BEACON POINTE ADVISORS

BEACON POINTE RESEARCH

THE HALF EMPTY/HALF FULL GLASS

NOVEMBER 2008

CONFIDENTIAL – PROPRIETARY

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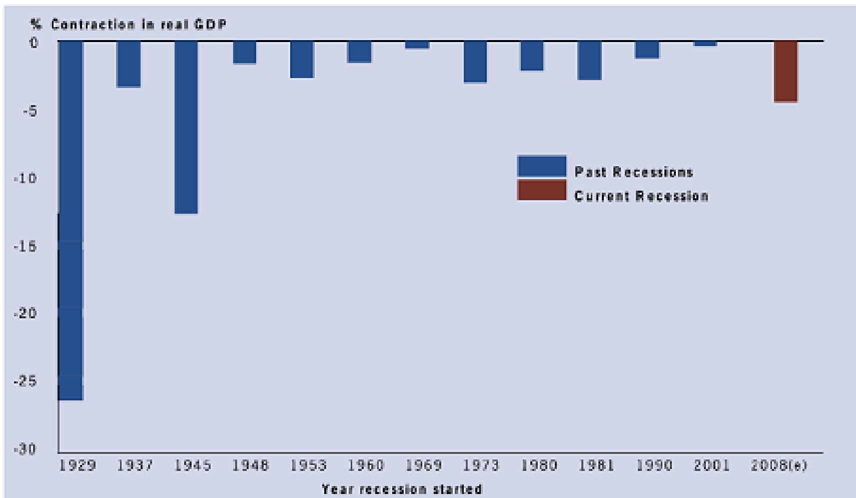
The Half Empty Glass

The U.S. economy continues to deliver bad news. A slow and tentative recovery is anticipated to begin in mid-to-late 2009. It is possible that this economic cycle will bring a more pronounced GDP contraction than at any other time in our county's post-WWII history. For instance, Capital Guardian projects a peak-to-trough contraction in GDP of almost 5%. A large portion of it is expected to come through in the 4Q08 and 1Q09 readings of GDP growth (or lack thereof).



Source: Capital Guardian, NBER Bureau of Economic Analysis

One of the earliest and most vocal forecasters of a prolonged and severe recession was Professor Nouriel Roubini of the Stern School of Business at New York University. He has appeared on numerous talk shows and newspaper front pages over the past few months, earning the nickname "Dr. Doom". (The original Dr. Doom was Professor Henry Kaufman of Salomon Brothers, who was widely known for his bearish views throughout the 1970s and 1980s).

Dr. Doom I

Dr. Doom II

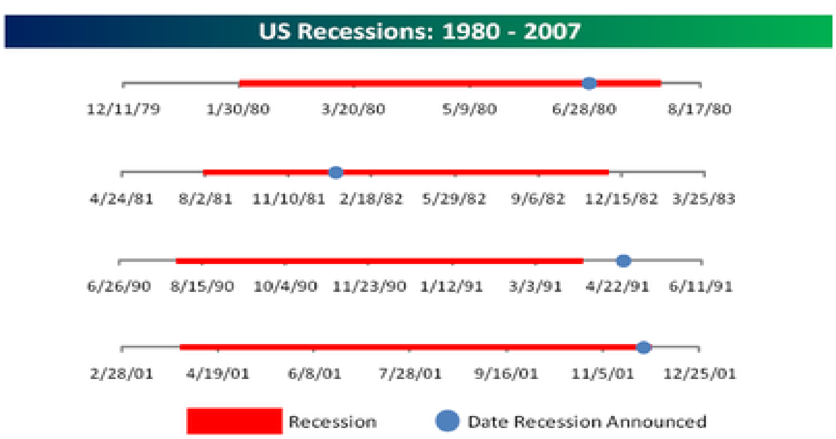
In a recent Forbes Magazine article ("The Worst Is Not Behind Us", November 13, 2008), Roubini summarized his views as follows:

- "The U.S. will experience its most severe recession since World War II, much worse and longer and deeper than even the 1974-1975 and 1980-1982 recessions. The recession will continue until at least the end of 2009 for a cumulative gross domestic product drop of over 4%; the unemployment rate will likely reach 9%. The U.S. consumer is shopped-out, saving less, and debt-burdened: This will be the worst consumer recession in decades."

