Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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Bear Markets and Recessions

> "Betsey thought she was wiser, now, than her man of business..., and she took it into her head to lay it out [invest] for herself. So she took her pigs to a foreign market; and a very bad market it turned out to be. First, she lost in the mining way, and … then to set the thing entirely to rights, she lost in the banking way. I don't know what the Bank shares were worth for a little while…; but the Bank was at the other end of the world, and tumbled into space, for what I know; anyhow, it fell to pieces, and never will and never can pay sixpence; and Betsey's sixpences were all there, and there's an end of them."
>
> *David Copperfield*, Charles Dickens, 1850

The four and a half year long bull market, which commenced in March, 2003, ended in October, 2007. On October 11, the S&P 500 Index hit an all-time high of 1576, having doubled from its bottom in the second half of 2002 and early 2003. From its peak in October, 2007, the S&P 500 Index declined a painful 20.2%, reaching an intra-day low of 1257 on March 17, 2008. The NASDAQ Composite had an even steeper descent, falling 24.7% during this period. In common parlance, the U.S. stock market was in a bear market during this five-month period, but in the past four weeks, the market has rebounded approximately 8%. It remains to be seen whether the bear market is over or whether the market's recent action is merely a bear market rally, and there is more pain to come later this year.

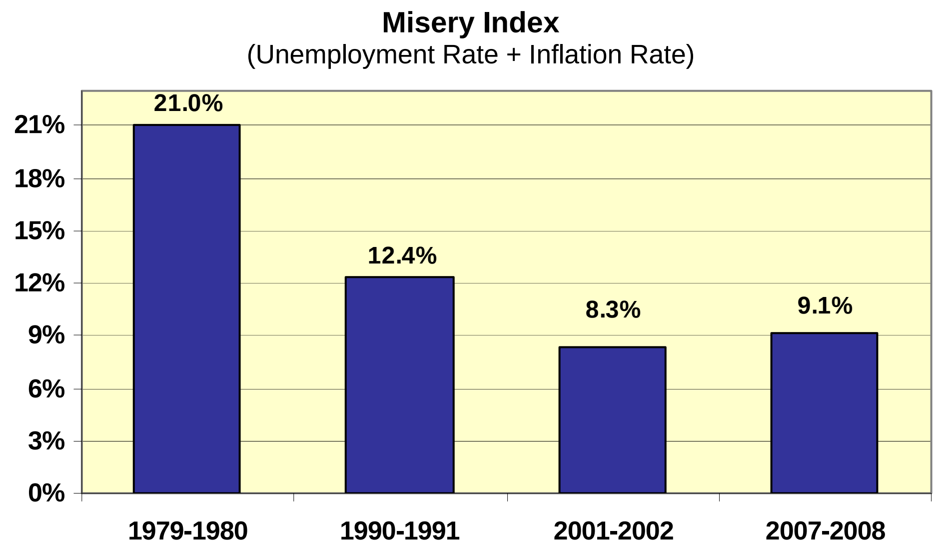
Bear Markets Precede Economic Recessions

It is important to note that generally bear markets begin before the economy goes into recession. In some prescient fashion, the stock market senses an economic slowdown months before the economy actually begins to contract. In the present case, the stock market began its slide in October, while the U.S. economy probably entered a recession in December, 2007 or January, 2008. Even now, it is not clear that real GDP in the U.S. has had a negative quarter, but as we discuss below, many of the key numbers are beginning to show the signs of a recession. The good news is that just as a bear market usually precedes a recession, the stock market also begins to anticipate the end of a recession well before it is over. Importantly, the most powerful rallies often occur during the last months of a recession, and this could happen in the second half of 2008. Thus, it is vital for investors not to confuse the behavior of the stock market with the path of the economy during difficult economic periods. This is another reason to avoid market timing because so much of the stock market's positive returns occur in a short period.

