



Quarterly COMMENTARY

THIRD QUARTER 2008

FROM THE DESK OF J. WILLIAM WALTMAN, JR., CPA CFP®

The QUARTER in REVIEW

Credit Market Freeze. Three words that succinctly explain the problem central bankers all over the globe currently face. What does this mean and why should we all care? The U.S. economy over the



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past 20 years has increasingly become a credit-based consumer society. Unlike the 1950s when families saved to put 20% down on a home purchase, carried little if any credit card debt, and saved a portion of each paycheck, many Americans today literally live paycheck to paycheck. If credit limits on credit cards are reduced, home equity lines of credit are pulled by banks, and consumers cannot get access to credit to fund their purchases, the economy faces a significant slowdown.

Businesses across this country are also being affected. Even if they manage to get financing to run their daily operations, the cost of this financing is rising dramatically. Institutions with variable rate debt in the market are paying much higher rates on this debt as interest rates spike. Banks are reluctant to lend to one another for fear of not being repaid. Make no mistake about it. These problems will have negative implications for main street if they persist.

The stock market reflected the

troubles in the credit markets with another loss for the quarter. As you can see from the table below, all the major indices finished with losses.

And what a way to end the quarter! The markets do not like surprises. Our elected representatives gave us just that by bringing a \$700 billion financial rescue package to the floor without the votes to pass it. This would not have been that remarkable except that, the night before, representatives from both parties paraded in front of the media announcing they had agreed upon a bill and planned to vote on it Monday. The markets were thus expecting the bill to pass. When it did not, the Dow Jones Industrial Average plunged, finishing down 777 points. The Nasdaq composite, a barometer for technology stocks, plummeted 199 points or over 9%. The market losses

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Major U.S. Stock-Market Indexes (All total return, 3-year annualized)

	9/30 Value	Performance (%)	
		YTD	3-yr
Dow Jones	10,831.07	-18.3%	0.8%
S&P 500	1,161.06	-20.9%	-1.9%
Russell 2000	671.59	-12.3%	0.2%
Nasdaq Composite	2,069.40	-22.0%	-1.3%

SOURCE – Wall Street Journal, October 2, 2008

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on September 29th totaled approximately \$1.2 trillion, more than the proposed bill that was defeated. Thus the market sent a very clear message to Washington. Get something done.

Now that the bill has finally passed, the question is, "Will it work?" The truth is, no one knows. In our opinion it may be better than the alternative of doing nothing. Treasury Secretary Henry Paulson's plan is to purchase \$700 billion in securities from financial institutions in the hope that banks with less exposure to bad mortgages and mortgage securities will be able to raise additional capital, strengthen their financial position, and resume lending again. One of the keys to this plan working is the price the Treasury pays for these securities. If they offer too little, banks will be reluctant to sell the assets as they will be facing more write-downs on these assets which will further impair their capital positions. If the Treasury pays too much for these securities, while it will help to implicitly recapitalize the banking system, it will expose taxpayers to significant losses. The most plausible approach under the plan is to purchase assets above the "mark-to-market" price, which some could argue is the fire-sale price, but below the true economic value of the asset if held to maturity. The Treasury will most likely outsource the management of the purchase and disposition of these securities to professional money management firms that specialize in fixed income securities. The devil is truly in the details.

What if the Paulson plan does not work? The U.S. Government could directly inject billions into the banking system to recapitalize it. In addition, taxpayers could receive stock warrants in institutions receiving capital infusions. Thus they would benefit when these banks recover and their stocks appreciate in value. While there are many competing proposals on the table, it is clear something must be done to unfreeze the credit markets, and soon.

Our Take

Despite the passage of the Paulson plan, the economy is still facing many headwinds. We believe we are in a recession, and it is going to intensify. The damage inflicted by the credit market conditions is just beginning to surface in the real economy. Unemployment, currently at 6.1%, will likely rise to over 7% in the coming year. Corporate profits will slow as consumer spending declines. Wall Street analysts' expectations for 2009 remain too high. Some analysts are still expecting double digit earnings increases next year. We just don't see it. Real estate prices will likely decline further as foreclosures increase due to rising unemployment. Real estate will finally bottom out when prices become cheap enough to entice major buying interest. This is assuming, of course, consumers can get access to credit to finance their mortgages.

The economy may be entering a period of major structural change not seen in decades. The shift is away from a credit-induced consumption economy to a wage-based consumption

model. This will have an enormous impact, affecting all manner of retail sales ranging from automobiles, electronics, to travel and leisure. The Wall Street model of excessive leverage is also dead. In fact, the days of the monoline investment banks are gone. The last two standing Wall Street investment banks, Goldman Sachs and Morgan Stanley, recently applied for, and received, charters to become bank holding companies able to accept deposits.

Our approach during this year has been to remain defensive. While each client's investment objective is unique, we generally remain underweight in stocks. Although the stock market has declined significantly this year, it is not yet cheap based upon our earnings expectations for next year. Each day the market declines, however, the more opportunities arise. Investors with cash will be able to purchase great companies at very attractive prices over the coming year. Please know that we remain vigilant in navigating these challenging markets with the goal of helping you to achieve your financial goals. We appreciate your trust in our services.

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