



ATLANTIC CAPITAL MANAGEMENT

## THE WEALTH EFFECT DEFINED

**Asset Choices May Halt the Consumer**

SPECIAL INVESTMENT RESEARCH REPORT  
MARCH 12, 2008

Written By  
Jeffrey P. Snider, Vice President

## TABLE OF CONTENTS REPORT SUMMARY

|         |   |
|---------|---|
| Page 1  | <b>Introduction</b><br>Personal Consumption Expenditures (PCE) are the key in the slow growth vs. contraction debate.   |
| Page 2  | <b>Part 1 – The History of American Consumerism</b><br>American consumers/savers invested in the stock market in great numbers starting in the early 1980's. Because the rates of returns on equities were greater than the other personal sector assets consumers/savers did not need to save as much income. Money that used to go toward savings was spent.  |
| Page 3  | Supporting evidence for Part One: Chart 1 – Composition of Personal Sector Assets (1951 – 2007), Chart 2 – Flow of Funds into Personal Sector Assets as a % of Total Financial Assets (1951 – 2007), Chart 3 – Growth of Personal Sector Net Worth (1951 – 2007)  |
| Page 4  | Chart 4 – Income minus Spending as a % of Personal Sector Assets (1947 – 2007), Chart 5 – PCE as % of GDP (1947 – 2007).  |
| Page 5  | <b>Part 2 – A Lesson from the Dot.coms</b><br>Net Worth Growth suffered through the bear market of 2000 – 2002, but the recession that followed was the mildest on record and took over a year to materialize. The reasons were 1. the bear market was slow moving, 2. there was another efficient asset class available as an alternative to stocks, 3. consumers had the ability to borrow when income and assets were weak.    |
| Page 6  | The beginning of the housing boom bailed out consumer spending. The 1990 recession was a similar story, net worth declined because of an asset class but without borrowing the recession was more severe than 2001. Both recessions were mild and quick because of alternate asset classes that kept net worth growth on track.<br>Supporting evidence for Part Two: Chart 6 – Growth of Personal Sector Net Worth (1998 – 2003), |
| Page 7  | Chart 7 – Flow of Funds to Personal Sector Assets as a % of Disposable Income, 2 Year Moving Average offset 2 years (1996 – 2003), Chart 8 – Change in PCE & GDP (1998 – 2003), Chart 9 – Total Mortgages as a % of Total Personal Sector Real Estate Assets (1997 – 2007).   |
| Page 8  | <b>Part 3 – A Break in the Trend?</b><br>Net Worth growth is no longer growth as both stocks and housing are suffering. With no alternative asset choices for efficient returns, no ability to borrow, no funds from banks to borrow, consumers/savers will be forced to increase cash flows to financial assets, increase saving and reduce spending.  |
| Page 9  | The contraction coming/already here should be more severe than the previous two because the net worth growth trend may be breaking.<br><b>Part 4 – Three-Legged Performance</b><br>Analysis of stock market performance during the last five economic contractions.   |
| Page 10 | Charts of the S&P 500 stock index for each of the five contractions and the current chart. Each chart demonstrates the three-leg pattern.   |
| Page 11 | Raw data on the charts from Page 10.  |
| Page 12 | The current market appears to be following the same trend. We may have already experienced the first leg down and the first fools' rally. If  |

this market pattern holds, and we believe it will, there is significantly more downside to come, and we are still early in the process.

Page 13

## **Part 5 – Policy Disaster**

The Federal Reserve has abandoned inflation fighting in favor of stimulative policies. Rate cuts and repurchase agreements cannot stimulate demand since the banking system is not functioning. The real goal of the Fed may be to buy time until the normal functioning of the credit markets returns, which also appears to be the goal/hope of financial institutions.

Page 14

The Fed has undertaken drastic action with inflation ALREADY high. Since we do not believe the Fed has any ability to prevent a contraction it is actually doing more harm than good. As such, the Fed may be prolonging the downturn and adding to the severity.

Page 15

The correct Fed policy is to raise rates now. The other policy factor that may affect the recovery is the policy on taxation. November's election may signal a change on the favorable taxation climate we now enjoy – again endangering the recovery.

Page 16

## **Conclusions**

Page 17

## **Endnotes**

## INTRODUCTION

### THE WEALTH EFFECT DEFINED

#### Asset Choices May Halt the Consumer

We ended our Special Report in November with a hard choice for the Federal Reserve: to fight inflation by increasing interest rates and slowing money supply growth, or to lower interest rates and accelerate money supply growth to stimulate demand. The Fed has made its choice clear, as Fed Chairman Bernanke proclaimed his desire to lower rates until this current “weak spot” passes<sup>1</sup>.

The difference between slow growth and contraction is not just an exercise in semantics. Those that expect slowing growth but no contraction are counting on consumers to keep the economy moving forward while the financial system works out the credit crunch. While much has been made over the last few decades of American consumerism, there are two components to it: willingness and ability. We have no doubt that American consumers are willing to stay consumers, the recent spike in borrowing against retirement accounts is a testament to how far they will go to maintain lifestyle, but the ability is now very much in question.

Looking back over the past twenty-five plus years of consumer spending reveals the weakness in the slow growth argument. There were several definable trends that allowed consumer spending to become such a big part of the economy. Those trends may be breaking. The credit crunch is not a cause of the current economic weakness, but a symptom of the breakdown in those trends.

We believed in August that a contraction was unavoidable. Looking at this new data we now believe that it is not only unavoidable it is likely to be more severe than previously thought. We now want to focus on how the stock markets may perform under such circumstances and several factors, including the Fed’s stimulative stance, that may increase the severity of the downturn and the time to recovery.



## Part 1 The History of American Consumerism

Personal consumption expenditures (PCE), the total amount of goods and services purchased by individuals, accounts for approximately 70.5% of all economic activity, or almost \$10 trillion in 2007<sup>2</sup>. It is no wonder that the recession vs. slow growth debate always hinges on one's outlook for the consumer. The slow growth side views the credit crunch as a banking system phenomena, distanced somewhat from consumer spending. We view it, as we stated in the introduction, as a symptom of a larger problem affecting consumers themselves. This section will detail how consumer spending became so important to the economy, and in doing so the weakness should become clear.

In the second quarter of 1980 the Federal Reserve began a campaign of restrictive money supply policies to slow persistent inflation leftover from the 1970's. That campaign produced a nasty period of economic contraction; some have dubbed it a double dip recession after the economy recovered in late 1980 and early 1981 only to fall into another contraction that lasted until the third quarter of 1982. In 1981 PCE only accounted for 61.8% of GDP. While that may not sound far below today's share, that 8.7% difference is \$860 billion a year in today's money.

The victory over inflation started a period of 25 years of steady, nearly uninterrupted, economic growth. During that period PCE grew at a faster rate than the overall economy, and its share of GDP grew from 61.8% to 70.5%. The conventional explanation is selfish consumers spending irrationally at the expense of their futures.

In order to spend more money consumers either have to make more or save less. Growth in Disposable Personal Income (DPI), like GDP, entered a period of slower, more stable growth. Without the requisite

increase in income, consumers saved less. The savings rate of the personal sector (measured as DPI minus PCE as a percent of DPI) was 15% at the end of 1981. By the time of the dot-com bust that savings rate had fallen to 5.73%, and it currently sits at 4.21%. As reckless as it sounds the demise of the American saver was not at all a demise, nor was it reckless. There was a rational explanation – the stock market.

