

Strategy Flash

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Equity Strategy

Cataclysmic Crescendo of Capitulation or Not?

- **Recent news, coming on the heels of the GSE bailout sends a chill.** The bankruptcy of Lehman Brothers and sale of Merrill Lynch is likely to cause a significant sell-off Monday morning as international markets are providing a clear precedent. Moreover, Financials are more than likely to take the brunt of the weakness, especially given their gains since mid-July, but should provide very attractive entry points.
- **New “firebreak” fund is reminiscent of LTCM.** The \$70 billion fund engineered by a consortium of banks helped along by easier loan terms from the Fed seems similar to financial institutions gathering to provide support when Long Term Capital Management threatened systemic financial risk 10 years ago. Moreover, the sale of Merrill to Bank of America suggests less of a chance of a domino effect.
- **Sentiment has not been bad enough but might hit an inflection point.** Our Panic/Euphoria Model has not yet fallen into panic territory despite the series of bad news for the past few months, indicating that investors have not positioned themselves conservatively/defensively enough, possibly hoping that the worst was behind them. However, there is a possibility that the news flow may provide the impetus to change positioning. Volatility has been forecast to rise for awhile and some surge is highly plausible.
- **Initial dollar weakness is unlikely to last, as the economic impact may be widespread.** A surge in gold prices, following a sharp decline over the past few months, is reasonable, but we remain doubtful about a renewed commodities pickup given weakening economies globally and the spreads between short-term German notes and Treasuries. Oil prices, for instance, continue to ease, as Hurricane Ike apparently did not cause feared damages.
- **Equities tend to mirror earnings and it is possible that the worst has been seen.** Quarterly EPS have a close correlation with S&P 500 levels and 2Q08 may have been the low point on earnings given massive financial company write-offs. Indeed, overall margins are back to 2002 lows, though non-financials seem to bear the greatest risk going forward.

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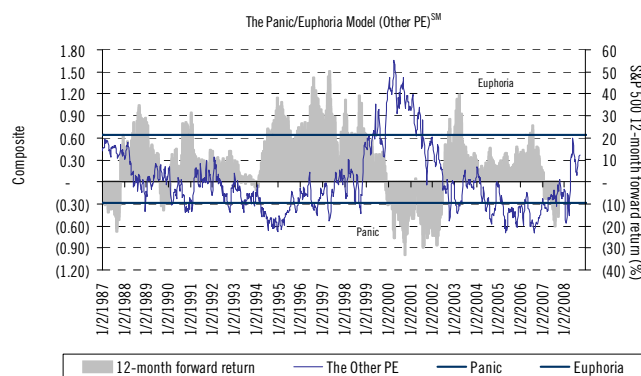
Financials Concerns

The news out this weekend of the bankruptcy of a venerable firm like Lehman Brothers and the sale of Merrill Lynch to Bank of America clearly has shaken many long time veterans of Wall Street as well as newcomers, particularly so soon after the government was forced to step in and rescue the GSEs. Moreover, it is likely that all the bad news is not yet out with specific concerns around a large insurance entity and counterparty risks of various derivative products in which Lehman is involved.

Indeed, we believe that that \$70 billion “firebreak” fund put together by a consortium of banks alongside eased terms from the Fed in terms of collateral to be used against loans (including equities) is being established expressly to allow for an orderly sale of assets without disrupting markets. Indeed, a similar though smaller plan was conceived of when LTCM was on the brink of causing major financial market damage in 1998. While we suspect that we may hear commentary about “moral hazard,” the alternative seems even more worrisome if capital markets were to seize up across the board and threaten all kinds of reasonable economic activity.

