

Walden Capital Newsletter

Walden Capital Advisors

First Quarter 2008

The downturn in the markets that started in the 4th quarter of 2007 continued into 2008. Much of the downturn was a result of problems facing the financial and housing sectors and the potential ripple effects they have on the overall economy.

There are some positives, including strong exports among domestic companies, and the Fed's commitment to formulating a strong policy response that addresses the underlying issues plaguing the financial system.

Stocks aren't pricing in a severe recession, but further declines could lead to attractive valuation levels.

While we believe it is important for us to discuss the more negative considerations, it is possible that we are close to a bottom.

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Quarterly Investment Commentary

Stocks were down sharply in the first quarter. A few strong days at the end of March were not enough to offset the pain of the roughest quarter we've seen in a number of years. Large-cap stocks were off by 9.5% for the first three months of the year, with growth modestly underperforming value. Mid- and small-caps were down by roughly equivalent levels of around 10%, and growth's underperformance of value was more significant as market-cap dropped. International stocks also had a rough quarter, losing 8.9% for the first three months. The Lehman Brothers Aggregate Bond Index was up 2.2% with government bonds up in the 3% range and corporate bonds flat to up 1%.

The U.S. Economy

Though the label is unimportant, it's probable that we are already in a recession or on the verge of entering one. It's clear that the severely troubled housing and credit markets are beginning to have an impact on the health of the overall economy. The worst phase of the credit market problems could last for several more months, and the housing problems could continue into 2009. High energy costs don't help but are not the primary concern. The problems facing the economy are clear:

- **Housing:** The housing market is in the worst downturn since the 1930s and the evidence strongly suggests there is



The Housing Market Index is based on a monthly survey of home builders and is composed of: traffic of prospective buyers, current single family home sales, and expected single family home sales in the next six months.

still a ways to go. With a large backlog of unsold homes and waves of foreclosed properties continuing to hit the market, it could take a year or longer to get inventory levels back to normal. The weakness in the housing market reduces wealth and spending, increases unemployment, and continues to contribute to problems in the credit markets.

- **Dysfunctional Credit Markets:** The bottom line is that credit markets are not functioning properly at present. There is an adverse feedback loop in play with losses from leveraged entities forcing them to sell assets (deleverage), which triggers more losses, and so on. The ability to borrow money at a reasonable cost to support consumer spending and conduct business is essential for a healthy economy. Perhaps even more important to a stable economy is the ability to refinance maturing debt.
- **Labor Market and Consumer Spending:** Not surprisingly, we are now beginning to see weakening in employment and consumer spending. A weak labor market could feed back to trigger more defaults as people have a harder time servicing their debts. This could delay recovery in the housing and credit markets and become a self-reinforcing cycle. Meanwhile, declining consumer spending will impact corporate profits.

It is also worth noting that while most of the rest of the world is doing better than the U.S., Japan's economy is also struggling and

Europe's is slowing. It seems likely that most of the developed world will continue to weaken. The emerging markets are in better shape; however, we don't expect them to be fully immune from economic weakness in the developed world.

There Are Some Positives

The biggest positive for the economy in the near term is the aggressive, and in some respects, unprecedented action of the Federal Reserve. Though the Fed's moves have not been as effective as they would like, they have made it clear that they will do what it takes to stop a major downturn and they still have weapons in their arsenal, such as directly buying mortgage securities in the public market.

The dollar's weakness has also significantly improved the competitiveness of U.S. businesses versus foreign competitors. Export strength is already evident with exports contributing a significant one percentage point to economic growth over the last six quarters (annual rate). This almost offsets the economic impact thus far of the housing downturn. This benefit could diminish if the global economy weakens significantly, however.

Finally, outside of the financial sector, companies are generally flush with cash, especially relative to debt-service needs. Balance-sheet strength is surprisingly healthy for this late in an economic cycle—the result of strong profit growth and below-average capital investment in recent years.

Longer-Term Economic Ramifications

There are two potential long-term ramifications. First, as the Fed and policy makers attempt to break the adverse feedback loop, the amount of stimulus being required increases the potential for higher inflation down the road—not 1970s style inflation, but more than we’ve been accustomed to. Inflation is unlikely to be a near-term problem because a deleveraging (debt reduction) and recessionary environment is deflationary not inflationary. But longer-term, the increased supply of dollars has to go somewhere and that raises the risk of inflation. It also undermines the dollar’s value relative to other currencies. That’s also inflationary as imported goods cost more. The second ramification is the likelihood of continued deleveraging on the part of households for several years, resulting in slower credit growth (less borrowing) in the next recovery. If consumers borrow less and spend less, economic growth and corporate earnings growth will be slower than they would otherwise be. All this raises the risk of some stagflation in the next economic cycle.

Closing Comments

As we write this, market volatility continues—but in the last few days it has been on the upside. However, we suspect this will continue to be a challenging investment environment, at least for a while. There is still uncertainty as to the extent of the losses yet to be written off by the financial sector and the resulting economic ripple effects. But stocks are reasonably valued now, and if they fall much further, it will represent an attractive buying opportunity for long-term investors.

We have often said that accurate economic forecasting is difficult and therefore we rely on valuation and diversification analysis as the basis for investment decisions. That approach has been helpful in this environment but we are not yet out of the woods. In terms of stock market prices, it is likely but not certain that we are now closer to the end than the beginning of the bear market, though more downside remains possible. We can’t know what the near-term is going to bring, but at times like this when economic uncertainty is high, our discipline and research process keep us grounded and give us confidence in our ability to make sound long-term decisions.