2009 STOCK MARKET OUTLOOK, PART I

Executive Summary

Weak economic news seems endless these days, but it's important to cling to two crucial facts. First, every bear market is followed by a bull market, which ends up being bigger than many people expect. Second, stocks routinely rebound in advance of an economic recovery while the economy is, in fact, still contracting with no apparent end in sight. Having just experienced a very severe bear market, which has made stocks unusually cheap, we are optimistic the stock market will rebound strongly this year, maybe immediately, or not, but rebound nonetheless.

That doesn't mean 2009 won't be tumultuous. We expect recession will continue through at least mid-year. But as a discounter of future conditions, the stock market should begin rising even as high volatility continues and the thrum of bad news drones on. Historically, bear markets end long before economic data improves—new bull markets climb a "wall of worry."

The fourth quarter stock market as a whole was dismal, with the MSCI World Index declining 21.8%.[i] Yet from November 20th, global stocks rallied 19.5%.[ii] Market weakness in January is retesting the November low, and while we cannot say with certainty whether that low will hold or be broken, we do know bears typically bottom and recover in a "V" shape—a steep, final drop followed by a similarly steep upward burst. Late-stage bear markets' vicissitudes are typically quite small compared to the initial uplift of the subsequent bull markets. In such environments, the sectors and regions performing worst on the way down tend to outperform during the initial surge. (Appendix I)

While it may seem like we're headed for a new "Lost Decade" like Japan in the 1990s, or worse still, a new Great Depression, we do not think so. Stories like that are always ever-present in such times. Underpinning our optimism is simply the biggest combined global monetary and fiscal stimulus in history. And to the extent the economy worsens immediately ahead, the bigger still the stimulus will get. The US budget deficit ballooned in 2008 and will further in 2009. By our analysis the government could take on much more debt to stem financial sector woes and stimulate the economy and markets.

Unlike past recessions, this fall's financial panic goaded businesses to brace for the worst by keeping inventories exceptionally lean and rapidly reducing staff. Although these responses sharpen the initial severity and speed of the economic downturn, they should also shorten its duration. Unless some major new exogenous problem emerges, an "L"-shaped stagnation or worse, while much feared, is in our view highly unlikely. (Appendix II)

Late last year inflation worries morphed into deflation fears following the financial panic and subsequent economic seizure. However, we cannot find a meaningful, lasting instance of deflation anywhere following a period like today's massive monetary expansion. In our view, inflation is the far more likely dominant force—but not emerging as a risk for several years. (Appendix III)

A key lesson learned in 2008 was the heightened potential for unintended, second-order effects of regulatory and accounting shifts. The implementation of the mark-to-market accounting rule (FAS 157) appears in hindsight a decisive catalyst for much of the recent financial sector carnage. (Appendix IV)

The Bernard Madoff scandal that came to light in December 2008 was heinous but not particularly unique. Scandal and skullduggery commonly reveal themselves near the end of bear markets. A critical aspect in the Madoff scandal was his opaque custody and brokerage arrangement that allowed him to conceal client losses for years. In contrast, Fisher Investments explicitly designed its Private Client business model to provide clients with direct access to their independent, third-party accounts with a high degree of transparency to avoid potential for such crimes. (Appendix V)

Trouble at the Big Three auto firms is being portrayed as a potential economic catastrophe. While an uncontrolled collapse in the US auto industry would assuredly be negative, in our view the ramifications of a prepackaged Chapter 11 bankruptcy would not be dire for the economy and would actually help ailing auto companies get on the road to lasting recovery. (Appendix VI)

With the inauguration passed, so far President Obama's actions have signaled a benign agenda. Politically and through his appointments, he is moving toward the center, typical of new presidents desirous of reelection. Economically, for now, he and Congress appear disinclined to raise taxes but very willing to spend enormous sums of money, which can be and usually is appropriate at this stage of the economic cycle. (Appendix VII)

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Appendix I: Looking Ahead: The Stock Market Should Rise Before the Economy Bottoms

Though we expect the recession to last well into the new year, we anticipate a new bull market will begin in earnest well before the economic trough. Indeed, it's possible the stock market's cycle low was recorded on November 20, 2008. Timing the bottom precisely isn't crucial to long-term portfolio success. What matters more, as we have long advised, is positioning portfolios to capture the initial upsurge of a new bull market, even if that means absorbing the heavy volatility around a bear market bottom.

History Shows Markets Bottom First

On balance, the fourth quarter stock market of 2008 was simply dismal. The MSCI World Index declined 21.8%.[iii] From the bull market peak on October 31, 2007, global stocks lost more than half their value to the low on November 20, 2008. But since that date, the World rallied 19.5% through year-end.[iv] In fact, the World had its biggest 30-day percentage gain ever from 11/20/2008 to 12/19/2008.[v] The only times in its 39-year history the World rose more than 14% that fast were at or very near bottoms of bear markets (02/1975, 09/1982, 02/1991, 11/2002) or corrections (11/98).[vi] Market weakness in January is retesting the November low, and while we cannot say with certainty whether that low will hold or be broken, we do know bears typically bottom and recover in a "V" shape—a steep, final drop followed by a similarly steep upward burst (more on this later).

The Financial sector panic's knock-on effects will require at least the first half of the year to work through the system, in our view. The panic caused businesses and individuals to hunker down unusually quickly and severely, anticipating the worst. This intensified the economic crunch, but it should also accelerate the culmination. Regardless of specific timing, when the real economy eventually begins to recover, don't expect official economic reports to indicate the inflection point for many months after—they are backward-looking and untimely. Market prices, by contrast, reflect future expectations. We expect stocks will do as they have always done historically and rally well before the economic recovery registers in government data or is broadly felt by the public.

As long as the broad economy is shrinking, and probably for some time after, media attention will focus almost exclusively on negative news. Emergent positive news will be largely ignored. Even today, good news is downplayed or unreported altogether. For example, historically low mortgage rates have led to historically elevated levels of home refinancing, which is helping to lower debt burden for consumers. But it has gone mostly unreported.

Why Is History a Useful Guide for the Future?

Many of the conditions and circumstances surrounding this bear market were unprecedented. But strictly speaking, every market cycle is unprecedented and unique. No two bear markets begin or endure the same exact way, but because many general patterns and characteristics tend to repeat, using history as a guide is very useful.

Forecasting markets is grounded in probabilities, not certainties. History is the only rational way we know to begin assessing reasonable probabilities for what might happen in the future. Knowing the past builds context for the present and possible future. But an assessment of history is only a jumping-off point. From there, we layer on conclusions drawn from economic and finance theory and then shade probabilities based on our analysis of new and unique factors. Without history, we would be starting with a blank page, which seems irrational in formulating probabilities.

There are fundamental things we don't believe change: the laws of supply and demand, other fundamental economic tenets, and basic human behavior, among others. So while we don't rely solely on history for predicting what is ahead, it provides a baseline for formulating reasonable expectations.

Envision a "V"

Throughout stock market history, bull markets have gained more than bears have lost—were it otherwise, markets would never move higher. But in the wake of 2008's drop, the MSCI World had lost virtually all its prior bull market gains, and the S&P 500 actually fell below its 2002 cycle low. Such an occurrence is rare, yet it doesn't necessarily portend poor returns ahead. Exhibit 1 shows returns in the rare cases an S&P 500 bear market completely erased the prior bull market's gain. Each case resulted in fast and outsized market returns on the way back up.