Despite a falling savings rate total Personal Sector Net Worth (NW) grew at an astonishingly solid rate during the 25-year period. Looking at it another way, cash flows into Personal Financial Assets (PFA) averaged 8% in the early 1980's<sup>3</sup>. Savers, on average, had to add an additional 8% in new money to their savings every year just to maintain the same growth in Net Worth. Beginning in 1985 that new money rate began to sharply decline until it stood at 1.64% in the first quarter of 2001. In other words savers in 2001 had to put far less additional money into savings than their 1985 counterparts to achieve the same growth in net worth. The asset mix savers/consumers turned to was much more efficient in terms of generating returns.

In 1981 stocks only accounted for 15.5% of Personal Sector Assets – Real Estate (RE) accounted for 41%, while time and savings deposits were 16.8%. The defeat of structural inflation unleashed a great bull market that the American public participated in at unprecedented levels. Only 4.6 million households owned mutual funds in 1980, by 2001 51.7 million households owned mutual funds<sup>4</sup>. In terms of the asset mix, at the top of the market in 2000 stocks accounted for 36% of all personal sector assets.

With more personal assets going to the stock market (very attractive in the early 1980's as the inflation rate came down coupled with historically low valuations) the higher



returns generated by the bull market meant less new money was needed to maintain consistent growth in net worth. In fact, net worth grew at a higher rate despite the

decline in savings. Relieved of the need to save and add to assets, consumers spent.

Economic recovery in 1981 & 1982, with lower inflation, started a bull market in stocks. Growing availability of mutual funds and retirement accounts led to a shift in the asset mix of the personal sector to include more stocks.

Increased use of stocks created more efficient assets for the personal sector. That meant that less new money was needed to maintain asset and net worth growth. By 1985 cash flows to personal sector assets began to decline dramatically.

Net worth growth remained relatively constant despite the decrease in new cash into assets. New worth growth turned negative in late 1989 & 1990, and then again in 1997 (Asian flu hitting the stock market) and again in 2000 & 2001.

CHART 1 - Composition of Personal Sector Assets

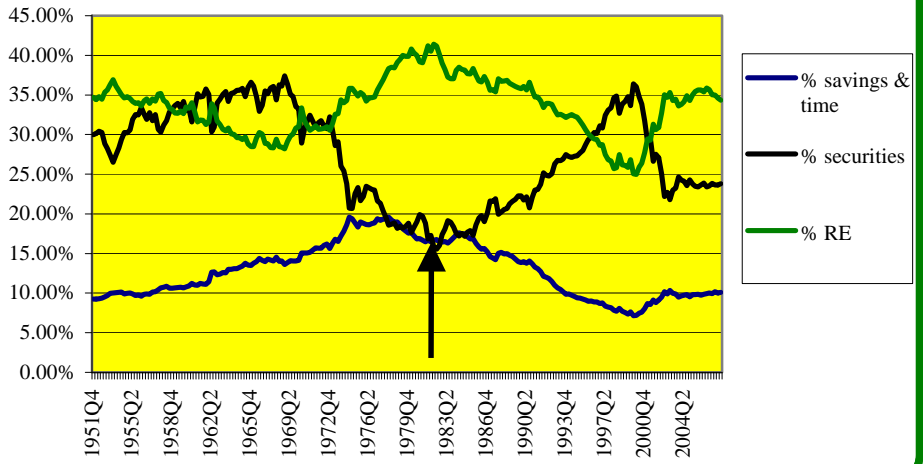


CHART 2 - Flow of Funds into Personal Finl Assets as % of Total Finl Assets

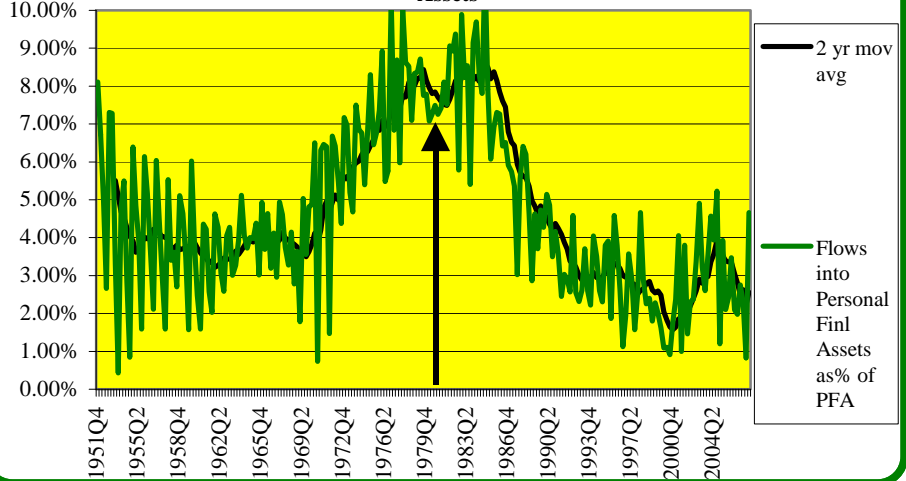
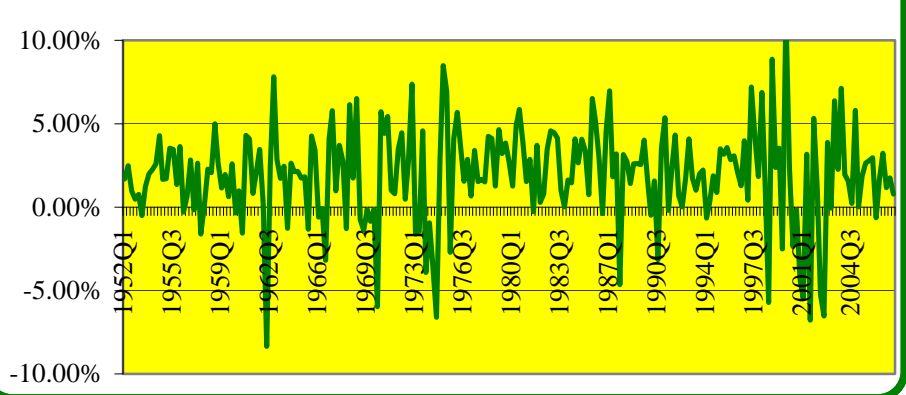


