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Given the extremely precipitous decline in stock markets all around the world during the last two weeks, I thought you would appreciate some insights and comments from me.

What just happened?

The S&P 500 dropped over 16% from its October highs to its low on Tuesday the 22nd – most of that damage having already occurred just since mid month. Declines of this magnitude usually snowball, culminating in a big burst of selling.

Is the Federal Reserve helping the cause?

I discussed in previous newsletters the apparent lack of resolve on the part of Fed to act decisively or even acknowledge that a problem was brewing. The .75% rate cut this past week represents a highly unusual action – and a highly dramatic change of heart. Unfortunately, they cannot stop what is already in the pipeline, which many observers believe is a recession. This coming week the Fed has its formal meeting and I believe that there will be ANOTHER half percent cut, which the market will view favorably.

Is there going to be a recession?

Recessions are notoriously difficult to predict. HOWEVER, the market seems to be pricing in a recession, meaning that this drop in stocks is already representing that assumption. Historically stocks hit bottom and begin to rise before a recession is even confirmed.

Does the horrible January mean we're in for a bad year?

Much is written along the theme "as January goes, so goes the year". Looking at the 5 worst Januaries over the last 80 years, the average 12 month and 24 month returns after that month are 12.3% and 26% respectively. While this does not provide any assurance for the next 12 months, it proves that no one should assume a pessimistic outcome for the next year or two.

What might happen in 2008?

This bear market decline will need to take its course. These larger market declines generally continue on until there is an overshoot, things look horrible and there is very little stock that anyone is willing to sell. So I do feel that the path of least resistance right now is to continue to drop for a while, likely continuing for a matter of months. A drop of 25%, plus or minus, would be consistent with historical averages.

Should we sell and buy back later when prices are lower?

That would clearly be the best plan if I only knew reliably how to do it. The job I have been hired to do is to choose good investments, not to know when the markets will turn. The next leg up in stocks could easily begin just as dramatically as this leg down.

Can you put some perspective on this?

The year after a severe down market, as a rule, is a strong up year. For example, in 2002 the S&P 500 was down 23% and in 2003 it was up 26%. Since I manage actively, my goal is to find the strongest sectors, regions and investments for the next leg up. Outperformance, if I am capable of achieving it, will bring us to a new high water mark – just a question of exactly when. For example, right now I am patiently awaiting signs that the banking and financial sectors are poised to turn back up. They have been hit so hard in the last few months that they are prime candidates.

Is there any good news?

Stock market declines often happen very suddenly. They are (in most people's view) impossible to dodge. If there is any good news today it would begin with the fact that more than half of the decline might be over, based on historical averages. Another good news fact is that markets generally bottom out before recessions are confirmed.

If you have been a client for at least a year, you enjoyed good gains last year. Looking backwards does not turn this decline into good news, of course, but it does help validate our strategy, which is to attempt to out-earn these declines before they happen and then after they end.

What Should You Do?

Selling into fear is usually untimely. Nevertheless, if this decline and its further downside potential are causing you to lose sleep and you want to explore your personal situation or discuss a more conservative model, please call or email me. Often downside moves are telling about our temperament and signal a need to reflect on that.

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