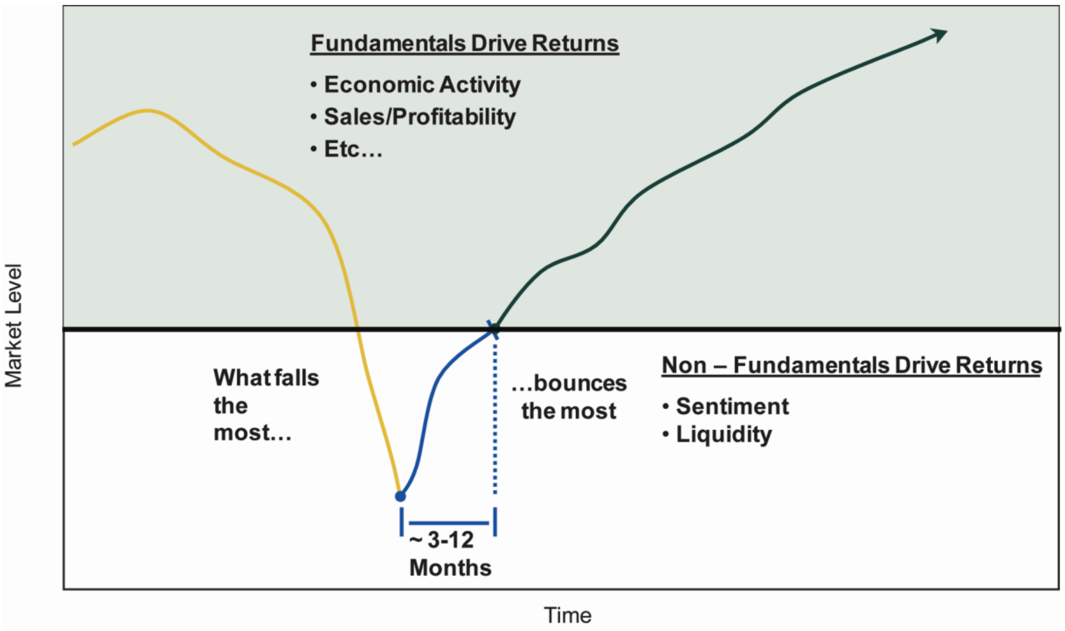
Exhibit 1: S&P 500 Returns Following Bear Markets That Bottomed Below the Prior Bear Market Bottom

Bear Market Bottom	1-Year Forward	3-Year Forward
6/1/1932	120.9%	115.7%
5/26/1970	43.7%	55.8%
10/3/1974	38.0%	55.3%

Source: Global Financial Data, Fisher Investments

Archetypal bear market bottoms form a "V" shape. Non-fundamental forces, like sentiment and liquidity, typically result in a last-gasp plunge (left side of the "V") and a similarly sharp recovery (right side of the "V") in the early stages of the new bull market and more docile gains thereafter.

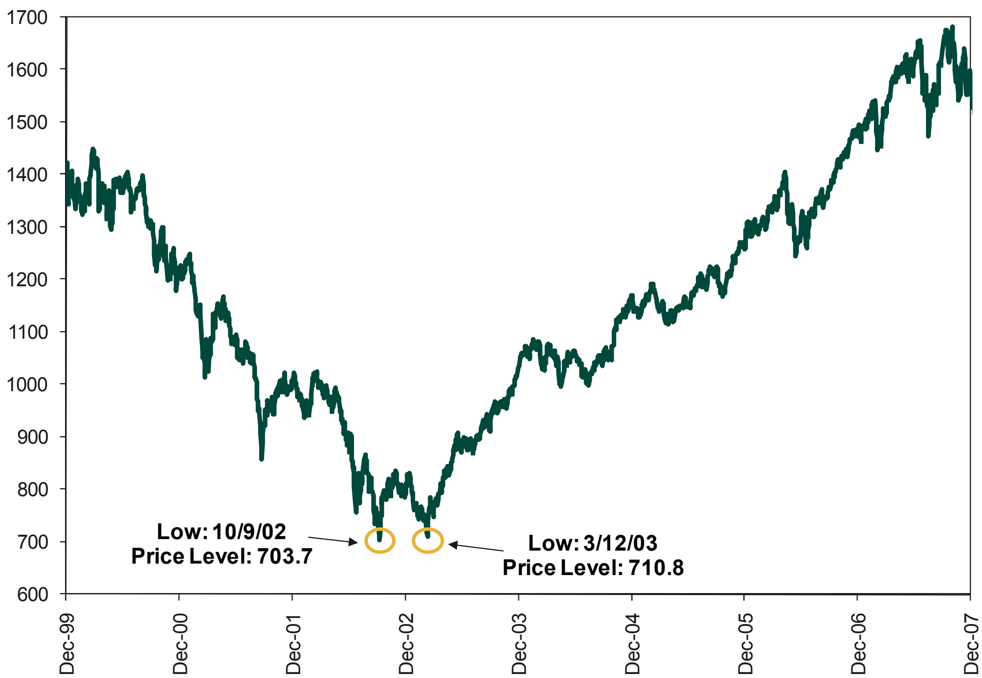
Exhibit 2: Generic "V" Shape of a Typical Bear Market



For illustrative purposes only. Not drawn to scale. Not to be interpreted as a forecast.

When we speak of a "V"-shaped bottom, we are not meaning to be overly literal. Bear markets sometimes end with a single culmination point. Other bears end with double or triple bottoms, when over the course of weeks or even months the first low point is retested after a brief rally or two. Sometimes the subsequent lows are a little higher or a little lower than the first, but in more distant hindsight the period is viewed as one basic "V"-bottom. For instance, the first bear of this decade had two bottoms—in October 2002 and March 2003 at roughly the same levels. At the time it might have felt like a "W," but in greater hindsight the "V" pattern is evident. If the November 20, 2008 low is retested over the next few months by having the market fall back to similar levels (maybe a bit higher or a bit lower), the concept of a "V" bottom would still be intact.

Exhibit 3: MSCI World, 2000 to 2007



Source: Thomson Datastream

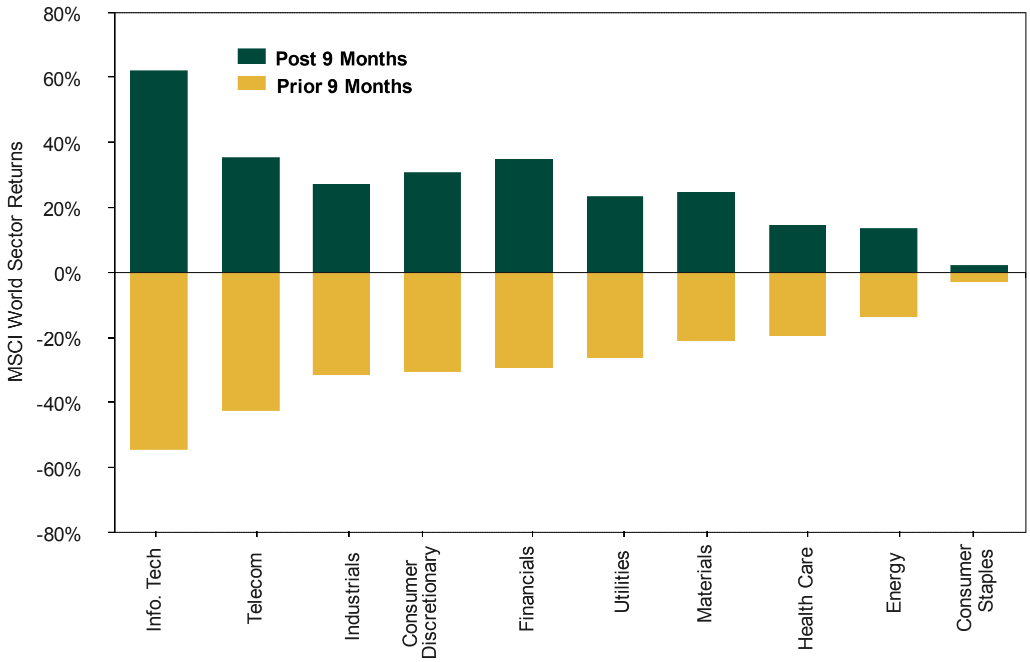
But another possibility exists—the dreaded "L." An "L"-shaped bottom is one that has all the losses of the "V" followed by a period of flattish returns. These are rare in history because stocks discount the future, and an "L" shaped bottom generally requires a significant, widely unforeseen event to blunt the positive force of the new bull market. The best example we can identify happened in the late 1930s. After bottoming in March, 1938, stocks had begun to recover from the depths of the Great Depression and poised to complete the right half of a "V." In fact, the S&P 500 gained 62.2% in less than eight months[vii] when it was sideswiped by the onset of WWII. The resulting nasty bear market was not about prior battles (the Great Depression) but rather a new threat to the world economy—the specter of Fascism.

