



The Federal Reserve, Wall Street, Big Banks and the media are all helping to push the economy into a recession. Whether or not they will be successful depends upon whether business panics or not. However, if a recession unfolds, it is not likely to last very long or be very deep. We are maintaining our **maximum equity** strategy and adjusting both our bond and stock exposure to reflect our current outlook.

Federal Reserve:

The Fed has two policy objectives -- to promote price stability and to encourage economic growth. Admittedly, these two goals can be at odds, and the debate for at least the last thirty years has always been over which of these goals posed a greater threat. So it goes today, with different analysts reaching different conclusions. However, for the Fed to give that debate center stage is like *Nero fiddling while Rome burns*. The Fed was created to be the lender of last resort and part of that mandate is to keep markets functioning – to provide enough confidence and liquidity that prices are set within a narrow bid/ask spread. That's not happening and the result is a flight to quality that is damaging the whole credit market when the problem should be limited to sub-prime mortgages, a small part of the total market. Until the Fed gets this right, most markets will stay volatile and some sectors will be illiquid.

Wall Street:

Greedy investment bankers and greedy investors need to take a bow for creating and buying securities of unfathomable complexity, collateralized debt obligations and the derivate securities based on them. Because few investors have the ability to really analyze the fundamental credit risk buried in these securities, the thought of pricing them when there are few, if any, bids becomes absurd. Yet, accounting standards demand that companies regularly price their portfolios to market, so prices are being written down and no one knows how realistic they are. Some of the “mark to market” calculations are causing very senior heads to roll now, and others will lead to massive and expensive lawsuits later.

Big Banks:

The regulatory umbrella under which banks must operate in the U.S. is arcane. So, clever bankers partitioned “regulated banking” into a corner of their corporate structure so they could stretch their tentacles into faster growing areas of financial services. One particularly helpful tool was to move certain

assets and liabilities off the balance sheet to a phantom entity almost certain to generate profits. Guess what? Now those off-balance sheet items threaten the ability of the actual banks to conduct business. The Fed's move to reduce short-term rates is designed to help by fostering a positive yield curve for banks to profit from traditional lending, but the truth is most bankers don't trust other bankers because they only know what they have done to present a good face. Without trust among banks, credit expansion is laborious and can fail.

The Media:

If it were only the liberal press, it would be easy to attribute fear mongering of a recession to a political goal of electing a liberal President, but all journalists seem to be sensationalists. A slow but growing economy is not newsworthy, but debating whether we are already in a recession or just facing one attracts speakers, an audience and advertisers.

The Business Sector:

The only economic sector holding strong cards right now is business. First, most took advantage of low interest rates to refinance their debt. Second, many took advantage of lowered trade barriers to rationalize their supply chain, lowering those costs. Third, most enjoyed profit growth beyond their expectations. Fourth, recent dollar weakness is opening markets. Now business leaders are faced with a dilemma. Domestic sales are slower, inventory is growing and everything they see or read points to recession. If they push the panic button and start cutting employees, consumer purchases will shrivel and the recession is a “done deal.” If they use their strength to find new markets or take market share from competitors – weaker domestic or foreign ones – and keep employment high then we probably will not have a recession.

Manufacturers New Orders



Last 10 Years

Source: Crandall, Pierce & Company



Source: Crandall, Pierce & Company

Maybe a Recession, but a mild one:

Most economists agree that when a country goes into a recession, stopping it from getting worse and reigniting expansion is the government's responsibility. Typically a lot of time is wasted debating whether it is a recession or not and who is at fault. Eventually, two courses of action need to be initiated. On the fiscal side, it takes some combination of reduced taxation and increased spending. On the monetary side, it takes lower interest rates and excess money to solve existing problems and to encourage the venturesome to take risk.

Fiscal stimulus seems to be already forthcoming despite a Republican President and a Democratic Congress and all the political harangue of an election year. And the Fed, despite its internal debate and other short-comings, has reduced interest rates, is pumping excess money into the system and is highly likely to do more of the same in the coming weeks and months. **We think these stimulative policies will work and the economy will improve this year.**

No Doomsday:

Since the Second World War there have been highly credible economists who have argued against another round of stimulative government policy. Since such policies always elevate the rate of inflation, the argument is that at some point it just won't work; existing debt will be so great that more will not be possible and economic collapse will follow. While the logic of the argument seems impeccable, the downfall of these dire predictions has been the "at some point" clause. Time and again, government, businesses and consumers have increased their financial leverage and an expansion followed.

As inherently risk-adverse investors, we are mindful of the risk to the economy and the markets, if this is the time the government tries to stimulate and fails. We remain vigilant, but do not think planning for economic failure should dominate a portfolio's structure.

The Stock Market:

Never bashful to predict a possible recession, the stock market has been trading down since October. We continue to have a **positive attitude on stocks** because we continue to believe multiples should expand from current levels, and we do not expect earnings to be weak outside of the housing and financial areas. On a global basis the American market looks attractive and should benefit from excess global liquidity.

In 2007 the various market sectors performed differently, radically differently, and while our choices to emphasize and minimize sectors have worked thus far, this is no time to just coast along. We have a significant exposure to recession resistant stocks in the healthcare, non-durable and the energy industries but are working diligently to identify areas and initiate positions that will benefit from government stimulus and an acceleration of growth later this year.

The Bond Market:

Most of the time one seamless market exists among fixed income securities, with anomalies left to the arbitrageurs to iron out. That is not the case right now. The flight to quality has been so intense, that the Treasury market is over-priced relative to just about every other sector of the market, even municipals, while some sectors have little or no liquidity. As always, we continue to maintain high quality portfolios. Our strategy is to maintain **average durations**, but we are making term-structure adjustments to further control risk by optimizing anticipated changes in the yield curve.