H.M. Payson & Co.

QUARTERLY INVESTMENT PUBLICATION ♦ WINTER 2008

PERSPECTIVES

The Evening ~~News~~ Noise

Once again, in our effort to go to press with a timely message, we are confronted by a volatile market and rapidly developing news cycle. The fact that the S&P 500 index eked out a modest gain for 2007 is indeed old news, and investors are focused squarely on the present. The major indices turned in their worst start in thirty years, with both the Dow and S&P falling by 10% in just the first twelve trading sessions. January 23rd was especially wild, with the Dow taking investors on a 600 point intra-day ride. For the moment, the markets seem to have regained a modicum of stability, giving us time to pause and reflect. Like the sailor riding out the storm with his gaze firmly fixed on the horizon, an investor can benefit by seeing past the volatility and adhering to thoughtfully constructed long term objectives.

Nate Beeler - The Washington Examiner

The issue is, of course, the increasing possibility of a recession. What began as a U.S. mortgage market crisis last year quickly spread to the global credit markets, severely impacting many companies in the financial sector. Several of the world's largest banks have been forced to seek infusions of capital from sovereign wealth funds. The implications of all of this for the broader economy - especially in the U.S., with the housing market in disarray - are not good. Recent economic indicators are indeed pointing to recession, with unemployment up, manufacturing down, and energy prices high. If all that isn't enough, some unvarnished populist rhetoric from certain presidential candidates is raising the potential for a tax increase under the next administration.

Needless to say, the media has taken up the drumbeat of "economic crisis" and is giving the carnage on Wall Street front page treatment. Admittedly, there are serious problems - but we can't help but wonder if we are witnessing a self-fulfilling prophecy, with the media literally talking the nation into recession. If the network news was one's only source of information, one would be convinced that we are in the throes of a calamity rivaling the Great Depression. The image being beamed over the airways is one of widespread foreclosures, homelessness, joblessness, industrial decline, collapsing stock markets and financial system meltdowns. The major networks are not the only guilty parties, as the financial channels have been relishing in the drama too.

It's certainly possible that the relentless barrage of bad news could influence the behavior of American consumers and businesses alike. Yet, it is during these periods of great uncertainty that we are compelled to remind our clients and ourselves that the short-term volatility of the financial markets always exceeds that of the underlying economic fundamentals. For investors, some dispassionate perspective on the issues roiling the markets may be useful in preventing hasty and counterproductive portfolio action.

Despite the ominous headlines, many economists continue to believe that whatever recession emerges, if any, will be short-lived. "Length of recession doesn't vary very much: about three quarters and that's it," said David Wyss of Standard & Poor's, who is not predicting a recession.[1] Moreover, government statistics are notoriously unreliable from month to month. They are frequently revised (often significantly), and one or two months of data does not comprise a trend. For all the hysteria around the unemployment rate jumping to 5%, it was not too long ago that this was considered statistically *full employment*. Over the past twenty years (which have been generally pretty good for the U.S. economy), the rate has been below 5% for only six of them. Industrial production fell slightly in December, but businesses have become much more disciplined with their working capital. Inventories are low, unlike previous periods entering recessions.