CHART 3 - Growth of Personal Sector Net Worth

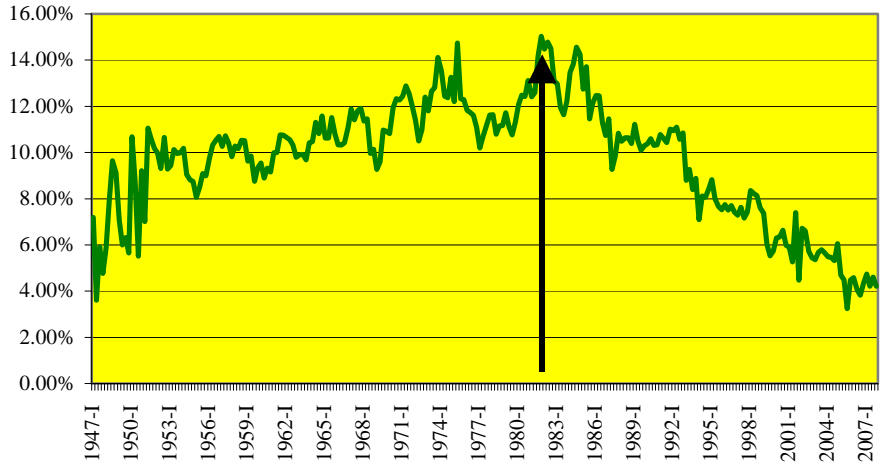




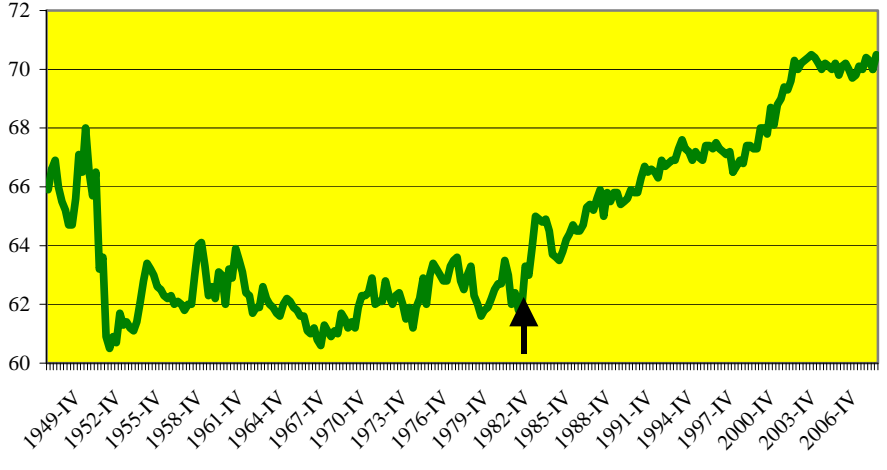
Increased overall returns on assets meant that less money needed to be saved to maintain net worth growth. Less money saved means consumers had the ability to spend more.

Growth in consumption outpaced overall GDP growth from 1981 through 2001 because of the net worth efficiency.

**CHART 4 - Income minus Spending as a % of Financial Assets**



**CHART 5 - PCE as % of GDP**





## Part 2 A Lesson from the Dot.coms

The stock market (as measured by the S&P 500 index) peaked in March 2000. What followed was one of the longest, deepest, and most painful bear markets of the last 50 years. Yet the recession that followed the stock bust was relatively mild. Given the dependence of the economy on consumers and the dependence of consumer spending on net worth growth, how could a blowup in the largest class of assets not destroy the consumer?

First, the bear market was a slow moving bear. Unlike a crash this bear took 931 days peak to trough, over two and a half years. Even though it was, as Tom Nolan was fond of saying then, like Chinese water torture it did allow for an orderly exit from stocks and into other asset classes. Second, consumers with relatively healthy balance sheets and NW's were able to borrow. Third, there was another asset class ready to take on some of the load that stocks were bearing.

Personal sector growth in net worth peaked in the fourth quarter of 1999. By the second quarter of 2000, NW growth that had averaged 10.4% annually since the last recession dropped to a 5.7% annual rate of contraction through the first quarter of 2003. As you may expect (again rational behavior), savers/consumers responded by cutting back on spending, but only a little at first.

It was not until the beginning of 2001 that PCE growth slowed noticeably. Following the trend described in Part 1, PCE growth was affected only after a marked increase in cash flows to Personal Financial Assets and the accompanying increase in the savings rate.

But consumer spending never contracted, it only slowed. Because of the slow moving bear market revolving consumer credit (credit cards) expanded throughout 2000,

not slowing until early 2001 when it became clear that the bear market, and the decline in NW, were more serious than previously thought. It was this borrowing that kept the recession at bay until the middle of 2001, a year and a half after the top of the bull market.

When credit card borrowing began to dry up in early 2001, PCE growth slowed from an average growth rate of 5.9% annually since the last recession to a 4% annual rate through 2003. That slowdown, added to the contraction in business spending from the dot-com bust, created the very mild 2001 recession.

The mild recession probably would have been much worse had consumers not had the housing option. DPI growth was weak throughout 2000 and 2001, so income was no help. NW was still contracting and cash flows into assets were rising. Without revolving consumer credit as an alternative PCE growth should have weakened more dramatically. It was the beginning of the housing boom that got consumers through.

Because RE was declining as a percent of all assets does not mean that RE was a bad asset. It just means that stocks were performing much better through the late 1980's and 1990's. From 1993 until 1999 real estate as a personal sector asset enjoyed solid growth. And homeowners even enjoyed cashing in some of the new equity in the form of mortgage refinancing and home equity loans. From 1991 through 1999 mortgages as a percent of real estate values increased from 39.6% to 44.9%.

By early 2001, consumers were ready to use real estate equity to keep slowing spending from getting slower. Mortgages as a percent of personal sector RE<sup>5</sup> (again, a measure of cashing in home equity) began rising sharply. Mortgage rates had fallen below



7% and were headed to rates not seen since the 1960’s. With home equity to spare, low rates, and a need for borrowing to replace revolving consumer credit, the housing boom began.

This new boom also provided an alternative asset that could provide sufficient returns to keep NW growth steady without new savings. As the demand for home equity loans was fed by the historically low mortgage rates it also made the cost of acquiring homes as an asset attractive. By the end of 2002 NW growth, PCE growth, and PDI growth had returned to pre-dotcom levels while stocks continued to struggle.

A similar story played out in the 1990 recession. This time NW growth was imperiled by trouble in the real estate market. That created the need to add cash to personal financial assets to try to stem the tide, which, in turn, led to a decline in PCE growth. PCE did contract, the fourth quarter of 1990 and the first quarter of 1991. With RE assets the problem, tapping equity was not an option.

What made this contraction mild was the equity market in the middle of its bull run. Even though the bull paused for the recession (and the build up for the Gulf War - the exact same period that PCE declined) the pause was relatively short. Stocks regained profitability quickly and PCE growth returned.

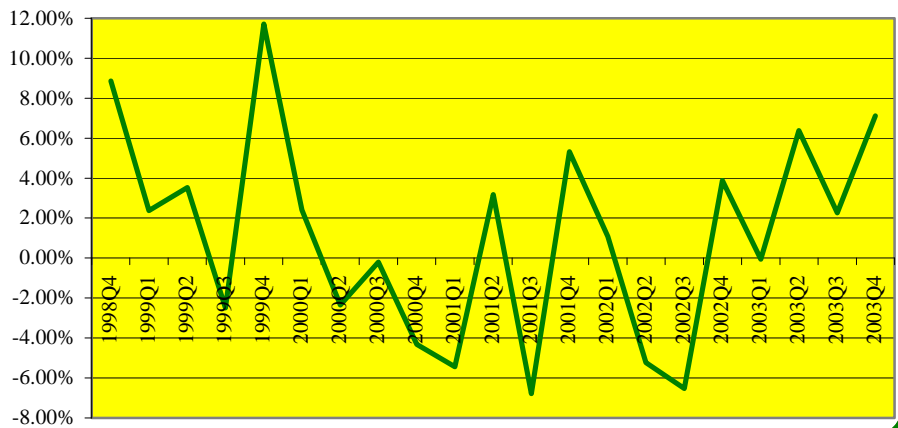
Looking at both recessions, consumption can be viewed as a function of asset and net worth growth. In 2001 the bear market hit NW. Borrowing filled in until consumers could regain their footing with the start of the housing boom, and then a recovery in stocks. Because of the borrowing ability, and the housing asset alternative, the slowdown in PCE growth was mild, and the recession as a whole was the mildest on record.