So it is possible the initial recovery from this most recent bear market could veer from the normal tendency of a "V"-shaped recovery, but we believe that would require some big, new negative factor(s) to emerge. Problems heretofore identified during the 2007-2008 bear market should no longer have market-moving power to blunt a recovery—it would take something new and different. At this point we do not detect such a lurking threat, hence our continued expectation for the "V"-shaped rally to play out. So in the absence of identifying new significantly negative factors that would cause us to turn bearish, we still favor equities to capture the anticipated upside potential of a "V."

What Falls Most Usually Bounces Most

Historically, when markets start up the right side of the "V," the categories that fared better in the bear market's first half but lagged badly in its later stages tend to bounce the most in the initial bull market bounce and then for a significant time after. Exhibit 4 shows the bounce phenomenon in the 2000-2003 bear market. That is just one example—the same concept holds true for past bear markets we've studied.

Exhibit 4: 2000-2003 Bear Market Sector Bounce (MSCI World)

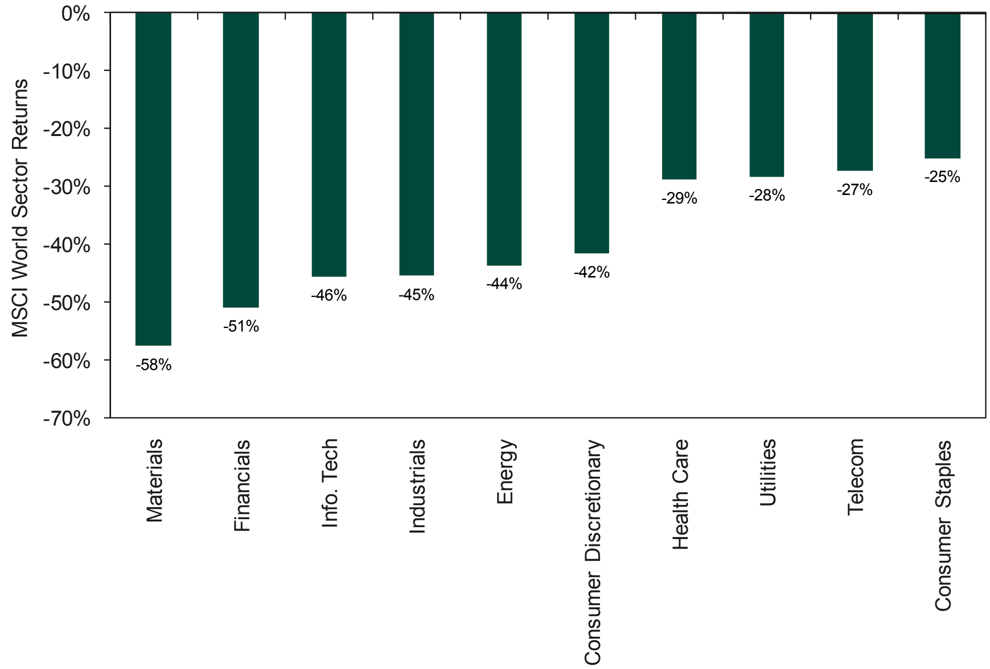


Source: Global Financial Data; as of 10/9/2002

One important exception to this historic pattern is the sector that led the bear down all the way from the top. While it usually experiences an initial pop, it tends to lag thereafter—usually for years—as investors keep fighting the last war. Energy stocks lagged for almost a decade after the 1980 Energy crash. Tech never regained a lasting outperformance since the initial 2003 bounce after the Tech-led bear of 2000-2003. By extension, in this cycle, Financials may get an initial bounce when broad markets recover, but we expect them to lag benchmark for very long thereafter.

The non-fundamentally driven right side of the "V" has historically taken around 6-12 months to play out, so because we believe we are just past or very close to the market bottom, it makes sense from a tactical standpoint to overweight categories that have fallen the most in recent months.

Exhibit 5: MSCI World Sector Returns 3 Months Prior to 11/20/2008



Source: Thomson Datastream; as of 11/20/2008

Materials, Technology, Industrials, Energy, and Consumer Discretionary were among the worst performers in the three months leading into November 20, 2008, as shown in Exhibit 5.

Setting the Stage for a New Bull Market

Though we can't say for certain if a new bull market has already started, there are numerous fundamentally bullish factors that we believe should pay stock market and economic dividends before long.

- **Massive Monetary and Fiscal Stimulus.** Governments around the world have coordinated to create the most massive wall of monetary and fiscal stimulus in history (see Appendix II). Even if the newly created money doesn't immediately jumpstart the economy (it always takes longer than people expect—and should, because spending takes a long time to implement), the money will flow somewhere before having its full eventual impact, and the most likely asset class, in our view, is stocks.

- **Valuations.** Stocks are dramatically cheaper than bonds. The spread between the MSCI World's earnings yield and the global government bond yield has widened massively to 6.9%. This is the biggest divergence we can measure in history. This favorable comparison doesn't mean stocks can't drop from here and become even cheaper—they can—the exercise is not meant as a forecasting tool. But it does demonstrate that valuation is not a constraint to a very significant stock market rebound.

- **Dividend Yields.** For the first time since 1958, the S&P 500 Index's dividend yield exceeds the 10-year US Treasury Note yield. Again, this is not a timing tool, but it gives another favorable sense of relative value.

- **Constrained Equity Supply.** Initial public offering (IPO) activity has been virtually non-existent in the last year. Some view a paucity of IPOs as a sign of market weakness. In actuality, fewer IPOs mean less supply of equity securities. Recall Ken's quarter century-old joke: "IPO means 'It's Probably Overpriced.'" Because stock prices are a function of the supply and demand of securities, flat or lower supply should ultimately translate into higher prices when demand eventually rises. The one corner of the market that has run counter to this trend is Financials—desperation share sales this Fall to raise capital had a dilutive effect, which is another key reason we remain underweight this category.

- **Improving Credit Markets**. After the September Lehman Brothers bankruptcy, credit markets experienced a virtual cardiac arrest. But since mid-November, there has been significant evidence of revival. Credit spreads have contracted; corporate bond and commercial paper issuance has increased; interbank lending rates have fallen; and mortgage refinancing activity has exploded.

Again, none of these in and of themselves augur the timing of a recovery for stocks. They do, however, point to the potential for a very strong recovery in the period ahead. Only time will tell for certain if a new bull market has started already.

Appendix II: Too Much Stimulus for a Depression

The contrasts between today and the 1930s are far greater than the similarities. In more instances than not, today is the reverse image of that period fundamentally. The only significant commonality is falling stock prices. In the Great Depression, central banks disastrously reduced money supply, governments raised taxes to balance budgets, and countries fought trade wars. Today's policy actions are overwhelmingly in the right direction, and the size and speed of the global monetary and fiscal stimulus unleashed are unprecedented. Exhibit 6 shows an array of falling interest rates from the world's largest economies. Exhibit 7 on the following page demonstrates the worldwide government response has been unprecedented and in near unison. Note these are just announced fiscal programs. Many of these countries are likely to increase the size and scope soon.

