SCHAFER CULLEN

CAPITAL MANAGEMENT

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President

Update and Outlook for 2009

March 2009

Our August market letter looked at the relationship between recessions in the economy and bear markets on Wall Street over the last 40 years. The idea was to put into perspective the current downturn. We found that:

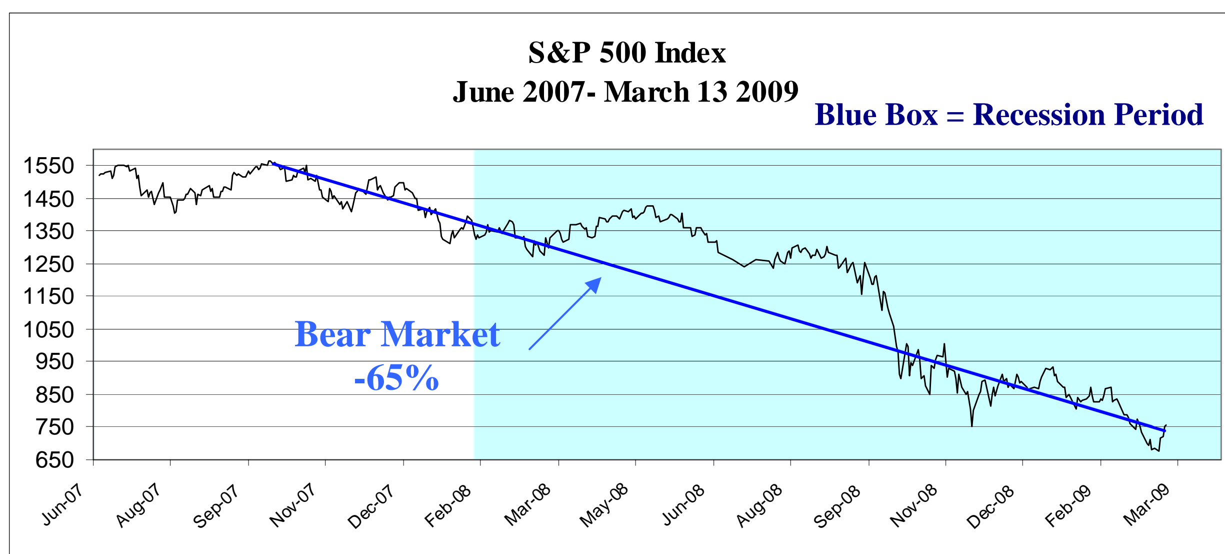
1) **Recessions and bear markets usually overlap and last on average about 18 months.**

2) **The stock market begins to turn up long before the recession ends and often while the headline news is at its worst.**

3) **The deflationary impact of the recession and bear market tend to pretty much wipe out the industry that was the most leveraged going into the downturn.**

4) **Most importantly, if investors used a combination of a value discipline (low P/E) and a long term investment horizon (5 years) they would have posted double digit returns through every recession of the last 40 years.**

Here is the update on the current recession and bear market so far:



Source: SCCM/Bloomberg, March 14, 2009

Market Perspective

The chart shows that the current downturn is worse than those we examined in our last letter, but it is also not so dissimilar to them. For instance, the bear market of 1973-74 showed a 49% drop, which was almost as bad as the decline we now see. Also, the recession of 1981-82 lasted for a full 24 months, longer than the one we have now to date.

We also see that as in prior recessions, the most leveraged industry going into the downturn gets wiped out. In the 1969-1970 recession, it was the conglomerates; in 1973-1974, it was the brokerage firms and in 1990-1991, it was the savings and loan industry. In our last market letter, we noted that 75% of all the brokerage firms disappeared in the 1973-1974 bear market. Sad evidence of that carnage comes to us from an old friend. In the June 1969 ad below, you can see that 36 brokerage firms were underwriting the then attractive stock of American Motors. The hard to believe fact is that 100% of these once solid, old line firms – all 36 of them -- had disappeared by the end of the recession. This time, of course, the most overleveraged were the investment banks.

The New York Times

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June 16, 1969

Source: New York Times, June 16, 1969

No End in Sight?