The Likelihood of a 2008 Recession

It is too soon to make a pronouncement about whether the U.S. economy is already in a recession, but there are many signs that a significant economic slowdown has arrived. GDP growth in the U.S. decelerated during the 4th quarter 2007, showing growth of just .6%. A robust economy in the U.S. creates in excess of 2 million jobs annually. During the first quarter of 2007, the U.S. economy created 328,000 new jobs – an indication of moderate but reasonable growth. In the first quarter of 2008, the economy lost 232,000 jobs – the worst performance in five years. Moreover, the unemployment rate jumped from 4.8% to 5.1%, while initial weekly unemployment claims have recently risen above 400,000. Over the past several decades, sustained readings of 400,000+ in new weekly unemployment claims have signified economic stress or a recession. It is important, however, to quantify the length and breadth of U.S. recessions over the past 30 years. The two most recent U.S. recessions lasted eight months each (August, 1990 – March, 1991 and December, 2000 – July, 2001). In 2001, real GDP dropped a mere .3% over the eight-month period, while the GDP decline in 1990-1991 was 1.3%. The two recessions which occurred in 1979-1980 and early 1981-1982 each lasted 16 months, and GDP contracted 2.2% and 2.9% respectively in the midst of stagflation – a combination of very high inflation, severe unemployment and low economic growth.

Several decades ago, U.S. economists created the Misery Index to measure the health of our economy. To calculate the Misery Index, one adds the national rate of unemployment and the inflation rate. To put things in perspective about where we are at the moment, the chart below shows the Misery Index at the peak of the most difficult times economically in the U.S. over the past thirty years:



In this presidential election year with politicians evoking the Great Depression, it is important to remember that the severe economic distress that Americans suffered in the 1930's were man-made. They were not caused by the stock market crash of 1929. Three disastrous monetary and fiscal mistakes were made between 1929 and 1933:

- The Federal Reserve Bank contracted the money supply in the U.S. by one-third, which greatly reduced economic activity and caused severe deflation.
- President Hoover dramatically raised income taxes from 25% to 63% on the highest income bracket and also raised corporate and estate taxes.
- Congress passed a highly destructive protective tariff called the Smoot-Hawley Tariff Act of 1930, which raised tariffs on 20,000 items and helped choke world trade.

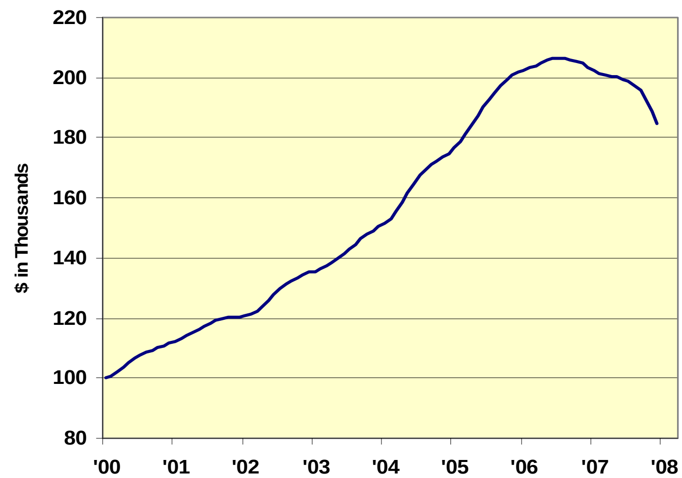
By the end of 1932, the unemployment rate in the U.S. reached 24.9%, while real GDP declined over 26%. Hopefully the Federal Reserve Bank, as well as politicians on both sides of the aisle, understand the harm that wrongheaded policies can cause to the economic well-being of the American people and will avoid these mistaken actions.

Economic Challenges in 2008

According to Martin Feldstein, professor of Economics at Harvard University and CEO of the non-partisan National Bureau of Economic Research, the single greatest threat facing the U.S. economy is the continuing decline of U.S. housing prices. This will lead to increasingly widespread negative equity in homeownership. Higher levels of unemployment and declining home prices in various regions of the U.S. will probably cause higher numbers of foreclosures and continued instability in the banking and financial sectors. This, in turn, will cause banks to be more cautious in lending which will reduce economic activity. At Bradley, Foster & Sargent, Inc., we agree with Feldstein's assessment. The chart below shows the housing bubble that took place between 2000 and 2006. Among those who shoulder some responsibility for this housing bubble are the Fed, which kept short term interest rates below 2% from 2001 to 2004; government entities, which pressured financial institutions to underwrite sub-prime mortgage loans; commercial and investment banks, which dropped their underwriting standards; and rating agencies, which gave creditworthy ratings to bonds and mortgage instruments of dubious quality.