Exhibit 6: Benchmark Overnight Central Bank Interest Rates

Country	6/30/2008	12/31/2008	Difference
US	2.00%	0% to 0.25%	-1.75% to -2.00%
UK	5.00%	2.00%	-3.00%
ECB	4.00%	2.50%	-1.50%
Japan	0.50%	0.10%	-0.40%
India	8.50%	6.50%	-2.00%
China	7.47%	5.31%	-2.16%
Australia	7.25%	4.25%	-3.00%
Canada	3.00%	1.50%	-1.50%

Source: Bloomberg; as of 12/31/2008

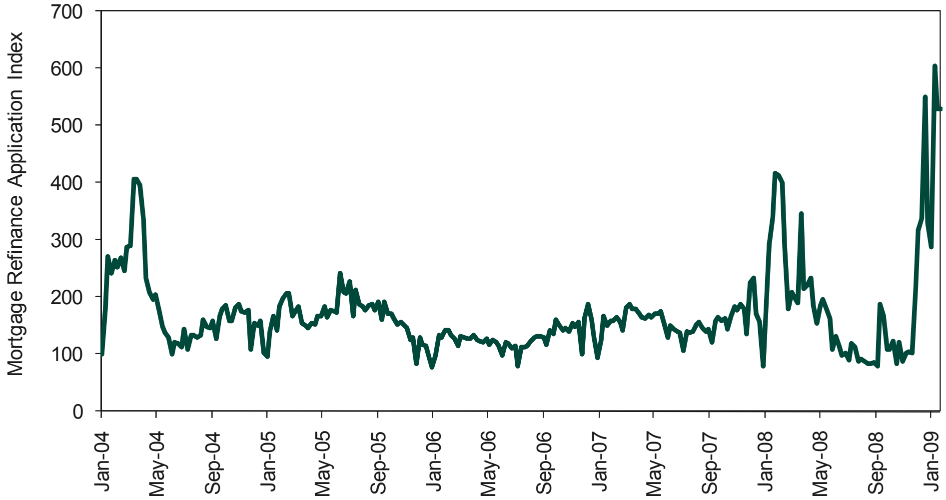
Exhibit 7: Fiscal Programs

Country	Billions (USD)	% of GDP
US	$825	5.8%
US+TARP	$1,525	10.6%
US+TARP+Existing Deficit	$2,341	16.3%
China	$586	14.0%
European Union	$254	1.5%
Italy	$102	5.7%
Japan	$70	1.6%
India	$60	5.0%
Germany	$41	1.1%
France	$33	1.4%
UK	$30	1.0%
Russia	$20	1.5%
Spain	$14	1.1%
South Korea	$9	1.0%
Netherlands	$8	1.0%
Australia	$7	1.0%
Hungary	$7	3.9%
Chile	$2	2.2%
Malaysia	$2	0.9%

Source: Barclays Capital, Fisher Investments

All this won't abruptly end the recession. Monetary stimulus affects the real economy with long lag times, usually 6-24 months. Before banks lend and consumers and companies borrow to spend and invest, the newly created money must flow somewhere. Some might go into debt refinancing and reduction, and already we see the impact in resurging levels of mortgage refinancing applications, as shown in Exhibit 8 on the following page. But some will almost assuredly flow into asset prices, and stocks seem much more logical than real estate or bonds today. Treasury bonds, if anything, seem overvalued, real estate still suffers from oversupply, and cash yields are very low today.

Exhibit 8: Mortgage Refinancing Applications Are Resurging



Source: Mortgage Bankers Association; as of 1/23/2009

Don't Fear National Debt

As of this writing, the House of Representatives has passed an $825 billion fiscal stimulus package featuring both major spending programs and temporary tax cuts and the Senate is still contemplating it. This is on top of TARP and previously existing budget deficits. It's too soon to comment on the plan's specific composition since it will probably change greatly between now and the final bill. We will provide more analysis as it takes more definitive form. In any case, we aren't put off by the magnitude of the proposed price tag—in fact a much bigger plan could be financed. The proposal includes both tax cuts and increased spending. The tax cuts tend to impact faster than spending plans because it takes time to put spending, particularly proposed infrastructure spending, in place. Tax cuts can put money in people's hands faster. So the proposals have one part that works faster and another part that is not so fast but longer-lasting, implying stimulus for a long time.

Should the Government Borrow Money to Stabilize Markets and Stimulate Growth?

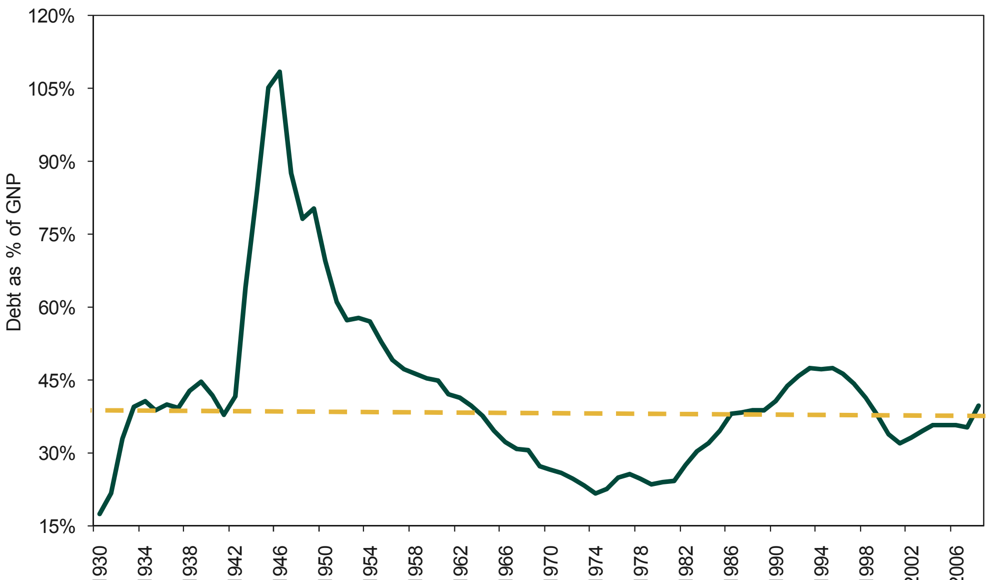
The short answer is yes.

Begin with the premise that the US government can borrow money by selling 30-year bonds at a cost of around 2.5%. Let's say it raises $1 trillion this way, above and beyond any current spending plans. With that extra $1 trillion the government buys $1 trillion of corporate bonds, mortgage-backed securities, whole loans, and so on, that also have 30-year maturities. As a package, the assets might yield 10% (probably more for a riskier pool, but let's stick with this as a round number). Now assume the government holds them to maturity. So annually, the government would pay $25 billion in borrowing costs and receive $100 billion investment income. The net annual profit would be $75 billion to the government, and $1 trillion of risky bonds would be taken out of circulation, presumably off the balance sheets of banks and others that could use the $1 trillion of sale proceeds to make new loans, shore up capital bases, or make expenditures. The arbitrage potential is enormous.

Here are the catches. First, at some point, the cost of government borrowing would go up as the government increased the supply of Treasury bonds. We can't know for sure what the price elasticity for Treasury bonds are or will be, but given that yields have remained extremely low (and actually have fallen in recent months) despite more than $1 trillion of incremental new issuance in 2008, we suspect the government could easily sell that much more without moving rates much. And the trade would still work if borrowing costs went to 3%, or 4%, or even 5%. Second, as the government bought the risky debt, the price for that debt would go up and the yield would come down. Again, predicting the price elasticity is tough. But again there is currently a sufficient yield spread to begin with that prices could move a bunch for the trade-off to be worthwhile. The third catch is the default rate on the risky assets. But once again, there is lots of cushion for the government to absorb a fair amount of defaults and still come out whole over the holding period. A silver lining in this is that if done, the buying of corporate debt would move to push corporate borrowing rates down as they bid up prices of corporate debt.