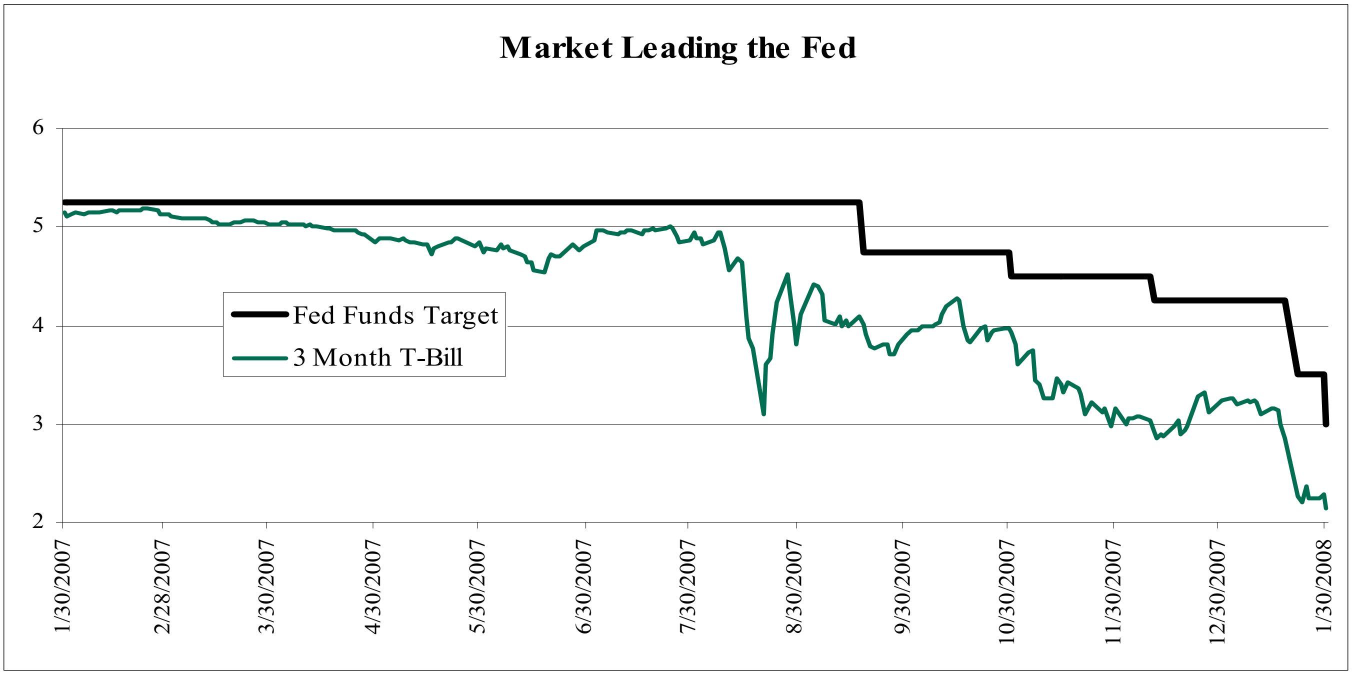
The real estate market continues to be the epicenter of the problem. The easy credit and irresponsible lending (and borrowing) practices of the past several years are clearly coming home to roost. This is an unpleasant time for some homeowners, homebuilders, financial institutions and bond investors. But real estate values were grossly inflated, and a correction in home prices is a necessary and healthy process (not to mention a *benefit* for prospective buyers).

Although it may seem counterintuitive, the speed of the decline in equities may provide some hope that most of the bad news has already been priced in. Volatility has been a feature of the modern financial markets, with information reaching participants across the globe with lightning speed, and computerized trading programs driving tremendous volume. From October's record high to the intra-day lows of January 23rd, the S&P 500 briefly flirted with the 20% decline that traditionally qualifies as a "bear market." By many measures, it appears stocks are already discounting at least a mild recession. For example, a recent report from Credit Suisse notes that the equity risk premium now stands at 7%, compared with its twenty year average of 3.4%. A number of technical indicators, including sentiment and insider buying, suggest severely "oversold" conditions, which are often followed by periods of above average returns. [2]

The Federal Reserve has recognized (belatedly, many would say) the potential threat to the economy, and has addressed it aggressively with interest rate cuts and direct injections of

[1] Source: The Wall Street Journal

[2] Credit Suisse Equity Research, January 21, 2008



liquidity. The .75% slashing of the federal funds target rate on January 22nd was quickly followed by last week's 50 basis points cut - the fifth in the past five months. Whether these bold steps will be enough to stabilize the financial system and right the economy remains to be seen; but at least they have served to arrest the stock market decline for the time being. So far, the European Central Bank has stubbornly clung to a tight money policy. This has kept the Euro strong relative to the dollar and exacerbated U.S. inflation concerns. If the ECB were to begin cutting rates, the potential inflationary effects of the Fed's recent actions would be reduced.

With compelling valuations and a determined Federal Reserve, we believe selected large capitalization U.S. equities continue to offer attractive risk/reward characteristics for those willing to endure some volatility. This is especially true relative to the total return potential offered by other asset classes. The earnings yield (inverse of the P/E) on the S&P 500 is over 7%, which compares very favorably to 2.3% on T-Bills and 3.5% on the ten year Treasury note. Admittedly, Treasury yields have been artificially depressed by the recent "flight to quality," but even junk bonds at 9% do not appear attractive given the associated risks.

So, the worst may be over… or maybe not. One thing we do know is the stock market is famously adept at discounting – well in advance – changes in economic conditions. After a year of volatility and steep declines for many stocks, we may indeed be in a recession. The question is: at what point might the market begin to look across the economic chasm to a recovery? With ominous headlines dominating the evening news, it is worth noting that the S&P 500 has produced *positive returns* during six of the eleven recessions since World War II. With luck, by the time the networks tell us who our next President will be, the financial news will be relegated to its usual place: somewhere between the celebrity rehab report and the weather.

TRANSITIONS

The Managing Directors are pleased to announce the following appointments:

Managing Director

JOEL S. HARRIS, CFA

Joel has been with the firm since 1995, and serves as a Portfolio Manager, Research Analyst, and Chair of the Marketing Committee.

JOHN S. BELIVEAU, CFA, CFP®

John has been with the firm since 1999, and serves as a Portfolio Manager and Chair of the Wealth Management Group.

Director

DAVID R. HINES, CFA

David joined the firm in 2003, and serves as a Portfolio Manager and a Research Analyst.

H.M. Payson & Co.

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