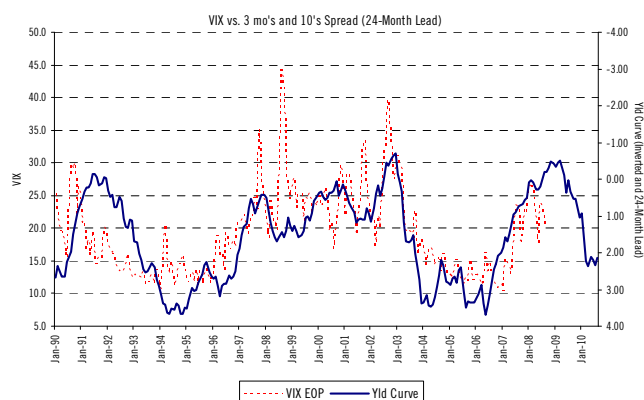
Interestingly, many may wonder if this is the catharsis that markets need to break out of its anxiety. Often, a major event transpires that finally allows for equity investors to essentially get over the hump. Thus far, our Panic/Euphoria Model was not showing the panic that we have seen in previous crisis periods (see Figure 1), as portfolios do not seem to be positioned for trouble. To be fair, we have argued for higher volatility for more than a year and there is still risk (see Figure 2), which may be coming to fruition currently.

Figure 1.



Source: CIR – US Equity Strategy

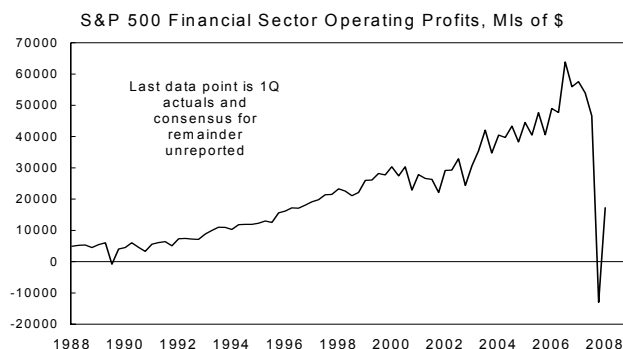
Figure 2.



Source: Haver Analytics and CIR – US Equity Strategy

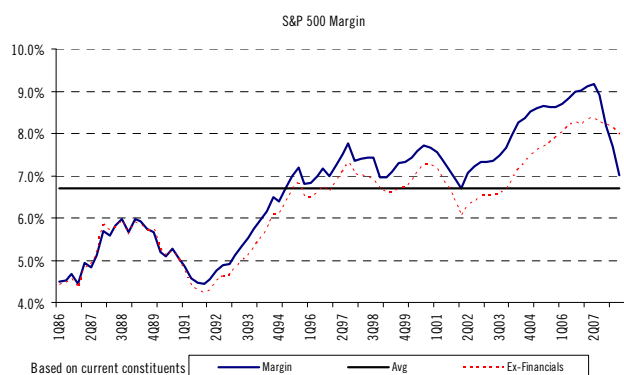
Financials have been the epicenter of investor worry and there is little doubt that the numbers have been horrific (see Figure 3), dragging down overall margins to 2002 lows already (see Figure 4). Although it becomes obvious to us that the future risk to earnings is developing in other areas, especially late cyclical such as manufacturing and commodities. As we have argued for a while, the continued tightness in credit markets is not at all good news for economic trends worldwide. Even as gold prices have jumped, given its safe haven status (as are Treasuries), we would not argue for investors to buy into this area now. Indeed, oil prices have continued to sell off despite dollar softness tied to the bad financial industry news.

Figure 3.