In 1990 another asset class halted NW growth and the result was the same. An alternate asset class performed well, and when it did pause PCE growth slowed, and even contracted. Without additional borrowing to fill the void the slowdown was more severe than 2001, but the quick return of NW growth from a very short stock market contraction allowed PCE growth to recover quickly, keeping the overall recession relatively mild.

Both recessions were relatively small in duration and depth because the long-term trend in net worth growth remained intact, with borrowing helping out in 2001. That trend was put in motion with the defeat of structural inflation in the early 1980’s and the increase in efficiency of the overall asset mix of the personal sector.

The stock market peaked in March 2000, producing a decline in personal sector net worth for four consecutive quarters (and five out of six quarters) beginning in the second quarter of 2000.

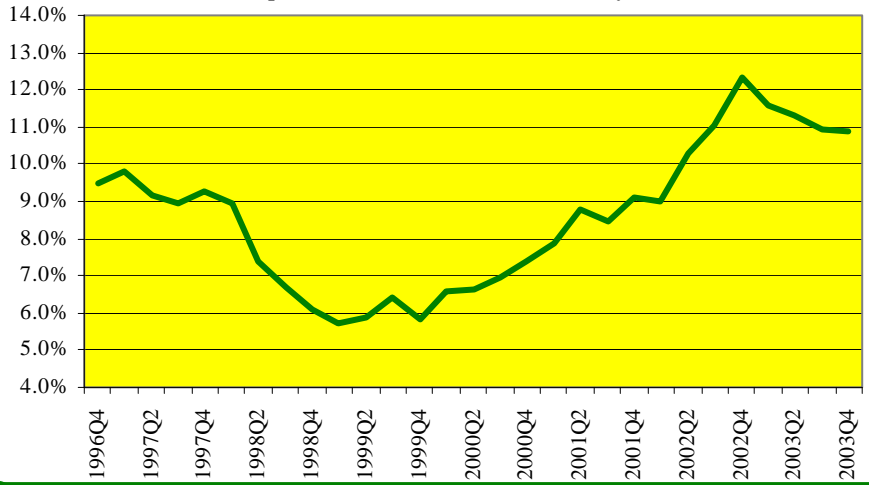
CHART 6 - Growth of Personal Sector Net Worth





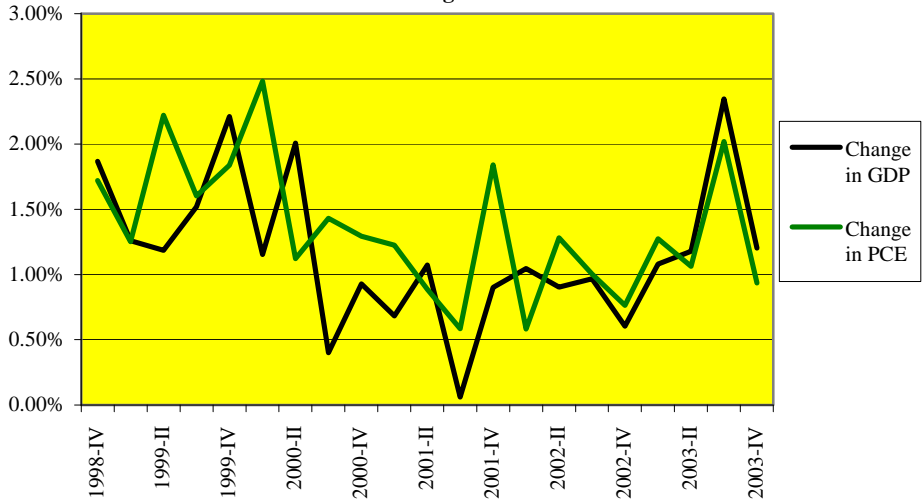
The decline in personal sector net worth forced consumers to save more. As a percent of personal disposable income, cash flows into personal financial assets moved noticeably higher in early 2000.

CHART 7 - Flow of Funds to Personal Sector Financial Assets as % of Disposable Income (2 Yr MA offset 2 years)



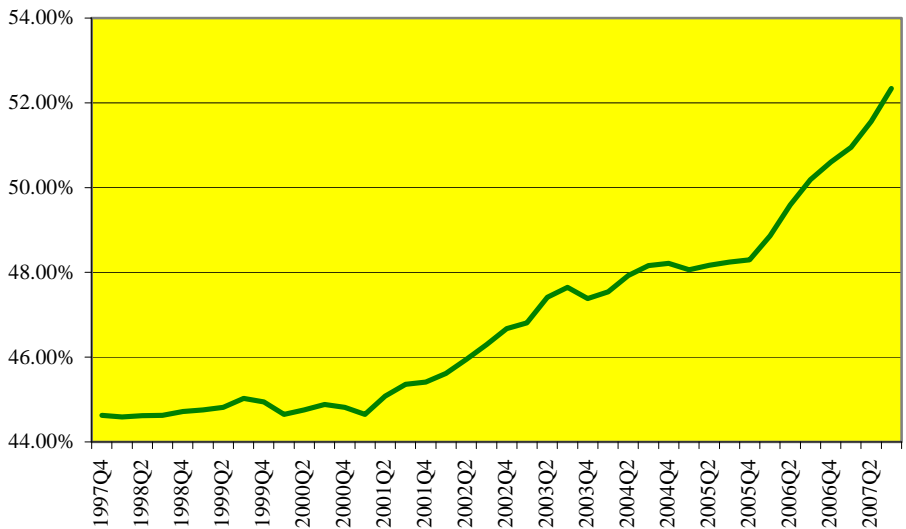
Having to put more cash into assets to offset the drop in net worth, consumer spending growth falls, but does not decline.

Chart 8 - Change in PCE & GDP



Just as PCE growth begins to decline significantly borrowing in the form of personal sector mortgages picks up. Even though growth in net worth continues to struggle and cash flows into assets remains high into 2002 PCE growth bottoms and begins to recover.

CHART 9 - Total Mortgages as % of Total Personal Sector Real Estate Assets





## Part 3 A Break in the Trend?

Data is still coming in from the fourth quarter of 2007, so definitive evidence of a decline in the growth of personal sector net worth is not yet in hand. But there is plenty of preliminary evidence demonstrating trouble in the asset mix. The median selling price of homes in the US declined **15.1%**<sup>6</sup> in January. That would translate to a \$3 trillion decline in the value of personal sector real estate, and a decline of 5.1% of personal sector net worth. That decline is close to the 6.7% drop registered at the low point of the 2001 recession (the third quarter of 2001). And that was just January.

Stocks are down 15% (as measured by the S&P 500) since October. As realization of the likelihood of recession has set in, stocks have fallen further and are not likely to recover anytime soon (more on that in the next section).