- "The world economy will experience a severe recession: output will sharply contract in the Eurozone, the U.K., and the rest of Europe, as well as in Canada, Japan, and Australia/New Zealand. There is also a risk of a hard landing in emerging market economies. Expect global growth--at market prices--to be close to zero in Q3 and negative by Q4. Leaving aside the effects of the fiscal stimulus, China could face a hard landing growth rate of 6% in 2009. The global recession will continue through most of 2009."
- "For 2009, the consensus estimates for earnings are delusional: current consensus estimates are that S&P 500 earnings per share (EPS) will be $90 in 2009, up 15% from 2008. Such estimates are outright silly. If EPS falls--as is most likely--to a level of $60, then with a price-to-earnings (P/E) ratio of 12, the S&P 500 Index could fall to 720 (i.e. about 20% below current levels). If the P/E falls to 10--as is possible in a severe recession--the S&P could be down to 600, or 35% below current levels. And in a very severe recession, one cannot exclude that EPS could fall as low as $50 in 2009, dragging the S&P 500 index to as low as 500."

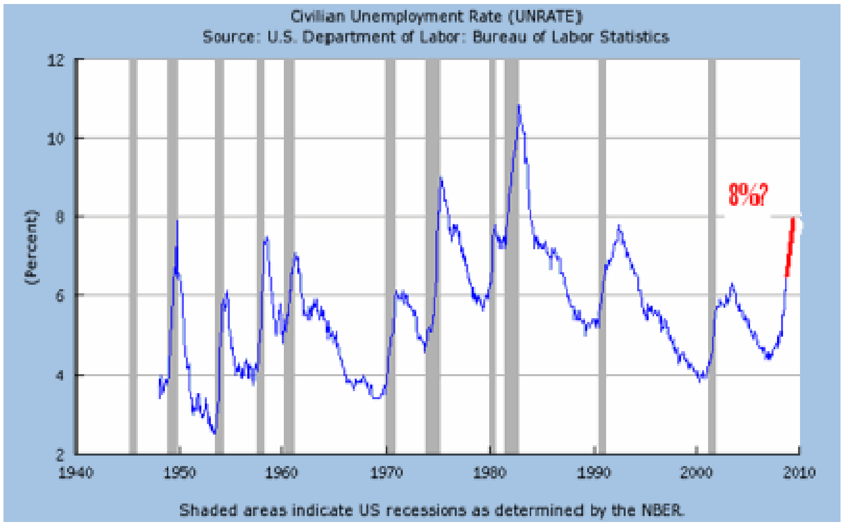
With regards to the last point, top down consensus estimates for S&P 500 earnings now stand at $63. The number referenced by Roubini is a bottom up estimate – a summation of the consensus expectations for each of the 500 companies in the index. There appear to be some unrealistic expectations for certain stocks, but consensus already reflects the likelihood of earnings erosion for the markets as a whole. Against that backdrop, active management becomes crucial in identifying the best individual valuation opportunities and avoiding those overvalued stocks that may be vulnerable to further downside earnings revisions. For the most part, Dr. Doom's predictions are already widely talked about in the media and discounted by the market. Therefore, his economic prognosis could materialize without necessarily producing further stock declines beyond the already depressed levels. This is a testament to the discounting nature of the markets and the overwhelming level of pessimism today.

Unquestionably, there is sufficient economic evidence to corroborate an ongoing recession. While it seems likely the start point was late 2007 or early 2008, we are still waiting for an official pronouncement from the National Bureau of Economic Research (NBER), which defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales." The announcement from NBER could be coming soon – according to Bloomberg, economist Robert Hall, head of the NBER's business cycle dating committee, said last week that recession evidence was now "conclusive" in his opinion. In some ways, an official announcement would be a welcome development. Based on the history of past cycles, the actual announcement of a recession by NBER has tended to fall closer to the end of a recession than the beginning, as can be seen in the following chart from Bespoke Investment Group:



