

EPIC ADVISORS, LLC

Weekly Market Commentary

October 7 2008

Sean Hannon, CFA, CFP

With less than thirty days to the election, voters are pounded from all sides with information about political candidates. Depending upon where one lives and what local politics dictate, the populist push will take different forms. Whether farm subsidies, infrastructure needs or education are the top issues in your area, one message nearly all people respond to is a balanced budget with less spending.

At the core, a disciplined federal government makes immense sense. After all, our economy is currently suffering from a credit crisis that was stoked by too much debt and undisciplined spending. Many states operate within balanced budgets, so why should the federal government be any different. By advocating fiscal discipline, our presidential candidates hone their image and appear prudent.

All of these arguments are rational and reasonable. However before we consider embracing this direction, we should consider the consequences. As George Bernard Shaw explained, the path to hell is paved with good intentions.

In theory, contracting credit should be an aspect of the business cycle. As the economy grows, credit booms, investments are made in financial and hard assets and price levels rise. Eventually, we reach a point where prudent lending standards prevent further credit expansion, borrowing stagnates and economic growth either moderates or declines. During the decline, certain borrowers will experience hardship and default on their loans. If during the expansion, debt levels remained moderate and loan standards prudent, defaults will be limited and economic damage contained.

Our current crisis is much different. As the credit bubble expanded earlier this decade, household debt grew from 60% of GDP to 97% of GDP. Similarly, household debt as a percentage of disposable income (measured as income after taxes) grew from 89% to 127%. Simply, if Americans did nothing but work, sleep and eat it would take nearly 2 years to generate enough income to pay off our debt levels. Starting with high debt levels, economic contraction enhanced the risk of loan loss. Normally this would force prudent lending standards as the risk of loss is elevated. Instead, the credit bubble was inflated as investor demand for extra yield and the belief that asset prices only increase caused many lenders to loosen underwriting standard and create subpar loans. The end result was a credit environment unprepared for asset deflation and changing consumer behavior.

As housing prices continue dropping, many homeowners find that they owe more on the house than it is currently worth. Many people bought homes with the assumption prices could only increase. As they find themselves with negative equity, the rationale for owning a home shifts and their choice is to walk away. While the process of default and foreclosure is expected across lending cycles, the current environment is unique. Normally, we see economic stress cause people to lose a home they would

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rather keep. Currently, we have seen people willing walk away from homes prior to a true downturn in the economy. This has caught many lenders off guard and has led to tightening of credit to nearly all clients. Thus today's borrowers suffer for yesterday's mistakes.

With the access to credit eliminated and debt levels high relative to disposable income, individuals find few options to expand consumption. If consumer spending drops, economic growth also drops. So what are the alternatives? Since the economy is dependent upon borrowed money to grow, we must rely on the one entity with the ability to borrow and spend – the federal government.

While I rarely advocate increasing deficits, the current economic picture requires extreme measures. With individuals and companies locked out of the credit markets, the risks to economic growth are massive. As we have seen in the last 6 weeks, financial markets are awakening to these risks and the results have been brutal. We have seen our politicians react to these problems in clumsy fashion. With the focus on the Treasury's most recent band aid, the Dow Jones Industrial Average (Dow) has dropped below 10,000 while volatility continues to soar. Buying bad assets may help eliminate uncertainty, but it does not guarantee that credit markets unclog and lending continues. Instead, we need more drastic actions to stem asset deflation. Only then will banks lend against collateral with a stable and measurable value.

Looking at our country, our needs are numerous. Our infrastructure has fallen into disrepair and needs updating. An expansion of both education and healthcare services would be easily justified to the American people. Tax incentives for research and development would increase employment and innovation. Combined, the federal government would be using its borrowing capacity as a way to reflate the economy, raise asset prices and increase our standard of living. Via inflation, asset prices will stabilize, credit markets will unlock and economic growth can resume.

Normally, I would never advocate inflation to cure our economic ills. In theory, we should work through our credit binge, suffer the economic fallout and allow the economy to return to a true growth rate. These are not ordinary times. Given the size of the problems and the effect it is having, failing to take an inflationary path will lead to, at best, a deep recession and increase the possibility of a severe depression that will affect the entire country and thus, the world.

If I am correct about the need and intent of the government to inflate the economy, the investment implications are many. In an inflationary environment, Treasury bonds will suffer. Currently, the 2 year Treasury pays 1.45% and the 10 year Treasury pays 3.49%. The initial steps of an orchestrated increase in inflation will be led by a Federal Reserve (Fed) interest rate reduction. When it occurs, you should

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expect Treasury yields to decline further. At that moment, I would exit these positions as increasing inflation will erode the value of the bonds and the low interest rate will result in the loss of purchasing power.

The largest beneficiary of increased inflation will be hard assets and related companies. Gold offers the purest exposure, but all commodities should do well. Equities that either supply commodity producers (i.e. –fertilizer companies) or currently possess abundant commodity reserves (i.e. – oil companies) should see their shares perform well. Real estate should begin to bottom and then eventually outperform.

As the Presidential election is near, keep a close look at the economic plans presented by the candidates. It is my belief that in order to prevent another Great Depression, greater and more painful than the one in our past because so much more wealth is at stake and the population of our country has increased, our government must spend on infrastructure, healthcare and education.

Watching a bear market decline can be brutal. The current environment has shown large losses with massive volatility. The combination of lower prices and high volatility leave you with the feeling that even when prices are high and the outlook is brightening that disaster lies around the corner. This combination causes confusion, breeds investor contempt and escalating losses. Inside the price decline, opportunity awaits. If my view of increasing inflation is accurate, the investment implications are clear. Since the stocks I would find attractive have suffered major losses over the past month, they are now extremely cheap. While every trader is always told to never catch bottoms and trade with the trend, those with conviction can step into this market and buy stocks at prices that seemed unimaginable a few months ago. We have often been told that fortunes are made at the bottom of a bear market. In order to take advantage of the opportunities presented, we must be disciplined, believe in our convictions and act accordingly, and vote!