Because of the availability of alternate efficient assets in 1990 and 2001 the pause in the trend of long-term NW growth was short. In 2008, with RE contracting severely and stocks struggling, there is no alternate asset class except time and savings deposits. Those assets do not generate sufficient returns to keep the savings rate at its currently low level. That means that cash flows to assets will have to increase, and consumer spending will have to adjust lower.

While borrowing was an option for consumers in 2001, consumers who had built up equity in homes, in 2008 those consumers have tapped their equity and then some. The credit crunch is the major symptom of that fact.

Credit card borrowing is not an option either. Since the credit crunch is ravaging the banking system it does not have the ability to bail out consumer spending. The

biggest source of growth in consumer credit for the first half of 2007 was from commercial banks and securitized pools. The securitized pool lending dried up by October 2007 (along with the rest of the credit derivative market) and commercial bank lending failing in 2008. And even if banks did have the cash to lend they are not going to lend like they did in 2006. As a result of the credit crunch banks are being forced to tighten credit standards to conserve capital in an effort to maintain minimum capital reserve ratios.

Without the ability to borrow sufficiently, consumer spending will be weak in the short-term. The current spike in borrowing against 401k plans<sup>7</sup> reinforces the idea that consumers have run out of places to find money. Borrowing against retirement is a last resort move.

And remember, even with the ability to borrow PCE growth slowed and a recession followed in 2001. Add to the mix a troubling employment picture, which is already pressuring DPI growth (contracting on an inflation-adjusted basis in January). A slowdown in consumer spending has already arrived, as PCE in December and January were flat on an inflation-adjusted basis. There is also anecdotal evidence from the earnings reports of Wal-Mart and McDonalds – both reported upbeat earnings as consumers sought out cheaper alternatives in record numbers, Walmart with consumer goods, and McDonalds with prepared food. The consumer bailout of the slow growth argument does not hold up in the face of the evidence.

Looking at it from an intermediate perspective this is a classic recession scenario. That was the conclusion we reached in August 2007. What we are now trying to ascertain is the depth and breadth.



From a longer-term prospective the trend in NW growth without efficient asset alternatives is troubling. Without an asset class generating effective returns consumers will be forced to save rather than spend. The two efficient return-generating asset classes both have major problems. The real estate market is experiencing a severe contraction and it will probably be anywhere from two to five years before we see any turnaround. Even then we do not expect to see 2004 and 2005-type price appreciation; the returns are going to be much more modest. But that will be no help to the consumers of 2008.

A return of the bull market in equities to drive NW growth needs a strong economic growth environment with low and steady inflation. Both of those foundations are now threatened – current valuations do not take

into account a more severe downturn, and inflation pressures are already evident.

Without those two asset classes performing effectively, and without a borrowing alternative, the contraction should be more severe than 2001 and 1990. Whether or not it will constitute a recession is an argument for academics, for investors the exercise is pointless. All that matters is that there is now the climate for sustained weakness in consumer spending and a return of persistent structural inflation. The next sections will detail our analysis of how the stock markets should react, and two additional factors that are likely to affect the length and depth of the contraction.

## Part 4 Three-Legged Performance

During the last five economic contractions/recessions, the stock market has reacted in predictable fashion. Each market shows an “approach” characterized by a new high followed by a slight downturn and a recovery to the high, or just below it. The approach is usually the first inkling of trouble that takes the market by surprise, but is easily set aside as optimism reigns. Following the approach is three successive severe downturns (legs). A fools’ rally separates each leg. Each leg down is typically started by negative economic data showing that economic contraction is more and more likely or severe. Each fools’ rally is kicked off by bargain hunters and then

carried by optimism that there is a solution just around the corner that is ultimately proved false by more negative economic data.

Looking at the charts on Page 10, each recession shows the approach, three legs down and the rallies in between. Only the 1990 recession was weak in its pattern – the recession was overshadowed by geopolitical events, namely the Gulf War. But even that bear market had some resemblance to the three-leg pattern.



1981 Double Dip



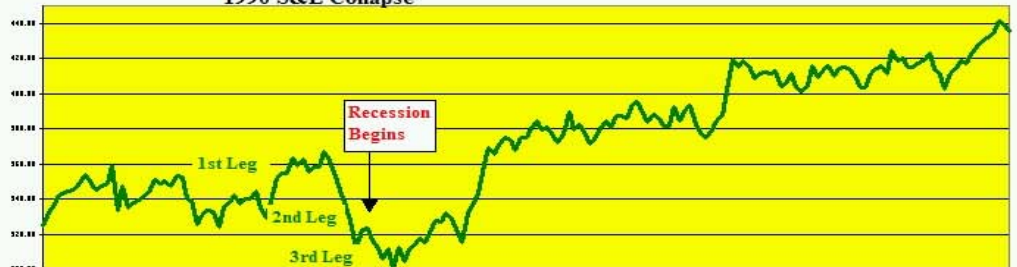
1974 Oil Shock



1971 Inflation Shock



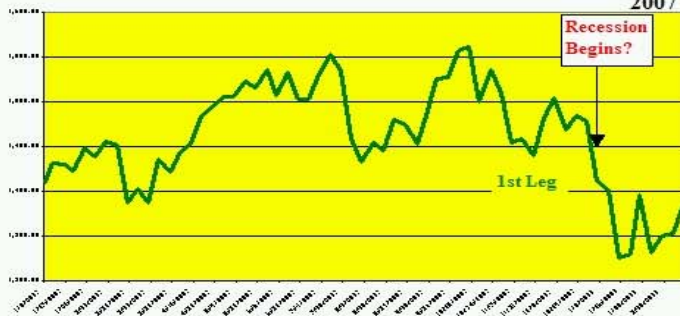
1990 S&L Collapse



2001 Dot.Com Bust



2007 Credit Crisis





| 1981 Double Dip                     |               |                |                |                 |
|-------------------------------------|---------------|----------------|----------------|-----------------|
|                                     | Value         | Date           | % Move         | Time            |
| Initial High                        | 141.96        | 11/24/80       |                |                 |
| Approach High                       | 135.18        | 8/10/81        | -4.78%         | 259 days        |
| 1st Leg Down                        | 111.64        | 9/21/81        | -17.41%        | 42 days         |
| Fools' Rally                        | 127.32        | 11/30/81       | 14.05%         | 70 days         |
| 2nd Leg Down                        | 104.46        | 3/8/82         | -17.95%        | 98 days         |
| Fools' Rally                        | 119.92        | 5/10/82        | 14.80%         | 63 days         |
| 3rd Leg Down                        | 102.20        | 8/9/82         | -14.78%        | 91 days         |
| <b>Total Decline</b>                |               |                | <b>-28.01%</b> | <b>623 days</b> |
| Initial Recovery                    | 143.99        | 11/1/82        | 40.89%         | 84 days         |
| <b>Full Recovery</b>                | <b>171.60</b> | <b>6/20/83</b> | <b>67.91%</b>  | <b>231 days</b> |
| Time to Even<br>(from initial High) |               | 10/18/82       |                | 693 days        |

