

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

December 2, 2008

*This is the ELF Capital Management, LLC Market Letter for the month ended November 2008. If you do not wish to be included in our circulation, please reply indicating your desire to be removed and we will be happy to oblige. Alternatively, any of your friends or colleagues may receive this on a regular basis by entering their email address on our list-server via this [link](#). Feel free to forward this to any of your friends! Thanks for your interest and we hope you enjoy the letter.*

## **Economic and Market Predictions for 2009**

Should auld acquaintance be forgot  
And never brought to mind?  
Should auld acquaintance be forgot  
And days of auld lang syne?

For auld lang syne, my dear,  
For auld lang syne  
We'll take a cup o' kindness yet  
For auld lang syne.

Its interesting that this is most commonly sung song each New Year's Eve and most people don't have the foggiest notion what it means? Of course, many have already had quite a few beverages beforehand and may not really care what it means. It turns out that "Auld Lang Syne" came from Scotland more than 200 years ago; and the words "Auld Lang Syne" are loosely translated as "days gone by". This song will seem most fitting this year, and maybe more than most. Are you ready to ring in the New Year?

For a better part of this year, many have experienced fear and that fear has manifested great pain. It has been self-fulfilling. Many businesses are facing difficult times and job losses are mounting. The stock market has reached lows not seen in 80 years and most people with any form of savings have seen their net worth decline dramatically. Even when it seemed that the stock markets were well over-sold, they continued to fade lower. However, despite all of this doom and gloom, I'm becoming more optimistic that there is light at the end of this tunnel. So, with the hopes of spreading some holiday cheer, this month's letter will provide a glimpse of why I think 2009 will be more prosperous. With this being my first attempt at offering predictions for the New Year, I hope it brings good tidings and renewed spirit.

So, for auld lang syne, join me in taking a cup o' kindness yet, for auld lang syne. And, with it, my predictions for the New Year:

- Unemployment will rise to just below 9% by March or April and will ease back towards 7%, if not lower, by year's end.
- By the time unemployment peaks, the Dow Jones Industrial Average will rise more than 50% from November's low and gain another 10% to 20% before 2010.
- The S&P500 will perform at least as well as the Dow and the Russell 2000 will do better than both.
- Consumers will become more confident by mid summer and eager to spend for the back-to-school season.
- Inflation will remain relatively tame throughout most of next year and begin to rise by the 4<sup>th</sup> Q of 2009.

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

December 2, 2008

- The housing market will stabilize just in time for the summer selling season and home buyers will return to the market. However, a more than adequate supply of existing homes will keep it a “buyer’s market” and prices won’t rebound much.
- Lastly, I expect to see a number of new banks being formed to fill the void left by the collapsed “shadow banking system” and existing banks who remain too afraid or capital constrained to lend.

### **Unemployment Rate**

While my prediction might sound like it was arrived at it by using a consensus of forecasts, instead I took to crunching some numbers. The process involved researching the US Department of Labor’s web site, downloading monthly unemployment data and charting the data against some other economic indicators. To find a reasonable set of comparable data to work with, I could only go back as far as January 1948. The exercise produced results that were quite fascinating.

Since January 1948, the US has experienced 10 periods where unemployment rose more than 1% in a single trough to peak (low to high) cycle. And, we have already begun the 11<sup>th</sup> cycle. These periods of rising unemployment were almost always the result of a recession. And given that few people can agree on how to define a recession, it might be less confusing to define it as any period that causes unemployment to rise more than 1%.

Job losses are currently accelerating and the consensus of economists is forecasting that nominal GDP, in the 4<sup>th</sup>Q of 2008, will be -3.0% to -3.5%. If it does, and I suspect it will, it will go on record as the worst single quarter nominal GDP figure reported since the 1930’s. However, because deflation will likely add 1% or more to this low nominal GDP figure, I’m not as concerned about the magnitude of the number. And, real GDP seems a more accurate guide as to measuring the pace with which our economy is contracting. Nevertheless, I do expect that businesses will react to the data and unemployment will accelerate faster in the 1<sup>st</sup>Q of 2009.

For the record, GDP (Gross Domestic Product) represents the monetary value of all finished goods and services produced within a country’s borders; and nominal GDP includes the impact of inflation, or deflation as the case may be, while real GDP excludes the impact of inflation or deflation.

