workers cannot make payments. Bank lending is hampered.***

- A traditional recession characterized by a rise in unemployment, profit weakness, and a fall in inflationary pressure. Traditional recessions are self-correcting and respond to Fed stimulus.


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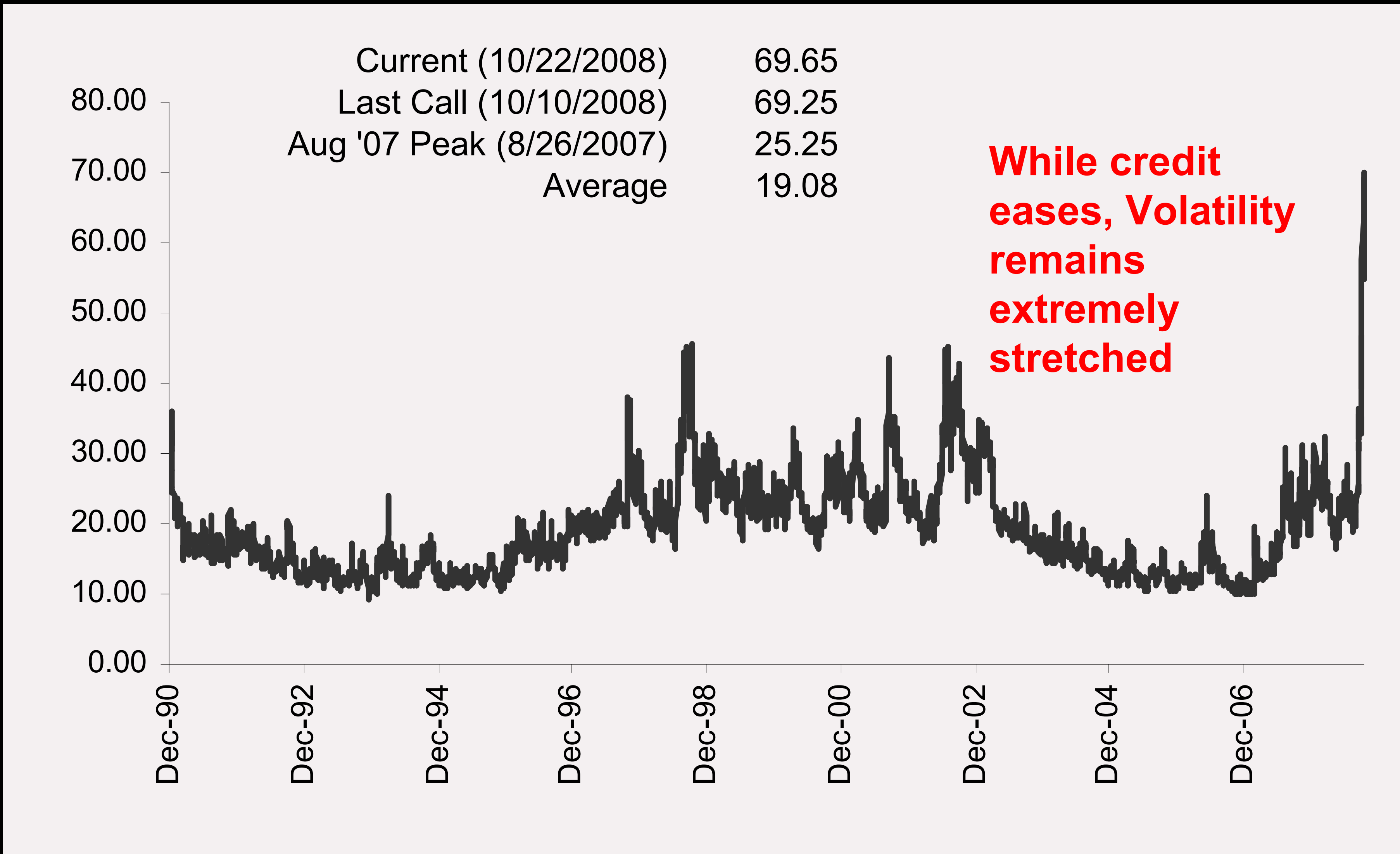
# VIX




Source: CBOE

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# Historical Moves in S&P500 (since 1929)

**Realized Volatility — A Historical Context**

| Year | Period | # Days > +1% | # Days < -1% | Total |
|---|---|---|---|---|
| 1932 | Great Depression | 82 | 87 | 169 |
| 1933 | Great Depression | 86 | 69 | 155 |
| 1938 | Run-Up to WWII | 66 | 69 | 135 |
| 2002 | Tech Bubble Unwinding | 52 | 70 | 122 |
| 1974 | Oil Crisis / Nixon Resignation | 47 | 66 | 113 |
| 1999 | Tech Bubble Inflating | 51 | 40 | 91 |
| 1987 | Buyout Bubble / Black Monday | 50 | 40 | 90 |
| 1982 | Bull Market Begins | 43 | 39 | 82 |
| 1928-2007 | Median Days > +/-1% | | | 47 |
| 2008 | Year-to-Date | | | 94 |

**Layman's vix (for those who haven't studied options pricing theory)**

| Year | Period | Return | Year | Period | Return |
|---|---|---|---|---|---|
| 6 Best Days | | | 6 Worst Days | | |
| 10/30/1929 | Great Depression | 12.5 | 10/19/1987 | 1987 Crash | -20.4 |
| 9/21/1932 | Great Depression | 11.8 | 10/29/1929 | Great Depression | -16.1 |
| 10/13/2008 | Current Credit Crisis | 11.6 | 5/14/1940 | World War II | -10.3 |
| 4/20/1933 | Great Depression | 9.5 | 10/15/2008 | Current Credit Crisis | -9.0 |
| 10/21/1987 | 1987 Crash | 9.1 | 7/20/1933 | Great Depression | -8.9 |
| 11/14/1929 | Great Depression | 8.9 | 9/29/2008 | Current Credit Crisis | -8.8 |

Source: Standard and Poor's Corporation



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# Implications of Increased Volatility

Institutional Investor Perspective

- VIX: Implied volatility based on options pricing on S&P500 stocks

Private Investor Perspective

- Risk: <u>The likelihood of outliving your savings</u>

Stock Perspective

- P/E multiples: Multiples contract when uncertainty rises resulting in lower stock prices


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# Stock Prices, Earnings, Multiples & Risk

$$P = E \times \frac{P}{E}$$

Earnings growth should slow in a recessionary economy. However, this is insufficient in explaining a 40% fall in stock values.

Multiples are a function of uncertainty and expectations.

As uncertainty rises investors seek a higher return to compensate for risk. The only way for this to be accomplished is for prices to fall providing greater potential upside.

As uncertainty declines, multiples should naturally rise.



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# Biography

Jonathan Golub is one of the industry's leading voices on the markets and economy. He is the former Chief Investment Strategist and Senior Managing Director for Bear Stearns. Jonathan was the US Equity Strategist for JP Morgan Funds from 2001-2007. He is a graduate of the Wharton School of Business.

Mr. Golub has presented to over 60,000 financial professionals, providing his perspective on topics such as the housing bubble, credit crisis, financial sector write-downs, US and global economy, geopolitical issues and more.

Jonathan's commentary has been featured in such publications as *The Wall Street Journal, Barrons, The New York Times* and *Forbes*, as well as on financial television and radio programming including *CNBC, Bloomberg TV* and *National Public Radio*.



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