Oh, but one last catch. The extra $1 trillion would drive deficit-phobes crazy. They would argue the sky would fall that much faster because of the increased size of the national debt. (Note that it would actually be revenue positive on a year-by-year basis.) But the asset side of the government balance sheet would go up by an equal amount. Even that aside, US net public debt (the portion issued that isn't actually owned by other US government agencies—which is all that really matters) today is nowhere near all time highs (set during WWII). And at 40% of GNP, debt is lower today than at any time between 1942 and 1963, as shown in Exhibit 9.

Exhibit 9: Net Public Debt as a Percentage of GNP



Source: Congressional Budget Office, Global Financial Data, US Department of the Treasury; as of 9/30/2008

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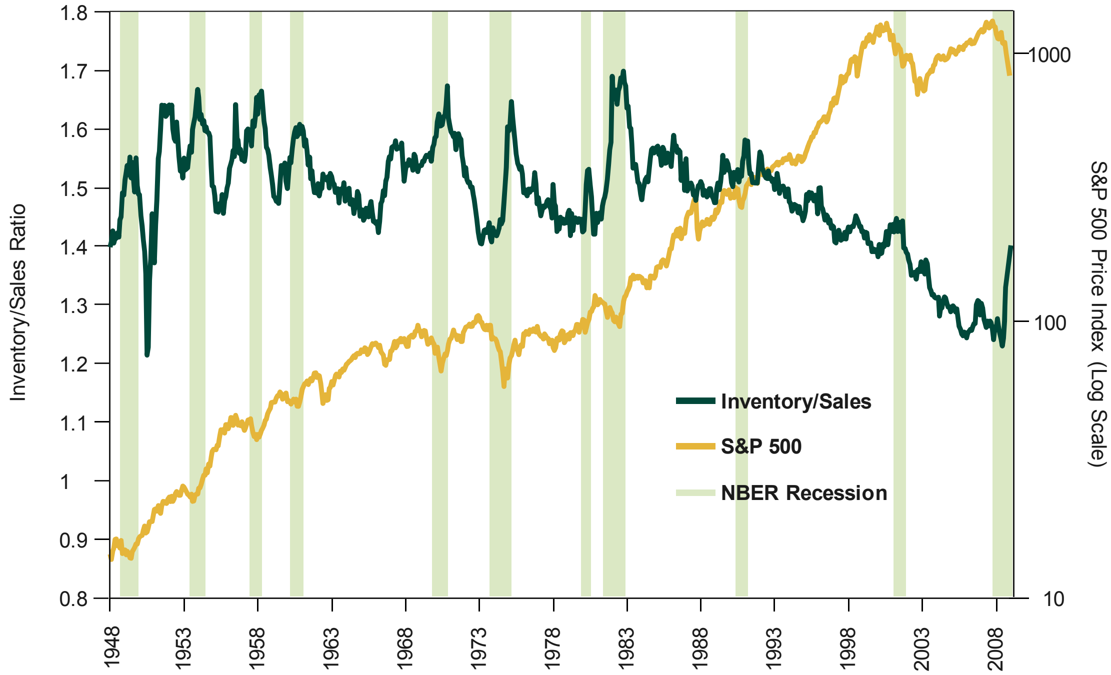
We've portrayed a clean hypothetical example. But in reality, the beginnings of this concept are starting to happen and likely to continue. We believe utilizing the government's low borrowing costs should be viewed as part of a sensible solution and not an additional layer to today's problems.

Recession Preparedness

In past recessions, before the advent of sophisticated business information systems, inventories would accumulate unbeknownst to management as sales trailed off. It would take companies months to figure this out. When they did, they would dump inventory and fire staff, depressing margins and protracting the recession, creating its deepest depths. Unlike past recessions, last Fall's financial panic goaded businesses to brace for the worst instead of being caught unaware and expecting continued good times ahead. They prepared by trimming already lean inventories to exceptionally low levels, scuttling capital expenditure plans, and reducing staffing levels early. Although these responses sharpened the severity of the initial economic downturn, they should also shorten its duration. This recession started with business inventory as a percent of sales at the lowest level ever, a positive sign not seen emphasized in media anywhere, but a powerful one nonetheless.

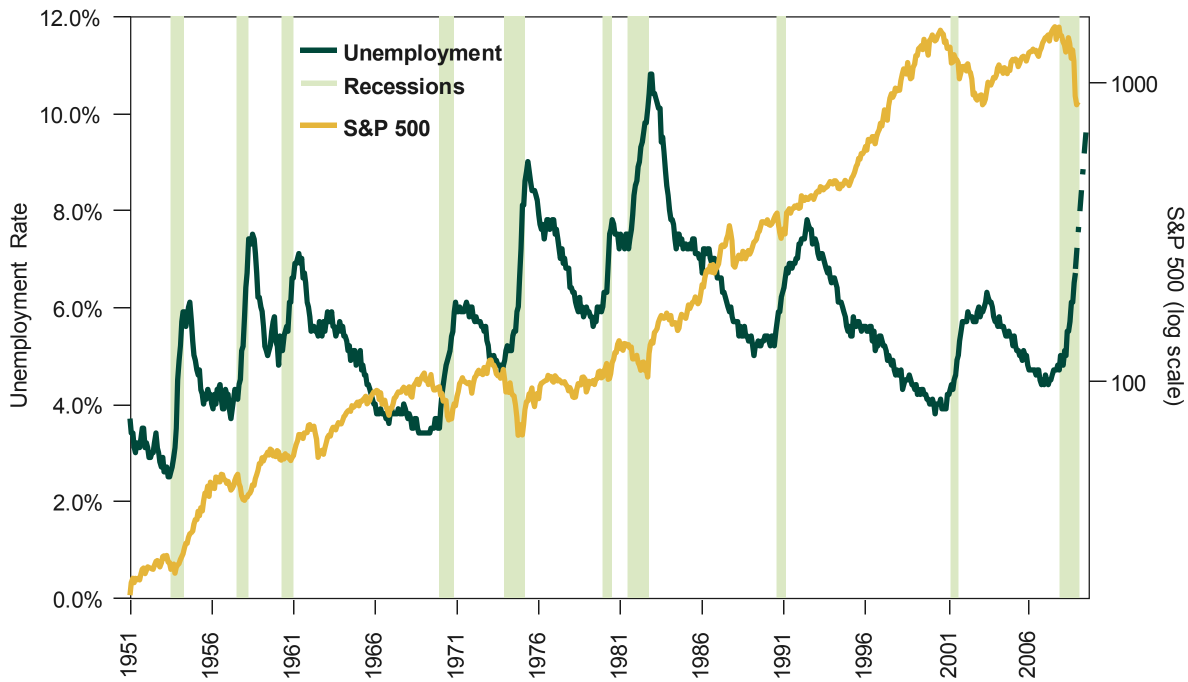
Exhibit 10: Business Inventories Historically Spike Late in Recessions



Source: Federal Reserve, NBER; as of 11/30/2008

The US lost 2.6 million jobs in 2008, portrayed in media as more than any year since 1945. This is misleading, since the size of the labor force is bigger today than ever before. As a ratio, the unemployment rate deteriorated to 7.2% in December. While quite a bit higher than a year ago, this level is still far below many past recessions. We expect the rate to trend higher still, likely beyond the end of the recession, which would be very normal. As Exhibit 11 shows, the economy has historically begun recovering well before the unemployment rate—though, the stock market usually started recovering before either the economy or the unemployment rate.

Exhibit 11: Unemployment Historically Increases Even After Recessions End



Source: US Bureau of Labor Statistics, Global Financial Data, NBER; as of 12/31/2008

America's Own Lost Decade?