Any market strategist who can scare investors is great for TV ratings, but the media sometimes makes us feel that we'll never get out of the fix we're in. So to make yourself feel better, read the commentary below. It's from a highly regarded market strategist at *The Bank Credit Analyst*:

A growing number of individuals and companies are falling behind in their onerous interest payments while the destruction of net worth and incidence of insolvency in the banking industry continues to grow sharply. And all long-lived assets continue to be liquidated – bonds, stocks, commodities and real estate. And this was not likely to stop soon…
The forces creating extreme illiquidity and ultimately deep recession are shaping up quickly: General disaster in the banking area plus extreme financial pressure on states and municipalities and the destruction of key players in the housing sector implies a long recession. The deflationary environment implies a long recession and continued pressure on the weakest sectors of the economy and the worst is yet to come.

The good news is that what you've just read was written in **October 1981**, not March 2009. And while the recession back then continued for another nine months, the stock market turned up just as the highly respected *The Bank Credit Analyst* was making this one of many dreary forecasts in the financial press. In fact, 1981 proved to be a great starting point for long-term value investors. The 5-year annualized returns from that year forward for the low P/E discipline:

Date	Annualized Return*
1981 – 1985	**26.5%**
1982 – 1986	**27.6%**

The only better 5-year period in the last 50 years was for those who started investing in the market the year after the 1973-74 bear market:

Date	Annualized Return*
1975 – 1979	**34.3%**

* Source: Standard and Poor's

Reviewing the Great Depression

Because the economy and market continue to deteriorate, some in the financial press are beginning to talk about a replay of the 1930s – a time of bread lines, 25%

unemployment and people jumping out of windows. This, it seems to us, is excessive. Alan Abelson of *Barron's,* for 40 years one of the most skeptical observers of the market, has the right take on the current downturn. "Something between a Recession and Depression," he writes, "might better serve to describe the relentlessly worsening pickle we are in, and perhaps convey its urgency without igniting widespread panic."

There are, of course, significant differences between conditions in 1929-32 and those we have today. When the market crashed on Black Friday, we did not have programs like Social Security, Medicare, unemployment insurance, or even 401k plans and pension benefits. We do now, which means that even as people cut back, we'll see no bread lines on television.

There are two major lessons to be learned in comparing the 1930's with today:

1) The 1929 crash was greatly intensified because a speculative stock bubble ran into an economic downturn. During the late 1920s, stocks had climbed to outrageous valuations. For instance, RCA went from 5 to 500 during this period. In the present downturn, there was no speculative blow off in the market because that had already happened in 2000 when the tech bubble burst. To be sure, when the current recession struck, prices were not especially cheap, but there was no speculative froth of the kind you had with market tops in 1929, 1973 and 2000.

2) **It is also important to remember that the stock market and the economy are two very different things**. If during the Depression, you held or bought stocks after the market was down 70%, even though they were headed for another 15% drop, the recovery from the market lows of 1932 resulted in a 350% rise (35.8% annualized) over the next five years. But while the stock market was exploding on the upside, the economy continued to be bad, as unemployment climbed above 25% through 1933, during the rise. Also, earnings were still turning down while the market rallied.

Great Depression (August 1929 – March 1933) = highlighted in blue   Source: msn.com March 18,2009

What Could Spark a Turn in the Market?

We think four conditions, while taken alone may not move the market, together could spark the recovery:

- **The Passage of Time**

As recessions and bear markets age, they eventually reach a point where, even as the bad news continues to come out, that bad news starts to become less bad. And that, combined with earnings comparisons which have become easier, has historically led investors to start buying stocks.

- **Attractive Valuation Levels**

For the seven years preceding the current bear market, the S&P market multiple was not especially cheap, with P/E's ranging between 16x and 20x. But after a 65% drop in stocks and a huge drop in earnings estimates, we are down to a level where equities seem attractively priced. If we assume earnings of the S&P 500 have dropped to the $55-65 range from $90 and peg the price of the S&P at $700, the multiple range becomes 11x to 13x depressed earnings. This would put market valuations at one of the cheapest levels since 1974 and 1982 – both major bottoms.