Housing Bubble

The S&P/Case-Shiller 20-City Housing Price Composite Index



Source: Standard & Poor's

Another major process underway is the deleveraging of the U.S. consumer who has borrowed too much, whether it be on a first mortgage, a home equity loan, an auto loan or a credit card. This is painful and will cause higher levels of nonperforming assets and loan losses at most U.S. banks this year and probably in 2009. The deleveraging of the consumer combined with high energy prices may well result in a longer period of economic weakness than the short and shallow recession of 2001. Finally, contrary to the economic chatter last year about foreign economies and stock markets decoupling from the U.S., the current economic slowdown in the U.S. will almost certainly cause a slowdown in Europe and Japan. However, the BRIC countries (Brazil, Russia, India and China) will probably be able to continue their pace of growth, albeit at the 4-7% growth level rather than the previous 7-10%.

Mitigating Circumstances

Bear markets and recessions, however unwelcome, are part of the natural course of events in a system of democratic capitalism. Investors need to understand how to best use them to their advantage. While the headlines scream gloom and doom each day as a recession appears to be taking hold, there are in fact various remedies underway which will heal the patient. The Federal Reserve has already cut the Federal Funds rate 300 basis points to 2.25%, and it is likely that still lower rates are coming. This has reintroduced a positive yield curve in the U.S. bond market and will help banks earn their way through this period of credit losses and markdowns. It will also help the consumer pay off more debt. While $300 or $400 billion in capital will be written off by the banks, there is much new capital which has been invested and will be invested later this year to assist the survival of the best franchises. The Fed has also provided up to $400 billion in liquidity through lines of credit to both commercial and investment banks to help stabilize the credit markets. Through a policy of benign neglect, the Fed has allowed the dollar to weaken which has helped boost U.S. exports 25% over the past two years, assisting both in job creation and in the balance of trade. The President and Congress have done their part by providing a package of $160 billion in fiscal stimulus which should help the consumer in a modest way beginning as early as next month. Large U.S. non-financial companies are in good shape with reasonable levels of debt and significant foreign revenues and earnings which will help corporate earnings. Finally, deflation in the housing sector should help keep inflation under control – despite energy and food prices. Better economic times will arrive in due course.

Bear Markets Since 1980

The following table shows the decline in the S&P 500 Index and the duration of the five U.S. bear markets since 1980. The 2000-2002 bear market was the worst since the Depression because of the extreme overvaluation of the market leading up to it. The bear market in 1980-1982 led to the 17-year bull market as the inflationary spiral was broken, taxes were cut and the economy was deregulated. The bear markets in 1987 and 1990 were short yet painful corrections in the long-running bull market which commenced in August, 1982. The current bear market began in mid-October, 2007, and by March, 2008, the S&P 500 Index had fallen 20%, although it has recovered some since then. It is not yet clear if this bear market is over or just in hibernation.

Start of Bear Market	Recession	Decline in S&P 500 Index	Bear Market Duration
Mar. 2000	Dec. 2000 – July 2001	49%	31 months
Sept. 1987	None	33%	3 months
Dec. 1980	Sept. 1981 – Sept. 1982	27%	20 months
June 1990	Aug. 1990 – Mar. 1991	20%	4 months
Oct. 2007	*To be determined*	20%	*To be determined*

Investors who braved the bear markets since 1980 saw the stock market (S&P 500 Index) rise more than 14-fold from 110 in August, 1982 to 1576 in October, 2007 (not including dividends). The most important lessons for investors in the current difficult environment are: *When investors are depressed and gloomy, this is the time when bargains are available. Do not get scared out of the market! Preserve capital by selling the stocks of companies whose performance disappoints. Avoid cyclical sectors of the market but stay invested in the overall market. Use this bear market to purchase high quality stocks at the great prices which are only available during times such as these.* This is how Bradley, Foster & Sargent plans to make the best of these difficult days.