

Lending and Borrowing

Oiling the Economic Engine of Our Times

By now, we have all read and heard about the problems with the markets and the global economies. At the risk of oversimplification, it's about debt and credit-- too much of one (debt) and too little of the other (credit). Debt and credit are the lifeblood of our economy. We will address each one and its effect on our markets to date.

DEBT--Whether one is a consumer, a private business or a public corporation, the more debt, the more headwinds in an environment of contracting credit. Banks are hesitant to make any loans but especially to those who are perceived to have too much debt. This is also where our concern about mounting job losses appears. Debt and unemployment are a bad combination and have been the cause of many home foreclosures and a major factor in the housing downturn. Furthermore, for those that feel like their job *could* be lost, spending will surely be curbed.

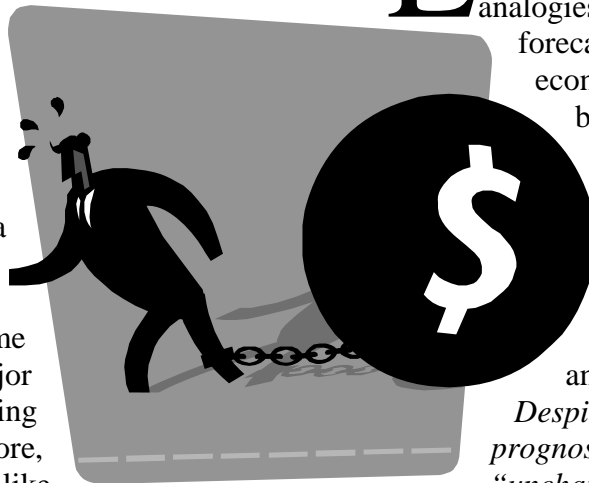
CREDIT--To make a medical analogy, if the economy is a muscle in spasm, credit is the lifeblood that needs to be pumped into the muscles. The fact is that there is no shortage of money in the system; it's simply hard to get to that money. Many businesses, large and small, depend on short term funding to keep operating on a daily basis. Short term

financing allows business owners to fund their payroll, pay vendors and "keep the lights on". The combination of a credit starved business and a retrenching consumer is a worst case scenario for any business. Tightening credit leads to lower consumption. The fact that banks are barely lending *to each other* is at the core of the problem. When this lending relationship thaws, we will be that much closer to a sustained economic recovery.

Let's put this into perspective. It is normal to reach for historical analogies to both explain and forecast the market and economy's direction. We do not believe that even the Great Depression or any one past recession is a good benchmark as the causes for each are very different, not to mention the policy tools available and how they are utilized.

Despite the numerous prognostications, we are always in "uncharted waters". The "D" word

is uttered more frequently with each opinion, though an actual definition to most is more elusive. A depression is a recession lasting two or more years with an unemployment rate of 25% or more. For the record, we do not share such a dire forecast. By definition a recession is a reallocation of capital within an economy. This process takes time and there is no quick fix. We, however, cannot help but notice certain encouraging relationships:



- **The S&P 500 yield (3.6%) is higher than the 10 year Treasury note (3.2%). This crossover has not happened in 50 years.**
- **General Electric's 2009 (forward) price earnings multiple (7.8x) is lower than GE's dividend yield (8.8%). Pfizer also falls into this category- P/E of 6.4x vs. yield of 8.2%.**
- **Approximately one-third of the market constituents of the S&P 500 could not requalify to get into the index because their market value is too low.**
- **The amount of global liquidity is equal to 80% of the value of the Wilshire 5000 index.**
- **On December 8, 2008 the United States Treasury auctioned \$30 billion of 4 week treasury bills at an interest rate of 0%. This issue was over-subscribed.**
- **The Boston Red Sox did not raise 2009 ticket prices for season ticket holders. This hasn't happened since the strike shortened season of 1995.**

(Observations noted above as of yearend 2008)

Although banks may be less willing to lend, the consumer is also less willing to borrow in this environment. The savings rate in the United States, which the government defines as the difference between what we earn and what we spend, is increasing. In a normal economic



environment, a growing rate of savings is healthy, but in a recession, it is seen as decreased spending and thus a further headwind for growth. If this trend gains momentum, it would cause declining employment and income, making it more difficult to save money.

This would make bank loan quality deteriorate, and banks even more hesitant to make loans. This "Paradox of Thrift" may make sense for the individual or family, but becomes a national problem if everyone increases their

rate of savings at the same time. We are now in an interesting transition where the private sector is moving from an era of too much debt to an era of thrift while the government now has the spending engine on full throttle as the Federal Reserve aggressively expands their balance sheet.



There is no doubt that our country and virtually all of the global economies are in the midst of a severe economic downturn/recession/slowdown. We would also point out that never before has there been such intense media coverage of these events as they occur. Job losses are being reported practically as they happen with 24/7 coverage and analysis of every economic report, "behind the scenes" stories, and a constant churning of the rumor mill. Technology channels such as the internet, cable television, Blackberries etc. bombard the consumer/investor with up to the second news about the latest market turmoil. This information flow reinforces a short term investment mentality that we

think is ultimately an unhealthy perspective as well as heightening the sensitivity of an already skittish investment community.

We have mentioned in past letters the need for “market clearing prices.” The former Lehman Brothers sold their portfolio of credit default swaps recently at a price of 9 cents on the dollar. While a painful transaction for the seller, now others know what those securities are worth. The introduction of an exchange for facilitating the trading of credit default swaps and other illiquid assets is a step in the right direction, though clearly later than we had hoped. Any asset is only worth what someone is willing to pay for it. A real estate analogy applies in this example: if an owner is selling a beautiful property in a great neighborhood...but only has 48 hours to sell it. As hedge and mutual funds are forced to sell securities to meet redemptions, these sales are being made in a market of fearful buyers, if at all. What results are days when the stock market drops hundreds of points in minutes (“There’s no bid to this market.”). Of the four stages of grief (denial, anger, sadness, acceptance), the Lehman transaction and the creation of a market clearing exchange could signal that we are further along this cycle than we may realize.

Understanding that publicly traded companies are feeling the full force of the economic downturn, many stocks are being sold without regard to their fundamental, long term, business prospects. This creates a market

where assets (stocks) are “mis-priced.” For the long term investor, this is where the opportunity lies.

Some of you have thoughtfully called to ask “How is Welch & Forbes doing in this market turmoil?” Since we are in the business of managing assets for a fee, we have taken our lumps like many others in our industry. Our strong relative performance has validated our investment process, but we understand that is small consolation in markets like this. We are thankful not to be affiliated with a bank, brokerage firm or any entity that takes proprietary risk or sells products. Welch & Forbes and its employees remain stable, objective and focused on the individual needs of our clients. We will never forget the fact that without our clients, we have no business.

Two steps are critical to an economic recovery: a stabilization of the housing sector and a free flow of credit that will allow the Federal Reserve’s low interest rates to increase demand. At the end of the day, we are a nation of survivors. Our economy will survive the test as well and hopefully our financial leaders will learn some lessons along the way to make our economy more resilient for the future. We are here for you as we have been for one hundred seventy years and we invite your thoughts and comments. As always, we appreciate your trust in Welch & Forbes- especially during these difficult times. ♦

