Q4.**2008**

ECONOMIC AND MARKET COMMENTARY

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2009 doesn't have to be a very good year to be better than 2008. The past year saw equities fall the most since the Great Depression as the global economy slid into recession. But I think that 2009 will surprise on the upside, with both the economy and the markets doing much better than expected.

1. **An unprecedented stimulus from the Federal Reserve.** There is no doubt that the economic shock from the subprime mortgage collapse threatened the viability of the financial system like no other event since the Great Depression. But in contrast to the 1930s when the Fed refused to provide any help to banks, the central bank has essentially guaranteed all deposits and lent the banking system nearly $1 trillion. Furthermore, the Fed has rapidly brought short-term interest rates down to zero, the prime rate down to 3.25%, and 30-year fixed mortgage rates down to 5%. It took the Bank of Japan, which faced similar problems in the early 1990s, nearly a decade to do the same. Even then, Japan avoided depression. We will do much better.

2. **More fiscal stimulus is on the way.** The Obama administration announced that it will lower tax withholding rates by about $300 billion as well as increase spending on infrastructure. Expect further help for state governments who are facing large budget deficits. In contrast, most policymakers in the 1930s advocated increased taxes and reduced spending to cut deficits, exactly the wrong medicine for an economic downturn.

3. **The decline in oil prices is a huge boom.** Last summer I estimated that an increase in the price of oil from $65 to $130 would cut U.S. GDP growth by two percentage points. The subsequent fall below $50 means that not only has that drag been eliminated, but the drop in oil prices may actually spur economic growth.

4. **Capital markets are discounting a high probability of a complete collapse of the financial system.** Risk premiums have reached all-time highs in the fixed-income and equity markets. Investors are clinging to treasuries at ridiculously low rates, since they were the only asset that made money in the 1930s. But a financial collapse will not happen. As soon as investors realize that this dire outcome will be avoided, they will abandon treasuries for higher-yielding assets.

HERE'S MY FORECAST FOR 2009

The U.S. economy will recover faster than expected. Unquestionably, the last quarter of 2008 and the first quarter of 2009 will show a significant decline in GDP. But I think the decline in those two quarters, which some are now predicting to be -7% and -5%, respectively, will be milder, and the second quarter might surprise with an uptick. This more optimistic forecast is based on low mortgage rates stabilizing the housing markets and increased lending by banks.

Equity markets will enjoy returns of 20% or higher. For the first time since the early 1950s, the dividend yield on stocks (now 2.55% on the Russell 3000) exceeds the interest rate on the

10-year Treasury bond. And this dividend yield already takes account of the dividend cuts announced by financial institutions and other firms. Accordingly, for the first time in more than half a century investors do not need to generate capital gains in order for stocks to beat bonds. Furthermore, Obama has indicated that he supports continued favored tax rates on stock dividends, so that the after-tax margin in favor of stocks is even greater.

U.S. Treasury bond yields will rise over 3% as the economy improves. Low-rated corporate bonds will increase in value as Treasuries fall. The Fed may not be able to hold its near-zero interest rate policy past the summer as the recovery builds.

I wish I could guarantee all these predictions, but of course I cannot. There are always risks to any forecast. The Fed must do more to encourage banks to lend to credit-worthy, non-delinquent customers. And the Obama administration must carefully structure its recovery plan so as not to bail out those that have been profligate and penalize those that have been thrifty. Nevertheless, just as 2008 disappointed us on the downside, I believe 2009 might surprise with much better numbers than most are now expecting.

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