Since 1948, the average unemployment trough to peak cycle was approximately 3% and the most severe were those that peaked in October 1949 and May 1975. In those cycles, unemployment rose by approximately 4.4%. The next most severe were in July 1958 and November 1982, when the unemployment rate rose by 3.8% and 3.6%, respectively. To give you an idea of how business has reacted to prior real GDP contractions, consider this:

- In October 1949, unemployment rose 4.4% and peaked at 7.9% after real GDP contracted 1.8% over the two consecutive quarters ending in June of that year;
- In July 1958, unemployment rose 3.8% and peaked at 7.5% after real GDP contracted 3.8% over the two consecutive quarters ending in March of that year;
- In May 1975, unemployment rose 4.4% and peaked at 9.0% after real GDP contracted 2.6% over the three consecutive quarters ending in March of that year;

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

December 2, 2008

- In November 1982, unemployment rose 3.6% and peaked at 10.8% after real GDP contracted 2.7% over the four quarters ending in September of that year.

When looking over the 1975 and 1982 recessions, it is important to know that these recessions were orchestrated by the Federal Reserve Bank to thwart periods of extremely high inflation at the time. In 1974, Fed Chairman Arthur Burns raised the Fed Funds target rate to 13%; and in 1980 through 1981, Fed Chairman Paul Volker raised the Fed Funds target rate to 20%. So, if you think the crisis we are experiencing now is bad, it was not nearly as bad as the recessions in 1975 and 1982.

So, with this information in hand and from the current cycle lows of 4.4% in March 2007, a severe rise of 4.4% would take us to 8.8% unemployment. While 8.9% unemployment does not seem very prosperous, after each unemployment peak, 90% of the time real GDP turned positive and began the next expansion. This confirms for me that unemployment is perhaps the most lagging indicator. What should also ease fears is that 70% of the time, the unemployment rate declined as fast as it rose. This reinforces the belief that layoffs are always overdone. Another positive to consider is that 80% of the time, unemployment declined and settled at or below 5% afterwards.

### **The Dow Jones Industrials, the S&P 500 and the Russell 2000**

Now, why do I think that the market will begin its recovery by the time unemployment reaches its peak? Well, when charting the data, I saw a relationship that really stood out in the data. Yes, this is all about me expecting history to repeat itself. It often does.

By the time unemployment peaked, the Dow Jones Industrial Average had begun its next expansion and recouped 50% or better from the lows – 9 out of 10 times. I don't mean after it peaked; I mean when it peaked. And, 100% of the time the Dow recouped 40% or more. This was rather eye-popping and I've checked the data more than twice.

While this is no guaranty that the same will happen this time, the probability of it coming to fruition is more likely than not. Naysayers may argue that "this time it is different" because we are in uncharted territory and there is no comparison. And I would agree that it is uncharted from the perspective of never seeing the market losses this deep since the 1929 Crash. However, I would argue back that this recession is fairly similar to the 1974 and 1982 recessions and this time, the government response is significantly more positive than it was then. As for the market dropping more now than then, I also believe that the media and hedge funds may have had more to do with the depth of this market collapse than any time before.

I'm old enough to remember that the recessions in the 1970's and 1980's were similar in that the banks were going through a capital crisis and the consumer confidence and spending fell off the cliff then also. And while the University of Michigan consumer confidence numbers are lower now than then, the media wasn't relentlessly pounding fear into us every night back then.

### **GDP, Housing and New Bank Formations**

ELF CAPITAL MANAGEMENT, LLC  
(*ENDOWMENT LIKE FUND MANAGEMENT*)

December 2, 2008

While my predictions for unemployment and a market rebound came to me by performing quantitative research, my predictions for GDP, housing and bank formations are more qualitative in nature.

As a primer, quantitative research involves classifying features, counting them, and constructing more complex statistical models or charts in an attempt to explain what is observed; while qualitative analysis draws upon the need to develop fine distinctions about the subject matter as opposed to organizing data into a finite number of classifications. When we talk about economics, both play a role. And, as quantitative analysis tends to sideline rare occurrences or emerging trends that can signal an opportunity in the making, qualitative reasoning may just be more apt for this discussion.