If not a new Great Depression, then perhaps the US will mimic Japan's long decline after its 1980s boom in asset prices (principally stocks and real estate), often called Japan's "Lost Decade." The parallels tempt such a comparison. It's true the US today, like Japan in 1990, is suffering from a real estate contraction, a debt-fueled banking crisis, and a period of economic weakness. But again there are critical differences. Japan's non-performing loans as a percent of GDP were eight times that of the US today.[viii] And crucially, the two cases differ dramatically in the speed and intensity of public policy responses.

Japanese banks didn't begin to write off bad loans until the mid-1990s—well after trouble appeared. A government bailout of ailing banks didn't arrive until 1999's formation of the Resolution and Collection Corporation. The Bank of Japan didn't start cutting rates until a full year after the domestic stock market collapsed in 1990 and took until 1999 to reach zero—a very slow pace. And quantitative easing (the central bank's equivalent of a deflation-fighting bazooka, printing new money to buy assets) didn't begin until a decade after the first rate cuts.

Contrast this with the current US cycle. Banks took their lumps almost as soon as problems surfaced, writing down bad assets beginning in 2007 and continuing throughout 2008. There could be more to come, but we believe it's overwhelmingly likely the majority of write-down pain is past. The Fed started cutting interest rates in September 2007, before the recession and bear market began, and in just a little over a year the target rate has effectively reached zero and quantitative easing has been formally instituted. The Fed has committed to "exceptionally low" rates for some time, and even said they'll consider buying longer-duration Treasuries to affect rates further up the yield curve. Liquidity injections began in early 2008 via several new temporary lending facilities for financial institutions. Those facilities have multiplied to include liquidity support for agency debt, mortgage-backed securities, and corporate paper. But that's not all. Fiscal expansion has also been fast and substantial—a $150 billion tax rebate in Spring 2008, the $700 billion Troubled Assets Relief Program (TARP) in the fall, and a potentially $1 trillion+ plan in early 2009.

Importantly, the US isn't working in a vacuum—central banks and governments around the world are implementing similar stimuli.

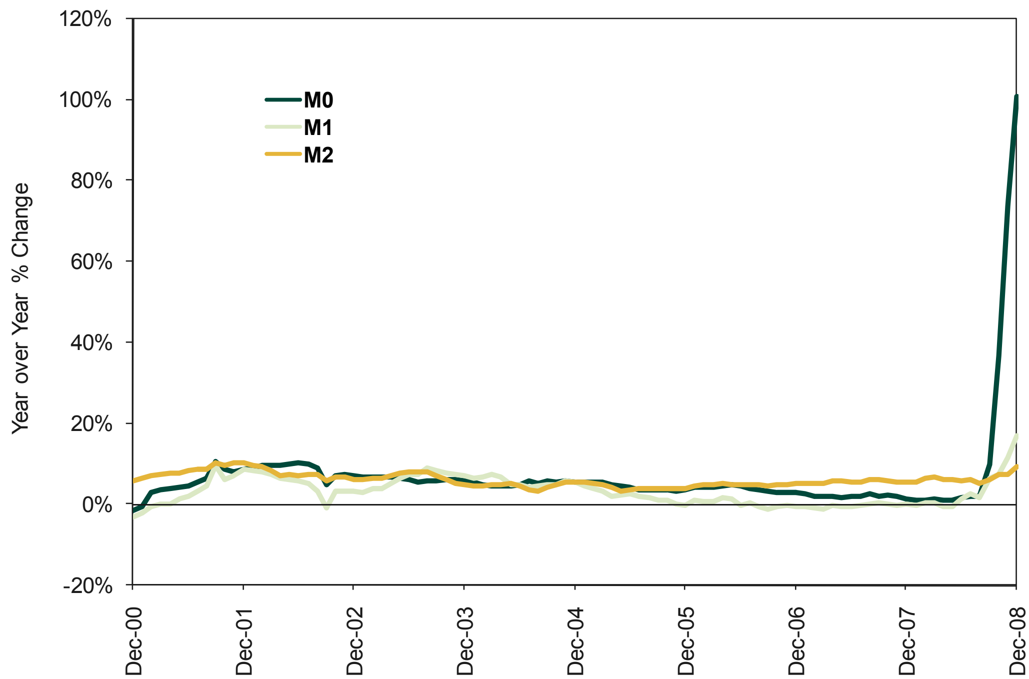
Such measures will take many months or even years to manifest their full effect. Government-induced stimulus can be clumsy, messy, and slow-moving. But the massiveness of the recent and coming programs gives us confidence a repeat of the Great Depression or Japan's "Lost Decade" is extremely unlikely.

Appendix III: Deflation Fears and the Fed

Inflation concerns rapidly transformed into deflation fears once the Fall financial panic set in. The US Consumer Price Index did indeed fall in October and November, and other broad inflation measures have decelerated in most countries around the world during the fourth quarter. Much of the decline could be explained by falling energy and food costs, reversing the sharp rises of the last several years.

In our view, a lasting deflationary spiral is very unlikely to take hold in 2009. Core price levels should remain fairly neutral, although headline readings might initially be negative as last year's high commodity prices are anniversaried. True, the recent shocks to the financial system caused the velocity of money to drop. (Money velocity is, loosely stated, the average frequency money is transacted in a defined period of time. As banks create new loans to the public and/or lend and borrow from each other, money velocity increases.) But the Fed and other central banks globally have acted extremely aggressively to inject new liquidity. The monetary base has essentially doubled since September, an unprecedented rate and one underappreciated and even unjustly feared by many.

Exhibit 12: US Monetary Base[ix] Y/Y Growth



Source: Federal Reserve; as of 12/31/2008

We can't identify a time in history when a fast growing money supply has resulted in a notable period of deflation. As mentioned in Appendix II, even Japan's longstanding deflation in the 1990s ended quickly after quantitative easing (i.e., printing money) began.

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At some point this newly printed money will begin circulating. Inflation rates will probably move higher, but not for some time, likely several years, after the new money has helped stimulate economy growth and much excess capacity has been utilized. Once that occurs, inflation, not deflation, will be the greater risk. Monetary policy's stimulative effects come with long lag times. New money takes time to be lent out by banks and utilized by borrowers in the real economy. In the meantime, the new money should flow into financial assets, including stocks, which is quite bullish. The typical process of excess money creation in a period of weak economy does not translate immediately into inflation because business can't raise prices while plant capacity utilization is at low levels—then too much competition among vendors to get volume up keeps prices dampened. In that time period, people get more optimistic about rising volume and financial assets rise in price. Later, when capacity utilization gets high enough, maybe over 85%, inflation can pick up quickly.

Sometime in the future, perhaps 2010 to 2012, we expect this bout of extreme monetary stimulus will result in a more pronounced inflation spike. We think commodity-oriented stocks will begin to reflect increased inflation expectations well in advance of higher official inflation readings.

Is the Fed Out of Ammunition?

In December, the Fed lowered the fed funds rate to effectively zero. Some fear the Fed has exhausted its monetary policy tools. This is not even remotely correct. Even with a zero interest rate policy, the Fed has ample capability to increase monetary stimulus. A central bank can print money infinitely—there is no technical "limit." It can never run out of ammunition.

