H. M. Payson & Co.

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RESEARCH NOTES

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A WEEK TO FORGET

For the second time this week, we find ourselves responding to some extraordinary developments in the financial markets. It is clear to us that this week's action was not about earnings, dividends, oil prices, bad management, mismanagement, or even GDP. There is nothing efficient in the way this market is operating, either in terms of pricing or the very market mechanism itself.

For all of us here – including the many seasoned veterans - this is probably the most difficult time we've confronted together with our clients. That said, being trampled by a frenzied crowd leaves us with only two real choices: turn and join them, letting fear lead us to take flight and sell in the face of circumstances completely out of our control; or, stand aside as best we can and let the mob run past us towards a decision we know they will ultimately regret once the danger and uncertainty subside.

With sentiment at such extreme negativity, some good economic news is being completely ignored: oil prices are down by 40%; housing is more affordable than in years; the U.S. manufacturing and export sectors are generally healthy. IBM and GE led off this quarter's earnings season with very encouraging numbers. Excluding financial and consumer discretionary sectors, S&P 500 earnings for the past twelve months *grew* by 12.9%.

At this point, it is our judgment that there is little one can or should do but to wait for the fear to recede - which it will, with time. In stark contrast to the beginning of the Great Depression, monetary authorities around the world are deploying extraordinary measures to inject liquidity into the system. Over the years, the markets and capitalism have been through challenging times in many ways worse than these. The fundamentals will reassert themselves over crowd psychology - as they always have – and rational pricing will prevail.

The dramatic re-pricing of risk across all asset classes has wrought compelling valuations, which will eventually provide support. The dividend yield on the S&P 500 stands at 3.4% - a mere 40 basis points below the 10-year Treasury yield, and the narrowest spread between these two indicators *since 1963*. In this fear-laden environment, it would be foolish of us to attempt to declare a bottom; but by virtually every measure, valuations are as or more compelling than at every major historical inflection point.

These are very trying times; but we have worked very hard to ensure that our portfolios are in impeccable shape. Even after accounting for the fact that we are heading into a worse than expected slowdown, the intrinsic values of the businesses we own are much higher than current quotations. In the meantime, these companies are well capitalized, generating cash flow, and are faring much better than average. We continue to look for opportunities as changes in market leadership begin to emerge.

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

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