In this 4<sup>th</sup> quarter of 2008, fear became so great that consumers cut back on spending – dramatically. So much so that commodity prices, like oil for example, have also dropped significantly. This is causing deflation. At the same time, consumer spending is said to be responsible for 70% of GDP and as a result, we can expect nominal GDP to be quite negative in this 4<sup>th</sup> quarter.

What seemed to create the most impact was the fear of job losses. Consumers cut back on their spending, businesses felt the impact and job losses began to accelerate. It all became self fulfilling. Call this a negative feedback loop. But, this loop does come to an end and it often ends quickly after one or two iterations. Let me explain.

When people fear job losses, everyone cuts back on their spending. Then business managers, or owners, will usually lay off enough people to weather the downturn. In fact, they often lay off more people than needed in order to avoid having to go through a second round of layoffs. If they have to do it a second time, they will make sure to not have to repeat the process. Laying off employees is not only disruptive to the entire business; every manager I have ever met never looked forward to having to go through it. Well, maybe I can remember one. A large lay off can be considered to be 15% to 20% of personnel; 5% to 10% is more likely. Once completed, the remaining employees learn that they have to pick up the slack and begin to feel safe. When they see that they have survived, they begin comfortable to spend again and are eager to begin shopping for deals while the rest of the world remains in fear. So, in a worst case scenario, this means that 80% of consumers now begin to rekindle their pent-up spending desires and start to shop again. And, this begins a positive feedback loop.

We should not disregard the impact of pent-up demand. Households do not significantly downsize their quality of life overnight, unless they have no choice in the matter. Those few that action to downsize their lifestyles, generally do so over time.

When these 80% to 90% of consumers begin to open their wallets again, even if they spend less than they did before, a positive feedback loop will begin. This will boost real GDP. As the stock market stages its recovery, it will create a positive wealth effect for those people who remained invested or bought into the lows. This will also reinforce consumption as people take some of these gains to satisfy their pent-up demand.

**ELF CAPITAL MANAGEMENT, LLC**  
*(ENDOWMENT LIKE FUND MANAGEMENT)*

December 2, 2008

Early on, the fixed income markets will react to this phenomenon, as a rising GDP will signal that the bottom has been reached with business and households becoming less of a credit risk. This will also motivate home buyers, who have been sitting on the sidelines and waiting to buy at the bottom.

As the credit risk abates, banks who have taken large write-downs will see a good portion of those loans become more valuable and we will see mark ups. This is one of the most telling reasons that financials often lead in economic recoveries. Financials didn't become the most hated because they offer no promise; they got killed because of the magnifying effect of the leverage they use. But using leverage is how they traditionally serve their function and make money. It is only when they over do it that causes the vulnerability to economic downturns – whether fear induced or not.

New banks will form to fill the void of what has been called, the “shadow banking system”. In the past two decades, rather than make loans and retain them as investments, banks originated loans, packaged them into securities and sold them to investors. Because banks sold them off, they no longer retained responsibility for making high risk or “bad” loans. Instead, banks got paid for originating loans, and after the loans were sold, they got paid to collect the payments and forward the proceeds to the investors. The system would have worked well if buyers of these loans were more discriminating before the shadow banking system grew so large. It didn't and here we are.

Those existing banks who participated heavily in the shadow banking system will be behind the “eight-ball” until they work-out the bad loans now held on their books. This will be to the advantage of those banks that remained traditional through this recent period. They will benefit greatly. However, the shadow banking system created more lending capacity than the current banking system can handle traditionally. Even when we weed out unqualified borrowers, lending capacity will be limited and that will create opportunity. As it has been said for generations that “necessity is the mother of invention”, I expect to see a number of new bank formations to fill this void. And these new banks will be buying for their own portfolio and be more prudent as a result.

Well, that's it. I'm eager to see how my predictions pan out and even more eager to ring in the New Year. I want to wish you all Happy Holidays and thank you for your past business. And, if you're not a current client, please look over our web site [www.hwkfs.com](http://www.hwkfs.com) and please consider booking your business or holiday travel with our online travel agency [www.marketlettertravel.com](http://www.marketlettertravel.com).

### **Our Investment Strategy Going Forward**

While we've been sitting on our hands for the last month, we haven't abandoned our desire to buy into dips. We think that December will offer us some opportunities and expect to do some light buying at each opportunity. With approximately 40% cash across our accounts, we will likely put up to 10% more to work in US equities and may put up to 10% into investment grade corporate bonds before the end of the year. Kind regards