| 1974 Oil Shock                      |               |                 |                |                 |
|-------------------------------------|---------------|-----------------|----------------|-----------------|
|                                     | Value         | Date            | % Move         | Time            |
| Initial High                        | 121.74        | 1/8/73          |                |                 |
| Approach High                       | 112.31        | 10/22/73        | -7.75%         | 287 days        |
| 1st Leg Down                        | 89.53         | 2/11/74         | -20.28%        | 112 days        |
| Fools' Rally                        | 101.05        | 3/11/74         | 12.87%         | 28 days         |
| 2nd Leg Down                        | 85.87         | 5/28/74         | -15.02%        | 78 days         |
| Fools' Rally                        | 93.76         | 6/3/74          | 9.19%          | 6 days          |
| 3rd Leg Down                        | 60.96         | 9/30/74         | -34.98%        | 119 days        |
| <b>Total Decline</b>                |               |                 | <b>-49.93%</b> | <b>630 days</b> |
| Initial Recovery                    | 96.58         | 7/14/75         | 58.43%         | 287 days        |
| <b>Full Recovery</b>                | <b>107.82</b> | <b>12/27/76</b> | <b>76.87%</b>  | <b>532 days</b> |
| Time to Even<br>(from initial High) |               | 12/27/76        |                | 1449 days       |

| 1971 Inflation Shock                |               |               |                |                 |
|-------------------------------------|---------------|---------------|----------------|-----------------|
|                                     | Value         | Date          | % Move         | Time            |
| Initial High                        | 109.37        | 12/2/68       |                |                 |
| Approach High                       | 106.74        | 5/12/69       | -2.40%         | 161 days        |
| 1st Leg Down                        | 88.04         | 7/28/69       | -17.52%        | 77 days         |
| Fools' Rally                        | 99.23         | 11/10/69      | 12.71%         | 105 days        |
| 2nd Leg Down                        | 84.42         | 1/26/70       | -14.92%        | 77 days         |
| Fools' Rally                        | 91.07         | 3/23/70       | 7.88%          | 56 days         |
| 3rd Leg Down                        | 68.61         | 5/25/70       | -24.66%        | 63 days         |
| <b>Total Decline</b>                |               |               | <b>-37.27%</b> | <b>539 days</b> |
| Initial Recovery                    | 105.60        | 4/26/71       | 53.91%         | 336 days        |
| <b>Full Recovery</b>                | <b>121.74</b> | <b>1/8/73</b> | <b>77.44%</b>  | <b>623 days</b> |
| Time to Even<br>(from initial High) |               | 3/6/72        |                | 1190 days       |

| 1990 S&L Collapse                   |               |                 |                |                 |
|-------------------------------------|---------------|-----------------|----------------|-----------------|
|                                     | Value         | Date            | % Move         | Time            |
| Initial High                        | 360.44        | 10/9/89         |                |                 |
| Approach High                       | 360.59        | 1/2/90          | 0.04%          | 85 days         |
| 1st Leg Down                        | 319.83        | 1/29/90         | -11.30%        | 27 days         |
| Fools' Rally                        | 369.78        | 7/16/90         | 15.62%         | 168 days        |
| 2nd Leg Down                        | 306.18        | 8/20/90         | -17.20%        | 35 days         |
| Fools' Rally                        | 326.53        | 9/10/90         | 6.65%          | 21 days         |
| 3rd Leg Down                        | 294.51        | 10/8/90         | -9.81%         | 28 days         |
| <b>Total Decline</b>                |               |                 | <b>-18.29%</b> | <b>364 days</b> |
| Initial Recovery                    | 370.96        | 2/19/91         | 25.96%         | 134 days        |
| <b>Full Recovery</b>                | <b>419.79</b> | <b>12/30/91</b> | <b>42.54%</b>  | <b>314 days</b> |
| Time to Even<br>(from initial High) |               | 2/4/91          |                | 483 days        |

| 2000 Dot.com Bust                   |                 |                 |                |                 |
|-------------------------------------|-----------------|-----------------|----------------|-----------------|
|                                     | Value           | Date            | % Move         | Time            |
| Initial High                        | 1,552.87        | 3/20/00         |                |                 |
| Approach High                       | 1,530.09        | 8/28/00         | -1.47%         | 161 days        |
| 1st Leg Down                        | 1,091.99        | 4/2/01          | -28.63%        | 217 days        |
| Fools' Rally                        | 1,315.93        | 5/21/01         | 20.51%         | 49 days         |
| 2nd Leg Down                        | 944.75          | 9/17/01         | -28.21%        | 119 days        |
| Fools' Rally                        | 1,154.45        | 3/25/02         | 22.20%         | 189 days        |
| 3rd Leg Down                        | 843.27          | 10/7/02         | -26.95%        | 196 days        |
| <b>Total Decline</b>                |                 |                 | <b>-45.70%</b> | <b>931 days</b> |
| Initial Recovery                    | 1,163.23        | 3/1/04          | 37.94%         | 511 days        |
| <b>Full Recovery</b>                | <b>1,217.33</b> | <b>12/27/04</b> | <b>44.36%</b>  | <b>301 days</b> |
| Time to Even<br>(from initial High) |                 | 7/9/07          |                | 2667 days       |

| AVERAGES                            |                |                  |
|-------------------------------------|----------------|------------------|
|                                     | % Move         | Time             |
| Initial High                        |                |                  |
| Approach High                       | <b>-2.51%</b>  | <b>173 days</b>  |
| 1st Leg Down                        | <b>-19.09%</b> | <b>97 days</b>   |
| Fools' Rally                        | <b>13.40%</b>  | <b>76 days</b>   |
| 2nd Leg Down                        | <b>-18.66%</b> | <b>81 days</b>   |
| Fools' Rally                        | <b>12.14%</b>  | <b>67 days</b>   |
| 3rd Leg Down                        | <b>-22.24%</b> | <b>99 days</b>   |
| <b>Total Decline</b>                | <b>-35.84%</b> | <b>593 days</b>  |
| Initial Recovery                    | <b>43.43%</b>  | <b>270 days</b>  |
| <b>Full Recovery</b>                | <b>61.82%</b>  | <b>400 days</b>  |
| Time to Even<br>(from initial High) |                | <b>1296 days</b> |



Using the average of those five market events we can develop a guide for the market in 2008/2009. The average total downturn, from peak to trough, is 35.8%. The average recovery from trough to peak is 61.8%, high volatility that creates investing opportunities. Looking at a current chart of the S&P 500 the approach occurred between early July and early October 2007. It was around July that the idea of a credit crunch became a possibility (after the June news of the Bear Stearns hedge funds kicked off the fun). Optimism returned in August as policy makers and talking heads, who were decidedly incorrect or just plain dishonest, reassured investors that this was a subprime mortgage problem despite a commercial paper market that had ceased to function. In September a little doubt crept in during the bank run (described in our November Special Report) but the Fed came to the rescue with rate cuts, and the market moved up again, surpassing its July high by a few points. A parade of economic reality – massive bank write-downs, consumer weakness, lower earnings forecast from financials at first – kicked off the first leg down in October. The Fed was able to briefly rally the market in mid-December with more rate cuts and bailout fantasies, but economic reality was too much for the markets leading to a January 2008 low and an end of the first leg. The first fools' rally has been given legs by more bailout rumors, this time the bond insurers (which completely ignores the failure of all the previous bailout attempts – SIV bailouts, mortgage foreclosure bailout, foreign capital infusions) after being started by rate cuts.