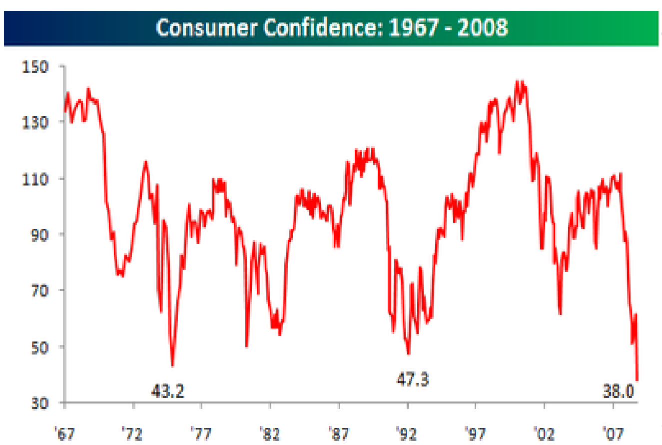
Source: Bespoke Investment Group

Let's examine in more detail a number of key economic indicators, which are painting an increasingly dismal picture of late. After an October reading of -240,000, the number of jobs lost this year now exceeds one million. Every month seems to bring more widespread weakness and downward revisions to prior periods' readings as well as future expectations. The unemployment rate stands at 6.5% and is most likely headed higher. Some economists now predict a rise in unemployment to as much as 10%.



Source: John Mauldin "The Problem with Deleveraging" (November 7, 2008)

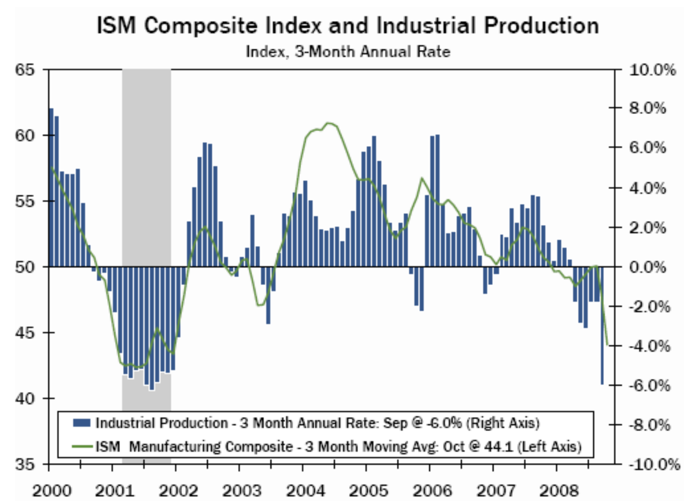
Not surprisingly, consumer confidence continues to fall, reaching a new record low in October. With the values of their homes falling, wage growth non-existent, and jobs harder to find (and keep), U.S. consumers are saving more and buying less. As a result, overall spending on goods and services has ground to a halt, with retail sales (on a same-store-sales basis) plummeting almost 5% YOY. The approaching Holiday shopping season is expected to be among the worst in history.

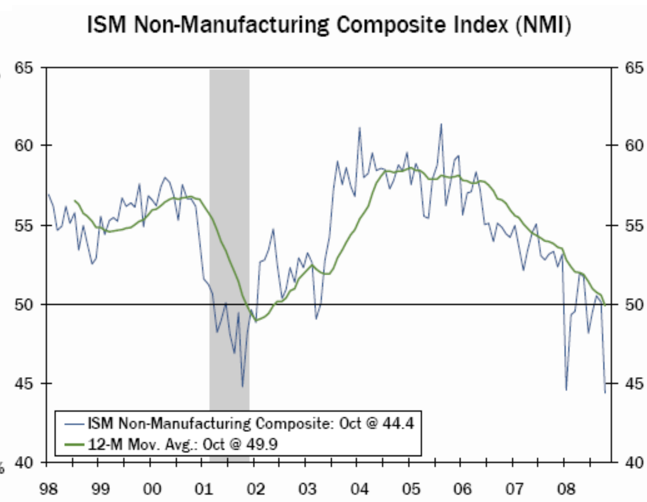


Source: Bespoke Investment Group

Source: Merrill Lynch Economic Research

Both manufacturing and services are slowing down significantly. The Institute of Supply Management (ISM) Manufacturing Index fell into recession territory earlier this year, with weakness apparent in new orders, production, and employment. The ISM Non-Manufacturing (or services) Index fell in October to its lowest level on record. (Note: 50 is the expansion/contraction neutral line; a reading above 50 indicates expansion, while a reading below 50 indicates contraction.)





