

# *H.M. Payson & Co.*

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## RESEARCH NOTES

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### **MORE PAIN, NO GAIN**

In the wake of continuing signs of global economic deterioration, together with the realization that bank rescue and stimulus plans coming from Washington will take time to yield tangible results, the major indices are revisiting the lows of last November. The reckless and poorly regulated activities of U.S. banks and mortgage lenders that placed the global economy in such a precarious position have caused palpable anger among the investing public and an erosion of confidence in the capital markets. Having counseled our clients to stay the course throughout this extraordinary period, we humbly acknowledge the anxiety caused by declining market values. Yet, as we carefully review the current situation we can only conclude that today's market environment offers substantially more opportunity than risk.

After pinning such high hopes on the new administration, investors have quickly come to realize that no "magic bullet" exists to cure the economic decline. While the ultimate effectiveness of the bold – if halting – policy responses will remain unknown until they have been given time to work, uncertainty always results in lower equity values. To us, the more important point is that these aggressive fiscal and monetary actions stand in stark contrast to the errant policy responses of the Great Depression, which is increasingly being invoked as a reference point. While the current situation is indeed serious, such comparisons are grossly premature if not absurd. Just for context, from 1930 to 1932 the economy contracted by 50% - versus 4% thus far; unemployment was in the range of 25% - versus 8% today. Furthermore, today's broad social safety nets simply did not exist then. Things may indeed get worse before this is over, but the vast majority of economists see few similarities to that dark period in our nation's history.

Apocalyptic headlines notwithstanding, there are a number of factors that presage an eventual market recovery. First, although risks to the banking system itself remain, the credit markets are showing tangible signs of healing. For one, the London Interbank Offered Rate (LIBOR), which garnered so much attention last November when it hit a record 5.73%, stands at 1.25% today. Yield spreads on investment grade corporate bonds have declined measurably, as several high profile issues have been well-received in the marketplace. So far this year, new issuance is on pace to substantially exceed 2007 levels, reflecting improved demand and liquidity.

Among the potential catalysts for a stock market recovery are record cash levels, extreme negative sentiment, and compelling valuations. Money market balances stand at 35% of market capitalization, a level not seen since 1982 (the beginning of the great bull market). This week's American Association of Individual Investors (AAII) poll showed "bears" outnumbering "bulls" by 35%. Such

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negative sentiment has historically been one of the more reliable contrarian indicators. Finally, valuations are arguably the most compelling in a generation. The spread between the ten-year Treasury yield and the dividend yield on the S&P 500 is now *negative 1.25%*, a record. While cyclically-depressed earnings are keeping P/E ratios above their absolute lows, today's valuations – measured against expected trough earnings - are consistent with previous major market bottoms. As ugly as the price action in the major indices has been, we note that recent market breadth (the ratio of advancing versus declining issues) is much better than in November.

Although the economic recovery may take some time, we once again point out the stock market's tendency to anticipate economic cycles before they are widely evident. In the meantime, we are perfectly content to hold quality companies with strong balance sheets and little or no capital market risk. Just one example would be Microsoft. Although it is perceived as a slow growth behemoth, its revenue has doubled over the past five years. Its profit margins are the envy of the corporate world and holding steady, as its products remain the global standard. The company generates \$15 billion in free cash flow annually, with which it can increase dividends, repurchase stock, and still invest generously in new ventures. Back in 2000, its P/E ratio was in the 60s; today it is less than 10, with a dividend yield of 3%.

Beyond our ongoing focus on quality, we are actively repositioning portfolios to participate fully in an eventual market recovery. Unfortunately, hope for the recovery of the common equity in many bank stocks is fading with each passing week, and we are continuing to avoid new commitments there. But outside of financials, today we can construct portfolios with compelling investment characteristics. We have maintained or increased commitments in sectors that we expect will lead a recovery, such as energy, basic materials, technology and consumer discretionary. Encouragingly, these groups are well above their November lows. We also see opportunity in certain segments of the fixed income markets for the first time in a while.

At this point, the current malaise is as much a crisis of confidence as it is an economic one. We have regularly admitted our inability to time market movements, and further declines may indeed be possible. But it has been our experience that periods of extreme uncertainty and fear signify inflection points that harbor extraordinary potential for patient investors. Given time, our resilient system will right itself, global economic growth will resume, and confidence will once again return.

***If you have questions or comments regarding this or any other Research Note, click here to contact the Research Department.***

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