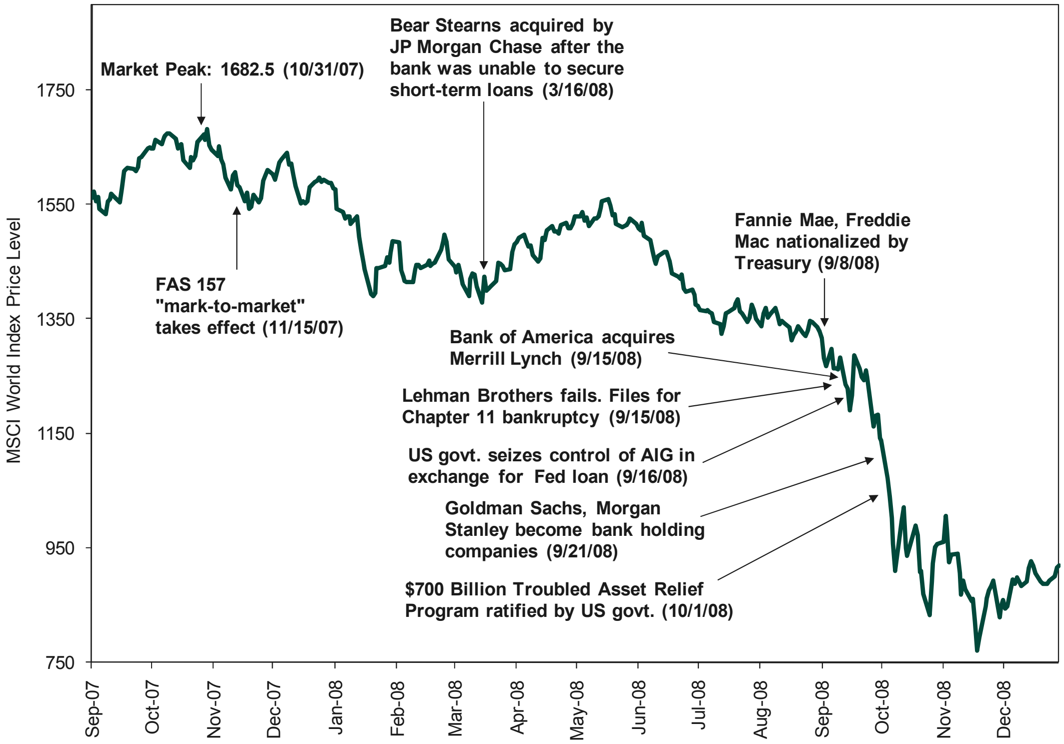
One straightforward tactic: The Fed is purchasing assets from the general public using newly printed money. Typically, the Fed's open market operations are limited to short-term government securities. However, in this crisis they've aimed to increase liquidity by purchasing other security types. Fed Chairman Ben Bernanke has described one such plan to buy $600 billion of mortgages and mortgage-backed securities. In a program already underway, the Fed is purchasing hundreds of billions worth of commercial paper. In theory, the Fed could purchase virtually any type of asset and hold it on its balance sheet in exchange for newly printed money. The Fed has indicated it will continue acting aggressively as long as is appropriate to ease liquidity shortages and fight deflationary pressures.

The cost of printing money is inflation. All else being equal, an increased supply of dollars reduces the value of each dollar, which translates into inflation. In normal circumstances, when the velocity of money is fairly constant because the banking system is working properly, a central bank should create just enough money to satisfy the real growth rate of the economy. But in an extraordinary time like today when the velocity of money declines due to a banking crisis and frozen credit markets threatening deflation, expanding money supply by printing a lot more of it is the right course of action.

Appendix IV: An Important Bear Market Lesson Learned

While the monetary policy actions discussed in Appendix III have largely been appropriate, in our view, many other government interventions in the financial sector have been massively damaging. This was followed by a negative cascading effect that culminated in the Fall 2008 panic, as illustrated in Exhibit 13.

Exhibit 13: Timeline of Government Interventions



Source: Thomson Datastream

One key element we have adapted to as a result of this bear market has been the heightened potential for unintended, second order effects of regulatory and accounting shifts. In hindsight it became apparent to us that the "mark-to-market" accounting rule instituted in late 2007 was a critical ingredient in creating the banking system's vulnerable state that made it susceptible to a mass breakdown. The now infamous FAS Rule 157 required financial firms to price hard-to-value assets (e.g. mortgage-backed securities) as if they would be liquidated overnight. But as markets for certain of these assets dried up almost completely, fire sale pricing was the only available reference point, and thus a spate of write-downs ensued based on those distressed prices, often well below their probable hold-to-maturity values.

In response to growing criticism, the Financial Accounting Standards Board issued an interpretation of Rule 157 in October, 2008, allowing accountants to ignore "distress sales" for reporting purposes. Congress subsequently requested the SEC—an unrelated entity—research mark-to-market accounting and determine its part in the panic. The SEC opined in a December, 2008 report that the mark-to-market rule played a negligible role in the crisis. Further, the SEC recommended only amending the rule as, in their view, its revocation would remove financial transparency and "erode investor confidence." We disagree with these conclusions. Further, we doubt any erosion of confidence could be worse than the crisis of confidence that annihilated major independent investment banks in a matter of months. We also think the odds are high, greater than not, the congressional aftermath to this whole period includes a whole new regulatory landscape that likely eliminates the SEC's role as we have known it to date. Rumblings from the Beltway make it likely a whole new regulatory structure gets implemented in our view, if not in 2009, then in 2010. This makes the importance of building a bigger muscle to analyze regulatory shifts very timely and necessary, and it is a lesson perhaps not everyone learned from 2008.

Based on all our previous experience, we would have said a year ago, or ten years ago, or even 30 years ago, that changes in esoteric accounting rules would not have any material impact on the broad stock markets. This belief had long served us well in forecasting. But in light of the 2008 experience, we recognize the great potential for seemingly innocuous accounting and regulatory rule changes to creep up in unexpected ways and places. Therefore, we have changed our belief and instituted an intensive protocol to better analyze future changes in accounting and regulatory rules, both in America and abroad.

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Appendix V: Madoff and the Bear

The Madoff scandal is undeniably a heinous tragedy, but it is also nothing truly new. Bear markets have always uncovered financial scandals, from the South Sea Bubble of the 1700s to Enron and WorldCom in the 21st century. Each erodes investor trust in the process but has never proven fatal to stock markets forever.

The fraud perpetrated by money manager and securities broker Bernard Madoff is the latest variation of an oft-repeated theme. Having allegedly confessed to committing over $50 billion in fraud via what is commonly described in the media as a Ponzi scheme, the Madoff scandal has received daily coverage since the story broke in December. Madoff's alleged crimes are frightening because money was purportedly stolen directly from investor accounts even as Madoff was considered by his clients to be one of the most trustworthy members of the financial community, a fact which only intensified the shock of his alleged crime.

In the wake of all bear markets comes a bout of scapegoating, and 2008 had plenty of potential villains and scapegoats. Lehman Brothers CEO Richard Fuld, for instance, was maligned to be sure, but he hasn't been accused of anything close to criminal activity. A subpar executive who garnered enormous pay? Probably, but insofar as we are aware he didn't knowingly commit illegal acts. In contrast, Madoff (assuming his confessions are accurate) is a true criminal who perpetuated fraud for decades. His alleged swindle makes it easy for people to pinpoint blame, unlike the vague and nebulous sense of culpability surrounding the various bank failures. Lately, a new contender for top offender emerged in India, as the chief of tech firm Satyam Computer Services admitted cooking the books in Enron-esque, billion dollar fashion. If past is prologue, more may very well follow in this cycle.

The most important investor protection Madoff's investors lacked was the transparency that comes with separating the investment advisor, or decision-maker in whatever form, from asset custody and brokerage. Such action provides prophylactic protection against such swindles. Amazingly, in media this hasn't been pointed out. Madoff's advisory business apparently maintained its clients' assets in accounts custodied *at his own brokerage firm*—so he could get his hands on the client money directly and siphon it off. To make matters worse, he utilized a highly suspicious, rinky-dink accounting firm to produce its audit reports. His investors relied essentially on *his* word for the value of *their* assets. It appears, account statements reported fictitious values, and no well-regarded audit firm was in place to prevent such a fraud.

Fisher Investments' Private Client Group was deliberately designed to make such deception impossible. Our clients' assets are managed in separate accounts registered in the individual client's name at an unaffiliated broker-dealer custodian. Our clients always have direct access to viewing the assets in their accounts independent of asking Fisher. And Fisher Investments never takes possession of client assets. We deliberately set the business up that way to remove even the temptation of Madoff-type fraud—this is not just the temptation to our top officers but also so we don't have to worry about embezzlement activities from lower level employees. It not only protects our clients, but also the firm. It is just basic, fundamental good business all the way around.