The Half Full Glass

Certainly, extrapolating these trends into the future would easily lead one to envision a doomsday scenario akin to the Great Depression; however, no trend lasts forever. That is why economic forecasting is more art than science. No one, not even Professor Roubini, knows what will happen in the next month, year, or decade. What we do know is that there are major differences between economic fundamentals today and those of the Great Depression. In previous letters we have discussed at length the unprecedented policy response that is taking place on a coordinated global basis, with Central Banks around the world sparing no effort to prevent systemic financial and economic collapse. While the U.S. economy seems likely to get worse before it gets better, the probability of a 27% fall in GDP, a 25% unemployment rate, and 27% deflation is extremely remote.

The following table from Charles Schwab contrasts today's environment to the Great Depression:

Now Versus the Great Depression: No Comparison

Key Factor	Great Depression	Today
Gross domestic product growth	-27%	+1%
Industrial production	-52%	-4%
Unemployment rate high	25%	6%
Federal deficit as percentage of GDP	1.4%	4.9%
U.S. exports	-66%	+13%
Consumer Price Index	-27%	+4%
Money supply	-29%	+6%

…yet the extent to which the Depression set the U.S. economy backwards is unlikely to be revisited

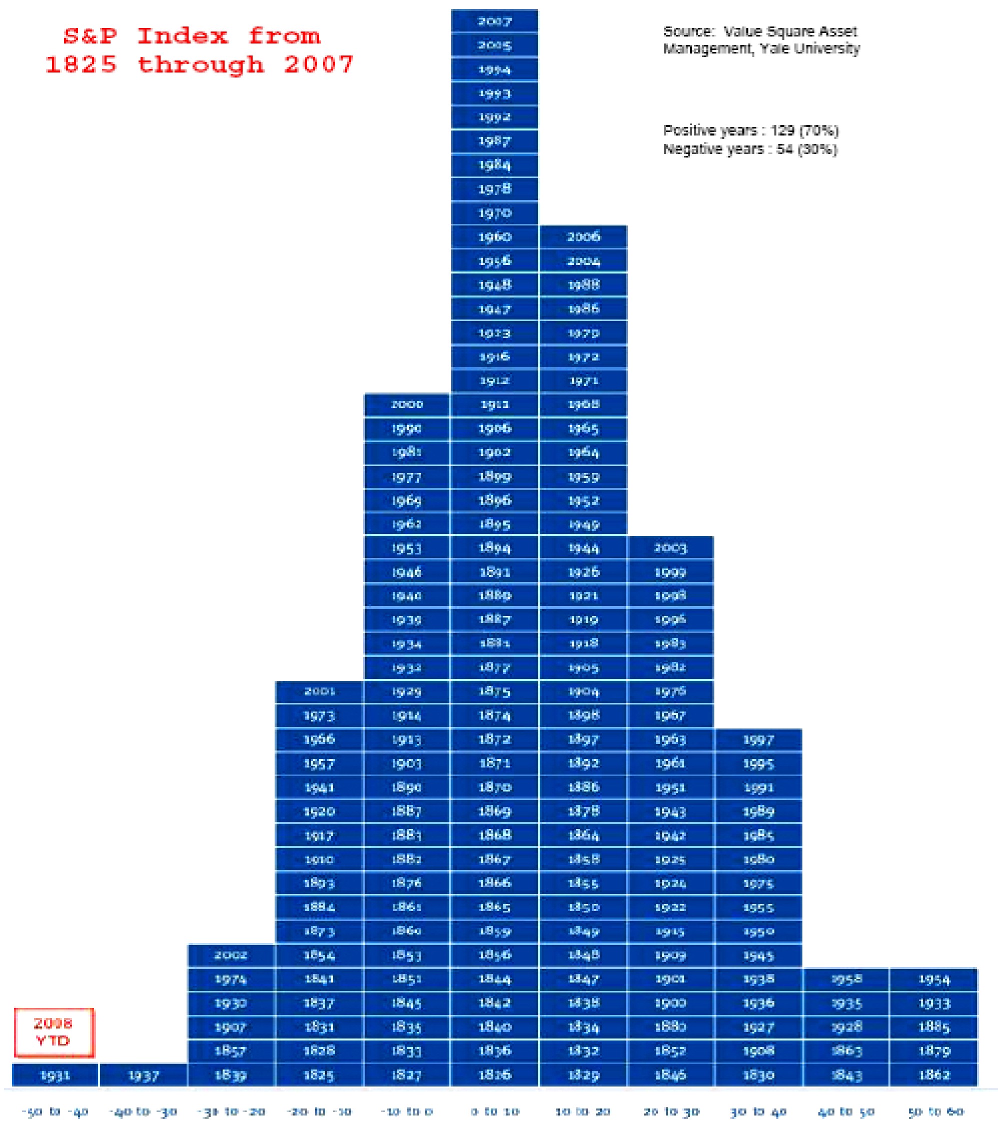
These metrics are likely to deteriorate in the coming months, before the economy starts on its way to recovery…

