



Quarterly COMMENTARY

FOURTH QUARTER 2008

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

The QUARTER in REVIEW

Bailout USA This past year will be remembered for many things. The worst price collapse in stocks, real estate and corporate bonds since the 1930s, a credit



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was infamously quoted as saying, "as long as the music is playing, we must dance." When the music stopped the party was over more quickly than most imagined. In our opinion the main source of all this excess leverage was the Federal Reserve, plain and simple. Mistakes such as lax lending prices, irresponsible consumer behavior, and poor oversight of investment banks only compounded the problem.

bubble that imploded wreaking havoc on consumers and businesses, and a systemic banking and financial crisis that claimed Bear Stearns, Lehman Brothers, Indy Mac, Washington Mutual and Wachovia. But perhaps the most memorable thing that may be written about this period is that it was a time when everyone, except for Lehman Brothers, was too big to fail, and it was the responsibility of the U.S. Government to prop up companies from the banks to insurance companies to the automakers.

How did all of this happen? While there were many contributing factors, the most important was the lax monetary policy of the Federal Reserve. They made money very cheap and banks were able to lend at attractive spreads. And what do you think some bankers did? Surprise of surprises, they began to lend the money as fast as they could to increase earnings and stay ahead of their competitors. In some sense it became a race to the bottom. Chuck Prince, the former chairman of Citigroup,

The Federal Reserve and Department of the Treasury are now embroiled in an epic battle with market forces to head-off a deep recession, if not a depression. The policy actions taken over the past 9 months are nothing short of staggering. A brief list will help to illustrate the point.

	MAXIMUM COMMITMENT	TAPPED THUS FAR
Federal Reserve	\$ 5.5 T	\$ 2.1T
FDIC	\$ 1.5T	\$ 149B
Treasury Dept	\$ 1.1T	\$ 597B
FHA	\$ 300B	\$ 300B
US Gov't Total	\$ 8.5T	\$ 3.2T

Source: Federal Reserve, Treasury Department, FDIC, Federal Housing Administration, Bloomberg

Now, President-Elect Barack Obama is proposing an economic stimulus plan that may exceed \$700 billion. This plan stems from his belief that a "Keynesian" policy response of government spending to stimulate economic growth in the absence of private sector spending will be successful in reigniting the economy. Will all of these policy responses work? Perhaps for a while but, in the long term, significant risks loom. Historically, many recessions are caused by a buildup of excess inventories. This is not that type of recession. This is the more serious type, a balance sheet recession. Too much easy money led to the

Major U.S. Market Indices (All total return, 5 year annualized)

	Performance (%)	
	1 Yr	5-Yr
Dow Jones	-31.9	-1.1
S&P 500	-37.0	-2.2
Russell 2000	-33.8	-9
Barclays Capital Agg. Bond	5.2	4.7

Source: Lipper



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The QUARTER *in* REVIEW

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creation of too much debt, and now that consumers' credit is constrained, many are being squeezed.

The days of purchasing goods with no money down are gone. Americans are curtailing spending in an effort to restore their personal balance sheets. Since the U.S. economy is now largely driven by consumption, this does not bode well for economic growth in 2009. The Government is trying to stimulate the economy by borrowing even more money from our foreign creditors, printing and debasing the U.S. dollar, reducing interest rates to 0%, and expanding the Treasury's balance sheet to purchase all manner of securities from banks. This, all in an effort to get the wheels of credit moving again. A lack of low interest rates, however, is not the cause of our economic problems. You don't fix a broke man's problems by offering him more easy credit.

The reality is that U.S. consumers have too much debt relative to their incomes. And it is not only consumers. States are also facing a fiscal crisis not experienced in decades with California and others appealing to the U.S. Government for help to bridge growing budget shortfalls. The sad irony is that the Federal Government is currently experiencing a massive deficit which will exceed \$1 trillion in 2009. So the U.S. goes hat in hand to foreign creditors which, for the moment, are more than happy to loan us more money at very low rates. At the end of the day we are financed in large measure by the rest of the saving world. We cannot borrow and spend our way back to prosperity.

If true economic growth could simply be created from borrowing and spending we would never experience recessions. The painful truth is that businesses need to fail, consumers need to spend less, not more, and the economy must worsen in the short-term as we work our way through this transition. The Government is directly trying to prevent this from happening. The Federal Reserve Chairman, Mr. Ben Bernanke, wants to stoke inflation to stem his greatest fear, deflation. At the end of the day, he will be successful. He has the power to print U.S. dollars and expand the Federal Reserve's balance sheet to be the purchaser of last resort for all types of assets. But we all know there is no free lunch. This too will have a cost. That cost may be a further long-term devaluation of the U.S. dollar, rising inflation and interest rates, and higher taxes.

Outlook in 2009

Are stocks now cheap?

In short, no. The trailing price-to-earnings ("p/e") ratio for the Standard and Poor's 500 is over 19 using a closing price of 925. Worse yet, the forward p/e multiple is approximately 22 based upon current analysts' estimates. Thus on neither a trailing nor a forward earnings basis does the market appear undervalued. Nasty bear markets, such as the one we are currently experiencing, have been known to bottom in the 8-10 times earnings range. We believe that many are underestimating the duration and severity of this recession and the toll it will take on corporate profits.

The worldwide economy is in recession and it appears to be intensifying. Central banks all over the globe are in a rush to devalue their currencies and lower interest rates in an effort to spur economic growth. This broad-based devaluation of fiat currencies may lead to an inflation problem within the next 2 years. We remain very defensively positioned entering 2009 given that equity prices are not historically cheap and the fundamentals of the

economy are weakening. In such an environment, we favor hard assets. No matter how much money is printed, the world must still consume certain things to survive, function, or preserve wealth. Certain sectors of the bond market also offer compelling value.

Strong rallies in bear markets are to be expected. The key is not to fall in love with them. It would not surprise us to see a rally at the start of the year as enthusiasm for the economic stimulus plan grows. If this does occur, we expect this rally to fail later this year as the market comes to the realization that corporate profits will continue to be under duress for all of 2009.

Opportunities will abound for those investors with the patience to stick to their investment discipline. We remain very confident in our ability to preserve and grow our clients' wealth in these most trying of times. We sincerely appreciate your business and remain ever-vigilant in our mission of helping you achieve your financial goals.

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