- **Fiscal and Monetary Stimulus**

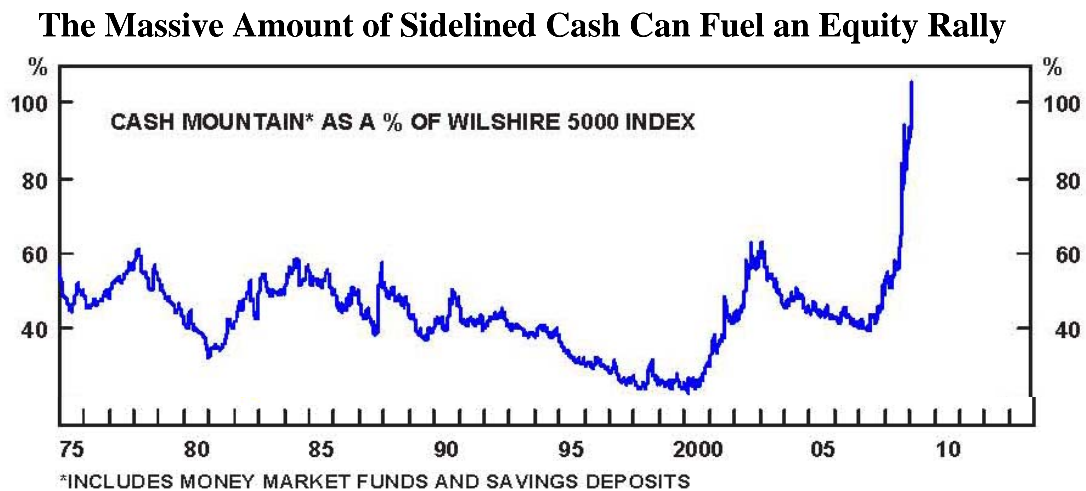
The stimulus package formulated by Congress should help the economy, even if the package is pork-laden. China has also produced a stimulus package as large as ours, and Europe, Japan and much of the rest of the world have followed suit. Most of the programs emphasize a combination of infrastructure and consumer stimulus and should eventually have a beneficial impact on the global economy.

During the last Fed meeting, Chairman Ben Bernanke, an expert on the Great Depression, decided to provide a huge monetary stimulus, which should also help the economy and the stock market. Like many other policy makers, Bernanke knows that the Depression-era Fed contracted the money supply when it should have done the opposite.

- **The New Bubble…Cash**

For stocks to enjoy a sustained recovery, cash needs to come into the market. At present, a huge amount of cash – money market funds and savings deposits -- sits on the sidelines. The chart below highlights how the build up in cash relative to the broad market (Wilshire 5000) has exploded. Ten years ago, when technology stocks were selling at the highest valuation levels ever, investors were stampeding into them. Now, almost 10 years later, investors are bailing out of stocks after a 65% drop and flocking into short term treasuries with yields not much more than zero!

The Massive Amount of Sidelined Cash Can Fuel an Equity Rally



Source: Cash Mountain - BCA Research, March 16, 2009

Summary

It may require some patience, but for the long-term value investor, market history suggests that after a 65% drop in stocks and after earnings have been adjusted downward, the stage is set for higher than average annualized rates of return over the next five years.

Jim Cullen
President

Disclosure:
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ROLLING 5-YEAR PERFORMANCE: BOTTOM 20% OF THE S&P 500 BY P/E

Annualized Rates of Return

Period	S&P 500 Bottom 20% by P/E	Period	S&P 500 Bottom 20% by P/E
1968-1972	**9.7%**	1987-1991	**10.5%**
1969-1973	**0.0%**	1988-1992	**15.4%**
1970-1974	**1.1%**	1989-1993	**14.5%**
1971-1975	**12.4%**	1990-1994	**10.1%**
1972-1976	**17.8%**	1991-1995	**23.2%**
1973-1977	**17.0%**	1992-1996	**17.9%**
1974-1978	**24.7%**	1993-1997	**22.0%**
1975-1979	**34.3%**	1994-1998	**17.8%**
1976-1980	**24.7%**	1995-1999	**18.2%**
1977-1981	**18.2%**	1996-2000	**13.9%**
1978-1982	**22.2%**	1997-2001	**13.3%**
1979-1983	**24.5%**	1998-2002	**4.7%**
1980-1984	**26.1%**	1999-2003	**12.1%**
1981-1985	**26.5%**	2000-2004	**16.0%**
1982-1986	**27.6%**	2001-2005	**15.4%**
1983-1987	**18.9%**	2002-2006	**16.0%**
1984-1988	**18.2%**	2003-2007	**17.3%**
1985-1989	**16.3%**	2004-2008	**-2.6%**
1986-1990	**6.1%**		

Source: S&P 500/SCCM Jan 2009