The optimism carrying the current rally should eventually be overwhelmed by the realization that the Fed cannot fix the problem (and is making it worse). The nearly 3% drop in the markets on Thursday

February 28, may signal investors are waking up to that possibility. That decline was caused by the release of revised GDP numbers from the fourth quarter of 2007 that did not revise growth upward, and in fact revised consumer spending lower. That was followed by weak forecasts from Sears and Dell, and then joined by a prediction of more bank failures from the Fed Chairman. All of this bad news flies in the face of the 2.25% drop in the federal funds rate, and numerous “temporary” repurchase agreements.

Whether or not February 28 was the start of the second leg down remains to be seen. What we do know is that the average time for the market to fully recover is 1,296 days or 3.6 years. While it appears that events are moving faster than in the past (maybe technology plays a part) the first leg down was actually a week longer than the average. From that we can infer that we are still in the early stages of this market trend.

While we are not market technicians by any stretch of the imagination there is enough data to accept the market trend. The lack of options for consumers/savers gives this contraction the potential for more depth and more breadth than the last two contractions. We expect a market decline (peak to trough) to be at least 30% and 35%. That is another 15% to 20% before the bottom. And we expect that by the end of 2008 we will still be searching for that bottom – the average time peak to trough is 623 days, or nearly 2 years. There are still many unsettled factors that need more time to fully play out which will determine the length and severity of both the economic contraction and the stock market's decline.



## Part 5 Policy Disaster

We said in our November report that the Fed would have to choose whether to continue fighting inflation or promoting growth. On February 27, Fed Chairman Bernanke signaled that the Fed has changed its stance – slowing growth is now a bigger problem than inflation and more rate cuts would be forthcoming<sup>8</sup>. In our opinion the Fed is not only wrong in its assessment, the rate cuts it proposes are counterproductive and may prolong the downturn. The Fed needs to come to the realization that rate cuts cannot spark demand in the current environment.

Rate cuts are designed to allow banks more freedom to make more loans since the rates they pay for deposits often follow the Fed's lead. That also leads to a decline in rates charged to borrowers, making borrowed funds more attractive, leading to more economic activity. But the exact opposite is happening. Consumer and business credit is tightening regardless of the direction of interest rates. Lending standards, as discussed above, have increased as a consequence of the subprime-lending spree. Banks are stretched to the limit already and cannot afford to perform their recession-saving role of making credit widely available. Cutting rates to zero will not change that. Only full disclosure and knowledge of potential credit losses will, and that picture is not getting any better with credit problems spreading beyond mortgages to credit cards and other consumer credit.

The “temporary” repurchase agreements the Fed has introduced to the banking system have become less temporary. Under these agreements banks can post collateral in any form, even credit derivatives that are basically worthless. At face value, the Fed is essentially transferring risk from the banking system and replacing it with fresh Fed capital, supposedly freeing them from declining capital ratios and putting them back on the road to good health.

Each repurchase auction is overwhelmed by credit losses and bank demand for the funds. With no end in sight these temporary repurchases and collateral exchanges are becoming permanent increases in money supply. Now the Fed wants to increase the size of the temporary repurchases to \$200 billion<sup>9</sup>. This indicates that the initial auctions were unsuccessful and that the problem is still growing.

Unable to fix the banking system these stimulative actions are only postponing the day of reckoning. The cheaper cost of money keeps weaker institutions functioning when a sound banking system is the prerequisite for steady growth. Until the credit crisis abates the Fed cannot stimulate consumer and business spending. If the Fed does realize this and is only trying to avoid major bank failures (they expect minor bank failures) that policy goal is dubious in the face of similar failure in the Japanese banking system in the early 1990's – the Bank of Japan propped up weak institutions for years resulting in fifteen years of contraction in the economy and asset prices.

We suspect that the real goal of the Fed is to provide optimism for consumers and investors (since the two are related) to buy time until the banking system can flush out its problems. The Fed's blatant overreaction to the fraud at Societe Genrale and the global stock market declines it created may be the most compelling evidence of the Fed's intentions. Those intentions are very much in concert with the financial institutions themselves. Going back to our August report, we detailed their desire to try to hide trouble in the hope that an orderly market for problem assets can suddenly appear and the write-downs will cease. The bailout of the SIV's was one attempt to create an orderly market, just as a bailout of the bond insurers is an attempt now. But, as the SIV bailout collapse shows, the Fed and



the financial system are doing a poor job as nothing seems to be getting fixed; problems are getting worse and multiplying. In short, the Fed's stimulative policies are not working regardless of its real intentions.

While it fails to achieve its goals, putting extra money into the banking system will eventually lead to inflation if left unchecked. More money to buy a fixed amount of inputs means higher prices. Under "normal" circumstances the Fed can live with that since it takes time for that inflation to work its way through the economy. By then the recovery has begun and the Fed has room to reverse course and increase interest rates while slowing money supply growth. But in 2007 inflation was already above target. As late as September 2007, the FOMC was debating whether inflation had sufficiently "moderated" to accommodate drastic action.

While the Fed **has** acted drastically the data has shown that inflation has not moderated and is doing the opposite. Inflation, as measured by the CPI, checked in at 4.4% in January, the highest level since 1991<sup>10</sup>. Perhaps the Fed is hoping that the weakness in the US economy will reduce price pressures. But a wing and a prayer is not productive policy.

The real drivers of current inflation are the falling US dollar and the increase in competition for resources from other growing economies. Since we import so many of our inputs, from oil to machine parts to finished products, the dollar plays an important role in determining the price US users pay. Lowering interest rates puts downward pressure on the dollar (lower rates here mean investments are more attractive elsewhere, diminishing the demand for the dollar and therefore its price). A lower-priced dollar relative to other currencies means that more dollars are needed to pay for a foreign item, or a relative increase in price for the US user. A lot of the inflation we now have has been created by the weak dollar, and lowering US interest rates is counterproductive in that

respect. And the Fed has no control over the economies of China, India, Brazil, etc. The only US action that can derail their demand for inputs is an economic contraction, which the Fed is supposedly trying to avoid.

The Federal Reserve has gambled on lower interest rates, most likely to shore up confidence in consumers and investors while the banking system tries to recover. It does not possess any realistic method of stimulating consumer or business demand without a banking recovery. But by lowering interest rates and printing money it is endangering the economic recovery it seeks. If inflation is already a problem affecting inflationary policies will make it more difficult to overcome in the future. As we discussed in Part 1 it was the defeat of inflation that created the climate for the past 25 years of solid, nearly uninterrupted growth, creating the bull market in stocks which was a function of low inflation-adjusted valuations. Increased inflation will delay the recovery in the stock market, both because it will take more of a decline to reach attractive inflation-adjusted valuations and the negative impact on economic growth will decrease the growth rates of stocks.

Lower interest rates also decrease the return of personal sector financial assets. A large portion of the asset mix, which is growing larger as stocks and real estate assets struggle, is time and savings deposits. Low interest rates in the banking system make these assets less efficient in the context of NW growth. Again, less efficient assets mean consumers have to save more rather than spend.

Raising interest rates and constricting money supply growth is, in our view, the only sensible alternative for three reasons:

1. To fight inflation now before it gets any further out of control. Increasing rates will help the dollar and ease import inflation.
2. Help bring an end to the credit crisis by forcing weaker financial institutions to



find viable alternatives or become insolvent. Under either scenario the potential credit losses become known and institutions that have acted responsibly are rewarded as they take over those that have acted irresponsibly (at cheap prices).