Source: Federal Reserve, *Historical Statistics of the United States*, Bureau of Labor Statistics, Bureau of Economic Analysis, National Bureau of Economic Research.[1]

Source: Charles Schwab Institutional: Investing Insights (November 2008)

Dr. John Hussman of Hussman Funds provided some perspective in as well: "…The market's valuation during the Depression didn't fall to the levels we currently observe until 1931 when the rate of unemployment was already 15%. Sure, if U.S. unemployment is headed to 25%, as it did in the Great Depression, then stock prices might fall in half even from here, as they did by 1932. But this is important – even if stock prices were to fall further, it would not be because of earnings losses that would permanently impair the fundamental value of U.S. companies. Rather, if further losses emerge, it will be because of increases in risk premiums that will be associated with extremely high subsequent returns. Indeed, even though unemployment shot to 25% in 1932, the S&P 500 more than doubled in the year following the 1932 Depression low, and tripled off of that low within less than three years."

One commentator astutely noted that this is not the end of the world, but it may be "the end of the world as we know it". We agree. For one, many of the most revered Wall Street financial firms have been deleted from the map. For another, investors have suffered severe losses in their personal and institutional portfolios, an experience none of us is likely to forget. Equity returns this year (down 45% YTD) have already made history, falling in the left-most tail of the annual return distribution, going back to 1825.



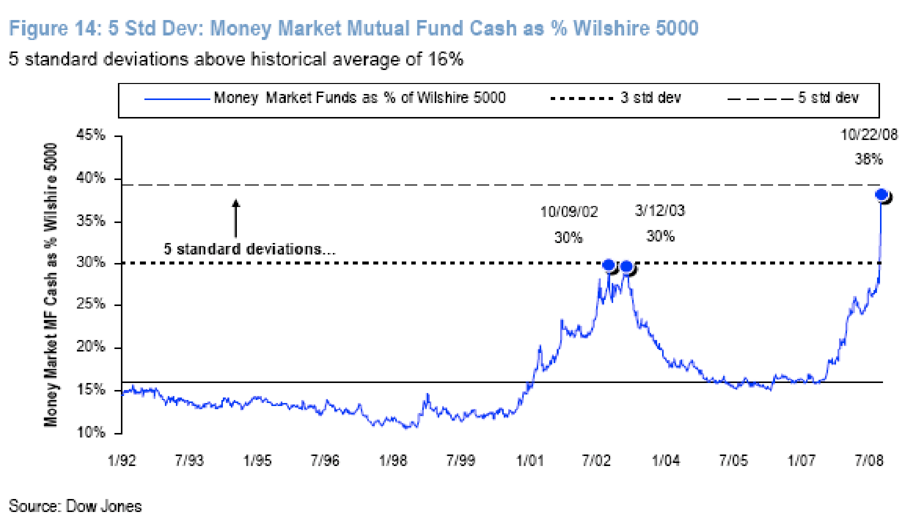
Source: Value Square Asset Management, Yale University