If there is a bright side to the Madoff episode, it's that much of Madoff's clients' money was apparently solicited via outside hedge funds (sometimes known as "feeder funds"). An increased wariness of "alternative investments" could redirect money out of hedge funds and back into traditional investment classes. This would boost demand for equities—bullish for stock prices.

Appendix VI: The Big Three and the Economy

It's nothing new to say the US auto industry is ailing. In fact, Ken Fisher wrote in *Forbes* in his March 27, 2008, column, "All my life General Motors and Ford Motor have tried to go bankrupt. It takes them a long time because, even at this sorry task, they're not very competent." But in late 2008 the woes of the so-called "Big Three" automakers (General Motors, Chrysler, and Ford) escalated as they faced potential bankruptcies.

Shortly after financial firms received federal rescue funds in the fourth quarter, the Big Three pleaded they needed rescuing as well, but initially came up empty-handed in Congress. Ultimately, GM and Chrysler secured $17.4 billion in bridge loans from TARP funds by sidestepping Congress and appealing directly to the Bush administration. (Ford decided the TARP terms were unattractive and turned away government money for now.) In addition, Canada pledged $3.3 billion to GM and Chrysler in return for warrants, and Sweden said it will provide direct loans to GM's Saab Automobile division. A Spanish province also promised GM $200 million in credit guarantees, and GM European executives tapped the German government for help. However, a loan isn't very likely to decrease the likelihood of bankruptcy—in our view it only puts off bankruptcy temporarily.

Bridge loans are little more than band-aids. A three-month grace period designed to reform decades of poor business practice, burdensome post-retirement benefit obligations, and inefficient labor agreements is too much to reasonably overcome. Equally suffocating is well-intended but highly burdensome regulation like the Corporate Average Fuel Economy (CAFE) standards. These standards force the Big Three to produce hundreds of thousands of small, fuel-efficient vehicles most consumers haven't bought and punish them for building SUVs and pickups that have sold extremely well. Politicians now think the way forward is to focus the automakers on "green" cars, but this requires tens of billions of dollars of capital investments, and there is scarce evidence they would sell in sufficient volume to make them economically viable.

The real question is the potential economic fallout from one or more bankruptcies. GM claims its bankruptcy alone would cost 2.5 million jobs in the first year. This seems a massive exaggeration—GM employs roughly 139,000 people in the US, Ford 94,000, and Chrysler 62,000.[x] The other 2.2 million jobs automaker CEOs intimated in their Congressional testimony include parts suppliers (~610,000 employees), independent dealerships (~740,000), and service providers, car washes, etc (~1 million more altogether).

It's a huge stretch to say all would suddenly be unemployed if GM or Chrysler were to file bankruptcy. First, there are other car makers the world over who still need parts to make cars, including a very material contingent of foreign-owned, domestically located manufacturers. And many of the dealerships sell cars from foreign car companies. And hundreds of millions of cars already in use that will still need servicing, washing, etc.

To believe bankruptcy filings from the Big Three would literally shut down all of these businesses completely is also absurd. To begin with, the overwhelmingly likely form of bankruptcy would be Chapter 11, which allows for reorganization rather than liquidation

(Chapter 7). The business would continue as a going concern, but debts and contracts could be restructured. A complete Chapter 7 shutdown is not remotely justified at this juncture.

We are not arguing that there would not be a meaningful impact on overall employment or that some related companies might not file for bankruptcy in the aftermath or that the local economies around shuttered plants won't feel pain. But we consider the magnitude of fear disproportionate to the likely economic reality. Remember, the Big Three have already shrunk headcount by more than 235,000 employees (45%) over the last decade—layoffs are nothing new for them in an era of increased productivity and fierce competition.

In our view, Chapter 11 is simply the most appropriate option at this juncture for ailing automakers. A common argument opposing bankruptcy is that people won't buy a car from a bankrupt company. A somewhat analogous situation happened with US airlines in 2001-2002. People didn't stop flying Delta or United because the companies were in bankruptcy. Understand that Delta and United Airlines exist today not because of government bridge loans in the aftermath of 9/11 but because of the restructuring undertaken during their subsequent Chapter 11 bankruptcies. The result? Moderate workforce reductions, pay concessions, restructured debt, and cutbacks in flight schedules. Today, these airlines are in much better financial shape because they reorganized. Note they didn't need to come begging the government for money during the financial crisis of 2008.

A similar outcome is likely if the automakers were forced down the Chapter 11 path—fewer plants, reduced brands, modest staffing reductions, and big concessions from creditors and labor. And if there was an extreme consumer response because people would fear car warranties would be at risk, the federal government could simply guarantee the warranties, which would require a tiny fraction of the liability of propping up the entire companies as the current loan programs attempt to do.

In all, the Big Three's ailments are a negative for the economy, but the magnitude of their woes is not a singular dilemma. There is a clear path out, and Chapter 11 bankruptcy is central to it.

Appendix VII: Initial Thoughts on the Obama Administration

Please note our political commentary and analysis is intended to be objective and nonpartisan. We are non-ideological in our market analysis and for that reason don't favor or oppose any particular political party.

With the Inauguration now passed, so far President Barack Obama's actions have signaled a benign agenda. Politically and through his appointments he is moving toward the center, typical of new presidents desirous of reelection to another term. Economically, for now, he and Congress appear disinclined to raise taxes but very willing to spend enormous sums of money, which can be and usually is appropriate at this stage of the economic cycle.

So far, Obama's move toward the center is starkly apparent in his cabinet and advisor choices. A bevy of Clinton Administration veterans are already onboard: Larry Summers (former Clinton Treasury Secretary), Leon Panetta (former Clinton Chief of Staff), and Hillary Clinton herself are prime examples. Obama also elected to keep Bush's Secretary of Defense, Robert Gates.

The Treasury Secretary selection is, of course, former New York Fed Governor and Henry Paulson right hand man Tim Geithner.

What was billed as a change movement has seen virtually nothing but back to the future so far. We doubt Obama would have even won the Democratic nomination if, for instance, he'd pledged that, "If you elect me President, I promise to keep George Bush's Defense Secretary on board." Imagine the same effect if he announced at the beginning of his campaign for "change" the degree to which he would recycle former Clinton staff at a time he was running against then frontrunner Hillary Clinton.

None of this should surprise. Incoming presidents routinely turn on their power base and move to the center to posture early and fast for later reelection. The end result is a fairly moderate cabinet, which we think is good for markets—a positive surprise compared to what many feared. Big change emerging from the Beltway forces the economy and capital markets to adjust—resulting in deadweight losses in the process.

As for economic policy initiatives, Obama and his team have been mostly non-committal on specifics for a stimulus plan beyond promising a big one. We plan to comment on the eventual plan once details crystallize—as of this writing there is nothing to comment on but speculation.

[i] Source: Thomson Datastream

[ii] Source: Thomson Datastream

[iii] Source: Thomson Datastream

[iv] Source: Thomson Datastream

[v] Source: Thomson Datastream

[vi] Source: Bloomberg

[vii] Source: Global Financial Data

[viii] Sources: Japanese Financial Services Agency, Bloomberg, Federal Deposit Insurance Corporation, and Fisher Investments Research

[ix] Source: Federal Reserve. M0, or the monetary base, consists of currency (banknotes and coins) and commercial banks' reserves held at the central bank. M1 and M2 are progressively more inclusive measures of money: M1 is included in M2. M1 consists of the most liquid forms of money, namely currency and checkable deposits. M2 adds primary household holdings of savings deposits, small time deposits and retail money market funds.

[x] Source: Company filings

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