Source: Citi Economics & Market Analysis

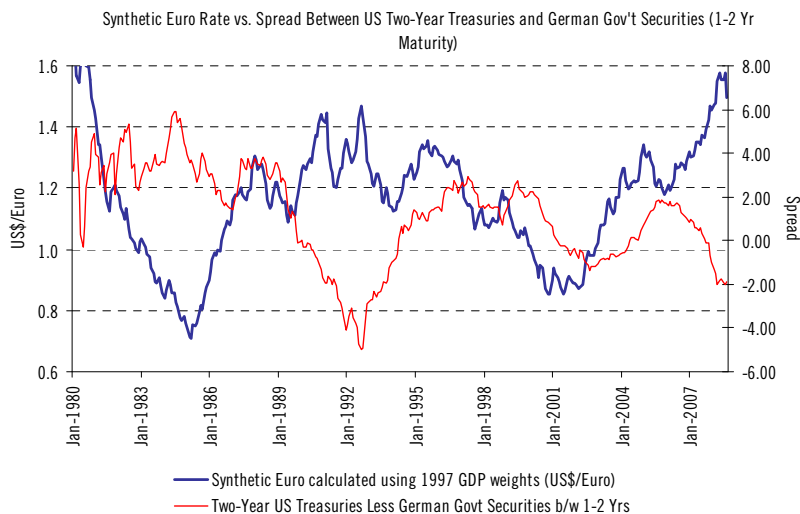
Figure 4.



Source: FactSet and CIR – US Equity Strategy

We do not believe that the dollar is about to break down given the spread between two-year German and US notes (see Figure 5), with the European economy showing greater weakness than the US and the ECB is well behind the Fed in its rate cutting cycle. In this context, we concur with our economists looking at a possible dollar/Euro exchange rate approaching 1.25 by late 2009.

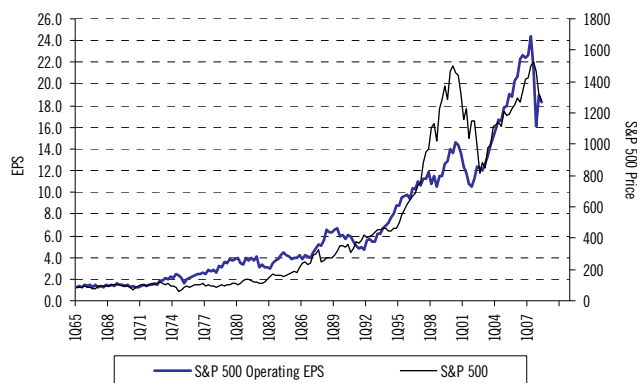
Figure 5.



Source: CIR – US Equity Strategy and Haver Analytics

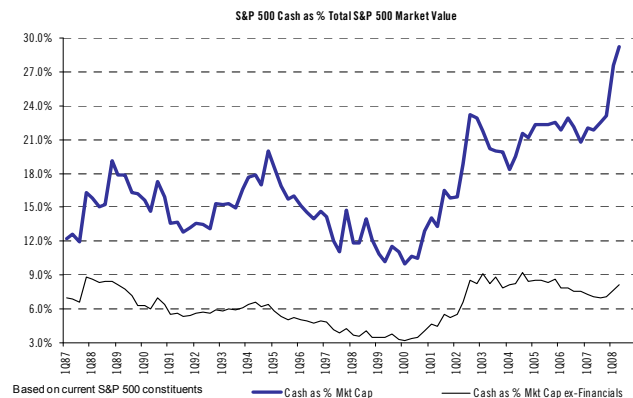
It is important to recognize that equities typically trade with earnings (see Figure 6) and we estimate that the worst of the quarterly operating EPS may be behind us with earnings broadly expected to show gains in late 2008 and into 2009, supported by less write-offs from the banks and investment banks. In addition, with recent sell-offs, the cash to market cap ex-Financials is approaching that critical 9% that was bottom in both 1987 after the market crash and 2002 following the tech bubble's bursting (see Figure 7).

Figure 6. S&P 500 vs. S&P 500 Operating Profits



Source: Haver Analytics and CIR – US Equity Strategy

Figure 7.



Source: FactSet and CIR – US Equity Strategy

Given the indications in the futures markets and the news from trading markets abroad, a challenging market open is clear, with our sense being that the morning trade will bear the brunt and it is likely that things stabilize as the day progresses. Emotion can prove to be one's worst enemy when it comes to investing, so we would advise people to use their heads and not their feelings.

Appendix A-1

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