While the market could go lower still, many distinguished investors are moving their portfolios from a defensive to a more constructive positioning, increasing exposure to equities (Jeremy Grantham), putting cash to work (Bob Rodriguez), overweighting U.S. stocks (Warren Buffett), and upgrading their portfolios into the highest-quality global franchises now available at historic valuations (Dodge & Cox). Many stock prices already reflect dire scenarios, such as a recession in perpetuity, the "death of the U.S. consumer", or the demise of entire industries. Granted, the economic environment is likely to remain challenging and volatility could persist for some time. Nevertheless such environments always create some of the best buying opportunities for the patient and long-term oriented investor. As the Russian proverb goes "Patience doesn't always help, but impatience never does".

Had we known what would happen over the past year, we would all have indeed looked for safety in cash and Treasury bonds, rather than see our portfolio values plunge. But events only become perfectly evident with the benefit of hindsight. At this point, however, regret does not help, and fear is imprudent. Cash on the sidelines has reached astronomical levels, much of it earning a negative real rate of return. According to Federal Reserve data, the amount of cash that U.S. households have in Treasury securities, money market funds, and bank deposits now exceeds $7.7 trillion.

Source: Forbes Magazine "What Are They Waiting For?" (October 29, 2008)

Furthermore, cash parked in money market funds as a percentage of the total market capitalization of the Wilshire 5000 Index has reached 38%, a 5-standard deviation (or extremely rare) event. Notice that the last time this ratio approached 30% was around the bottom of the previous bear market (late 2002-early 2003). This lends further support to our belief that points of maximum pessimism often mark market bottoms.



Wells Capital Management's Chief Investment Strategist Dr. James Paulsen used the two graphs below in support of his "buy" call on the stock market. The median company P/E in the S&P 500 Index has fallen to 10 times forward one-year estimated earnings – these are compelling valuations even if earnings estimates are revised lower. In addition, the ratio of U.S. market capitalization to nominal GDP has fallen to 66%, a level last seen in the early 1990s. Dr. Paulsen believes that investor behavior has flipped 180 degrees from "irrational exuberance" to "irrational pessimism", thus creating incredible opportunities going forward.

S&P 500 Price-Earnings Multiple*

*Median Company Price to Forward 1-Year IBES Mean Earnings Estimate

U.S. Equity Market Capitalization as a Percent of Nominal GDP*

*Last data point based on actual nominal GDP data through Q2 2008 and an estimated Market Capitalization adjusted for the total return of the Dow Jones Wilshire 5000 since the end of Q2 2008

In his October issue of the GMO Quarterly Letter, Jeremy Grantham wrote: "Topping off all of the offsetting virtues of this ugly past year is the arrival of cheap assets. All too easily we forget that you can compound wealth rapidly only by having cheap assets. For those with a long horizon, it is always better to have assets fall in price so that the compounding returns are higher… Now, finally, [U.S. equities] are cheap and likely to get cheaper. Likely, I believe, to set up a once-in-a-lifetime investing opportunity…" Kudos to Mr. Grantham for seeing the glass as half full (or ¾ full) rather than half empty!

The question, of course, is timing. Wouldn't it be great to know the exact point at which the market morphs from a bear to a bull?!? Of course it would be great, but it is also impossible. Absent that knowledge, all we can and should do is ignore the short-term gyrations in the stock market, turn off CNBC, and look farther ahead. Warren Buffett famously said that "if you are waiting for the robin to sing, it will already be spring". Beacon Pointe firmly believes that the stock market will be at considerably higher levels three years from now. In times of stress, people tend to significantly shorten their time horizons. However, this is precisely the time to focus on the long-term and give your portfolios the best chance to not only recover the lost ground, but grow at a compounded rate that will ensure wealth creation and the achievement of your investment goals. Successful investors are marathoners, not sprinters.

Please feel free to call Beacon Pointe at 949-718-1600 should you need additional information or have any questions.