The Delta Group

A FINANCIAL ADVISORY FIRM

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2008 Newsletter Musings:

Recalling the downfall of the glamorous internet stocks of the 90's with their compounding negative growth rates, the current version of bubble math wizardry was attempted by creating wealth from mortgage debt, subsidized and legitimized by a passive and neglectful Federal Reserve.

Wall Street's derivative creations such as these are self serving but widely accepted by hedge funds' quixotic search for risk-free above market yields. The current version of their design utilized the high rate sub-prime mortgage debt to make their leveraged schemes workable, but paid little heed to security (debt coverage/ FICA scores/market prices).

Several trillion dollars of … derivative schemes are in play in the financial world as various entities hedge bets and speculate with price and currency movements. The potential for a house of cards market meltdown worries ole' wise Wall Streeter's, and should us as well.

We should've taken our own advice more seriously. The "house of cards" meltdown did occur—the depth not seen since the Great Depression. The sheer stupidity, greed and dereliction of fiduciary duty by Wall Street and its financiers nearly collapsed our global financial banking system. Markets, although down ~40% for the year, remain anxious, debating the depth and duration of the recession. Demand for safe haven treasury bills has driven the short term rates to zero (0%), and propelled a spectacular and unbelievable descent of the 30 year Treasury rate to 2.5%—down from the mid summer yield of 4.5%.

Over the past two centuries, our economy has evolved from an agrarian subsistence to an industrial revolution which transformed the manufacturing process. Globalization directed our efforts towards a service economy; and, ultimately, insatiable greed gave us a finance/paper economy. "Progress" has taken us further and further away from basic needs to traders of illusion. Wall Street manufactured securities to suit their appetite for paper profit, and ultimately collapsed the house of greed. Wall Street will never be the same. RIP!

Economic

Logically, the economy tends to lead the stock market, both in good times (up) and bad times (down). An expanding economy generates excess profits and equity shares are rewarded accordingly with higher valuations, and vice versa. With the collapse of Lehman Bros. in September, doubts over the survival of other over-leveraged banks and brokers led to a complete collapse in money markets and a ~30% loss in the stock market. Interbank lending, entirely reliant on the faith of the counterparty (each other) to perform, came to a standstill, as fear of doing business with a bankrupt partner ceased most lending activity.

Credit markets are the life blood of the economy. Borrowing, whether on a short, medium or long term basis, is a business necessity. With the viability of lending institutions in question, our economy contracted 5%+ in the fourth quarter. The controversial $700B TARP (Troubled Asset Relief Program) program was primarily implemented to shore up bank balance sheets and restore faith in the system. This largely has been accomplished, Great Depression II has been averted, but a nasty multi-year recession remains in our future.

With consumers re-trenching (saving money) and demand collapsing for goods and services, company layoffs have become routine, sending the unemployment rate to record levels. The rate of both unemployed and under-employed workers, plus those having given up entirely has climbed to 12% of the workforce. As the recession worsens, this figure is expected to reach 16%-17% later in 2009. The auto industry's survival is in question, thousands of retailers will fail and government workers (state, city and county) will feel the pinch of falling tax revenues and will soon be checking craigslist for work in the private sector.

Although recessions are part of the normal business cycle (1 year out of 4), fear that the current downturn will cascade indefinitely lower appears misplaced. Having recovered from 32 recessions over the past 150 years, this logic is flawed. Our over indebted economy is in a de-leveraging process, which has the effect of driving

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prices of all goods and services (labor, commodities, housing) lower. This process will end when demand equals supply. Supply is abundant, but with consumers reeling, demand is faltering. After expanding over the past three decades, credit card debt was paid down during the 4th quarter. Perhaps a new era is upon us and living within our means is making a comeback?

In response, the Fed has acted aggressively over the past four months, including cutting rates to near zero, offering money market and interbank lending guarantees, absorbing toxic bank assets plus recent purchases of Fannie Mae debt to drive mortgage rates below 5%.

Those lucky enough to remain employed will fare well in 2009 and will find their discretionary income increasing. Gas prices are down 65%, dry goods are perpetually on sale and the timely mortgage refi will drop house payments 25%. New home buyers will find prices marked down 40% and affordable for the first time in history! Although our net worth is down and retirement plans postponed, our net income/savings are up.

Investment

The majority of the initial panic selling in October originated from margin call (leverage) induced hedge fund liquidations. Later, mutual fund redemptions also drained the market of optimism, and led the market down to valuations not seen since the bottom of the '80-'81 recession. Treasury bonds and gold were spared, while stocks large and small, domestic and foreign suffered record down drafts. Corporate bonds, good credits and bad (junk), sold off as investors bailed on all debt obligations not guaranteed by the Federal government.

Largely, diversification was a failure, as is the case during market meltdowns. With the expectation of bear market rallies (short lived) in 2009, a more conservative allocation towards fixed income (bonds/dividend paying stocks) seems suitable. As a result of the bond market sell-off, corporate bonds yields have climbed to 6%-12%, depending on credit quality. If credit markets continue their thaw, these historically high coupons will tempt investors back into the market and lift bonds prices higher. This combination of yield plus potential price gains is very risk/reward favorable.

The sell-off in stocks, meanwhile, has created a similar dynamic. Dividends yields, paltry over the past 25 years, are now higher than treasury obligations, with the Dow Jones average paying 4%. Although lost for nearly three decades, the income oriented investment theme has returned. Over the past 70 years, half of the 8% average market return has been generated by dividends. It appears we're on a "back to the future" track.

Gold, the universal currency, has been golden. With interest rates at zero, gold is now equal competition with cash, since it too pays no interest. With world governments printing money to counteract deflation fears, gold becomes a secure store of wealth.

Conclusion

Mostly, markets are where they belong. Valuations reflect anxieties. Panic sends prices lower, while optimism, greed and opportunity drive prices higher.

When the market gets a positive fix (confidence) on the direction of the global economy, current valuations will draw investors like bears to honey to the higher yielding risk assets from the safety of low (no) paying cash and treasuries. Conversely, further deterioration will send asset prices falling once again. Thus, leverage is out, and investment for current return is in. Rather than betting on the come, the income strategy offers a safer, more predictable investment approach.

Lastly, the SEC (Securities and Exchange Commission) has been a complete failure at maintaining market stability and preserving investor faith—which is their charge. Hopefully, the "Made-Off Scandal" will force this hapless agency to re-define their purpose in favor of the average Joe. Their ignorant and utter disregard for the long-term investor has been a tragedy for our time.

2008 will re-write history books. We lived it, and we will survive it. May 2009 be less upsetting!