3. Higher interest rates will help markets reprice risk. In our August Report we highlighted the credit market's desire to reprice risk as a function of returning to normal operations. Solid economic growth depends on bad ideas and bad money paying higher rates to become reality. If subprime mortgage candidates had to pay much higher mortgage rates the credit crisis may have been avoided. All the money that went to bad mortgages could have been directed to solid investments that were sustainable - investments that would have added to long-term economic growth – instead of building millions of homes and condos that should have never been built.

The second unknown factor is fiscal policy. The stimulus package recently passed by Congress and signed by President Bush is nothing more than window dressing – politicians acting like they are doing something. Costing the Federal Government \$150 billion, it may only add \$27 billion to

consumer spending (assuming a recent poll by the LA Times is accurate – only 18% surveyed planned to spend the money<sup>11</sup>). But the bigger threat comes from the election. All three of the major candidates are, to varying degrees, in favor of increasing taxes or, at least, hostile to tax cuts. Barack Obama and Hillary Clinton are already on record as favoring “taxing the wealthy” to pay for numerous expanded entitlements. John McCain has explained that he is now for tax cuts even though he was one of the few Republicans to vote against them. So his word on the matter is dubious. “Taxing the wealthy” is code for an increase in capital gains and taxes on all investments (supposedly only wealthy people invest). Just when the market is struggling to find a bottom it will have to digest the probability of increased taxation on investments. An increase in that probability will push economic recovery further down the road since higher taxes decrease economic activity, and higher taxes on investments will mean lower stock prices will be needed to achieve the low valuations that are necessary for the recovery.

The Fed can continue the wrong policy and Washington can change to the wrong policy. Both have the potential to increase the depth and breadth of the contraction and will be monitored.

## Conclusions

The slow growth/no recession outlook depends on a consumer bailout. But our analysis shows that the trend in consumer spending is breaking. The decline in housing prices, together with negative stock market returns, is/will continue to lead to a decline in personal sector net worth. Without growth in net worth consumers/savers need to save more disposable income. Saving more means either borrowing to finance spending until good times return or cutting back on spending. The credit crunch is not permitting banks to lend. Without sufficient access to credit through credit cards or mortgages consumer spending will have to be cut.

It was August 2007 when the credit crisis first hit and by December consumer spending had already fallen to zero after averaging 4% real growth since the recovery in 2002. In



January 2008 spending also registered zero. Those declines occurred without any significant increase in unemployment. If consumers are already cutting back how are they to carry the economy? The spike in borrowing against retirement accounts coupled with the guidance from retailers and consumer businesses demonstrates that consumers are running out of options right now.

Our economic analysis has not changed since August – we are going to experience a contraction; one that may already be underway. The pertinent questions now are how long and how bad, and how will the equity markets react. The answer to the latter question is the three-legged downturn in the stock market. Again, while we are neither market timers nor market technicians the charts make a very compelling case for that pattern. That precedent indicates we have only experienced the first leg down with much more downside to come. In terms of length of time, we are still early in the process.

The Federal Reserve's overreaction, in our estimate, in lowering interest rates is having a negative effect. The Fed cannot stimulate demand from lower interest rates because banks are tightening credit standards regardless of rates - even if they wanted to lend more they cannot because of the mess on their balance sheets. Rather, it appears that the Fed and financial institutions are trying desperately to buy time. But the current round of interest rate cuts and money supply additions is creating inflationary pressures with inflation already above average. By the time a recovery is possible rate increases may need to be so dramatic as to damage that recovery. By continuing the wrong policy the Fed has increased the probability of a longer and deeper contraction.

Tax policy is also an important factor. Any effort to raise taxes on investments will have a negative effect just when a recovery may be a possibility. It does not matter if the tax hikes will be in 2010, the expectation of increased taxes will be at the end of 2008 (depending on election results).

For equity investors patience is now the key virtue. Finding good companies at cheap prices is still the correct portfolio strategy. Depending on the factors described in this report, just how cheap is the question. One of the biggest issues we face now as investors is the very real danger of a prolonged severe contraction. We will continue to monitor events, policies, and trends to ascertain how real that danger is, and if a change in portfolio strategy is warranted.



## Endnotes

- 
- <sup>1</sup> Testimony of Federal Reserve Chairman Bernanke to Congress on February 27, 2008.  
[http://www.foxbusiness.com/markets/economy/article/text-bernankes-testimony-congress\\_497431\\_3.html](http://www.foxbusiness.com/markets/economy/article/text-bernankes-testimony-congress_497431_3.html)
- <sup>2</sup> All GDP & National Income data provided by the Bureau of Economic Analysis, US Department of Commerce.
- <sup>3</sup> All Net Worth and Personal Sector data provided by the US Federal Reserve Bank, Release Z1.
- <sup>4</sup> Mutual Fund and Stock Ownership data provided by the Investment Company Institute.
- <sup>5</sup> Mortgage and Real Estate data provided by the US Federal Reserve Bank, Release Z1.
- <sup>6</sup> “US Home Sales, Good Orders Feed Recession Fears”, Reuters. February 27, 2008.  
<http://news.moneycentral.msn.com/provider/providerarticle.aspx?feed=OBR&date=20080227&id=824904>
- <sup>7</sup> “More Tap 401(k) Accounts for Cash”, Associated Press. February 19, 2008.  
[http://www.boston.com/business/articles/2008/02/19/more\\_people\\_tap\\_401k\\_accounts\\_for\\_cash/?page=2](http://www.boston.com/business/articles/2008/02/19/more_people_tap_401k_accounts_for_cash/?page=2)
- <sup>8</sup> Testimony of Federal Reserve Chairman Bernanke to Congress on February 27, 2008.  
[http://www.foxbusiness.com/markets/economy/article/text-bernankes-testimony-congress\\_497431\\_3.html](http://www.foxbusiness.com/markets/economy/article/text-bernankes-testimony-congress_497431_3.html)
- <sup>9</sup> “Fed to Lend \$200 billion, Accept Mortgage Securities”, Scott Lanman, Bloomberg.com. March 11, 2008. <http://www.bloomberg.com/apps/news?pid=20601087&sid=a6LLuTru5Sio&refer=home>
- <sup>10</sup> All Inflation data provided by the Bureau of Labor Statistics, US Department of Labor.
- <sup>11</sup> “Market Dispatches”, Charley Blaine and Elizabeth Strott, MSN Money. February 28, 2008.  
<http://articles.moneycentral.msn.com/Investing/Dispatch/080228markets.aspx>

Atlantic Capital Management of Florida, Inc., is an SEC registered investment advisor. Atlantic Capital's Form ADV, Parts I & II, are available upon request or online at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). Atlantic Capital's Disclosure Statement is also available upon request. The commentary expressed is the opinion of Atlantic Capital and is meant for educational purposes only. No investment recommendations are given nor implied.



**ATLANTIC CAPITAL MANAGEMENT**  
560 VILLAGE BLVD, SUITE 260  
WEST PALM BEACH, FL 33409  
(561) 686-6844

[www.client-centered.net](http://www.client-centered.net)