

# Hugh's Comments



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## **Guaranteed by the Full Faith and Credit of the United States Government**

The financial markets have performed well since the Federal Reserve-assisted rescue of Bear Stearns and the successful offering of \$4.0 billion of convertible preferred securities by Lehman Brothers. That is, there is *some* evidence that the willingness of investors to take risks is recovering.

- The S&P 500 has risen 3.5%.
- Financials have been the best performing stock market sector.
- Investors have migrated to economically-sensitive, “bull market” industry groups. Homebuilders, consumer services, automobile manufacturers, and footwear companies have been the first, second, seventh and eighth best performers of 139 industry groups.
- Mid capitalization stocks have outperformed safer large capitalization stocks.
- The yield of 2-year U.S. Treasury notes and other U.S. Treasury notes have risen as investors have found less need to invest safely or conservatively.
- Yield on lower quality debt market securities have declined.
- Yields of lower quality mortgage-backed securities have declined.

That is, the preliminary message of the financial markets since March 17<sup>th</sup> has been that the combination of imaginative and aggressive Federal Reserve policy and other public policy initiatives (tax rebates) *MAY* work. It is important to note that the message is an encouraging message, but it is far from strong or definitive. Defensive stock market sectors continue to perform well; small capitalization stocks continue to perform poorly; important economic variables such as the Index of leading Economic Indicators continue to decline. It is, in our view, premature to shift portfolios to a more positive or “bullish” structure. More will be needed.

**“The ultimate result of shielding man from the effects of his folly is to people the world with fools”<sup>1</sup>**

Economists and public policymakers will debate whether the Federal Reserve should have intervened and assisted in the rescue of Bear Stearns (the acquisition of Bear Stearns by J.P Morgan), a substantial investment banking firm. Some will argue now, as economists have argued since the nineteenth century, that intervention by public policymakers is unwise. They will argue that interventions to save either speculators or lenders who financed the speculation are unwise because it encourages future excessive risk-taking (i.e. bubbles).<sup>2</sup> They argue that no rescues should be made; risk-takers should be allowed to fail; or the bubble or mania should be allowed to “burn itself out”. They argue that this is sound policy because it will cause risk-takers to think twice before engaging in excessive risk-taking if there’s a reasonable chance that they will lose all their money.

They also argue that there is something just or therapeutic about allowing the flames to burn themselves out. Kindleberger summarized the view.

The notion that a panic be allowed to pursue its course is compounded by two strains. One strain takes a certain amount of pleasure, or *schadenfreude*, in the trouble visited upon the market, as retribution for excesses of the past; this somewhat puritanical or fundamentalist standpoint rather welcome hellfire as just deserts of others. The other sees panic as a thunderstorm “in a mephitic and a healthy tropical atmosphere, “clearing the air.”<sup>3</sup>

There are still others who urge higher caution. They argue that, if a substantial financial institution is allowed to fail, investors (read: counter-parties) will lose confidence that the financial institution has the resources to give them their money. They will, of course, withdraw as did the depositors withdraw from the Nickerbocker Trust in 1907 until J.P Morgan (Morgan the individual; not the financial institution) showed up as a rescuer restoring confidence. If the loss of confidence becomes widespread (i.e. there is a general loss of confidence) the financial system will stop operating efficiently. This is known as systemic risk. Since the economy “runs” on money and credit, this risk is, it is argued, not worth taking. Rescues by the lender of last resort are believed to be appropriate.

Kindleberger again comments.

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<sup>1</sup> Herbert Spencer, “State Tampering with Money and Banks” Essays: Scientific, Political, and Speculative (London: Williams & Norgate, 1891), vol.3 p. 354 quoted by Charles P. Kindleberger in Manias, Panics, and Crashes

<sup>2</sup> 1.8 million homes were purchased in 2004 “for investment purpose.” 2.32 million homes were purchased in 2005 “for investment purpose.” National Association of Realtors.

<sup>3</sup> Charles P. Kindleberger, Manias, Panics, and Crashes (Basic Books, Inc. 1989) p. 153-154.

The opposing view concedes that it is desirable to purge the system of bubbles and manic investment, but that a deflationary panic runs the risk of spreading and wiping out sound investments that may not be able to obtain loans necessary to ensure survival.<sup>4</sup>

It is not possible in our view to settle the argument. It is simply worth nothing, as so many have observed, generally policymakers cannot resist the pressure to intervene. Hence, we never (or rarely) find out if letting the crisis burn itself out is the best course of action.

Kindleberger again summarizes the usual outcome.

The dominant argument against the a priori view that panics can be cured by being left alone is that they almost never *are* left alone. The authorities feel compelled to intervene. In panic after panic, crash after crash, crisis after crisis, the authorities or some “responsible citizens” try to bring panic to a halt by one device or another. . . . If there is a learning process at work—and the assumption of rationality requires one—the learning has taken the form of discovering the desirability and even the wisdom of a lender of last resort, rather than relying exclusively on the competitive forces of the market.<sup>5</sup>

There is no good answer. Many if not most of us feel intuitively that the market should be left to its own devices. And yet, we do not feel comfortable; and rarely would, in testing the view. The risks are believed to be too high and no one wants to bear the responsibility of having the problem spread while having done nothing.

For our part there is most likely a balance. Rescues need to be made...up to a point. In the case of Bear Stearns the Federal Reserve may very well have gone beyond that point. As we understand it, Bear Stearns was a substantial risk taker among those that financed the speculation in housing. So, we most likely would criticize the Fed for having gone too far. This is easy to do now that we’re four weeks beyond the rescue.

What we would not criticize the Fed for is the aggressiveness and creativity that they used in targeting the response once they decided to move. For that ...for the creativity and imagination they used in the specifics of the response...they deserve very high marks.

### **Employment Numbers**

Non-farm payrolls declined 80,000 in March after declining 76,000 in both January and February. Based upon the employment numbers, many have concluded that the U.S. economy contracted in the first quarter. While this conclusion is intuitively compelling, it is not statistically sound.

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<sup>4</sup> Kindleberger, p. 154. Of note that Lehman, after the Bear Stearns rescue, was able to raise \$4.0 billion in the financial markets through the issuance of convertible preferred securities.

<sup>5</sup> Kindleberger p. 158.

Non-farm payroll employment is one of four components of the Conference Board's Index of *Coincident* Economic Indicators. The other components include: personal income less transfer payments (2000\$), the Index of Industrial Production, and Manufacturing and Trade Sales (2000\$). The March employment numbers enable us to estimate level for the March coincident economic indicators. Since there is a strong statistical correlation between the Index of Coincident economic Indicators and Real Gross Domestic Product, we can estimate Real GDP on the basis of the index. The index implies statistically that Real Gross Domestic product increased .4% in the first quarter.

We include the regression output for those that may be so inclined.

Regression Output	
Sample size 113	Number of parameters 2
Mean 1.029	Standard deviation 0.0192
R-square 0.8091	Adjusted R-square 0.8073
Durbin-Watson 0.5399	** Ljung-Box(18)=121.8 P=1

Source: Johnson Illington Advisors, LLC

We would add that, as compelling as the statistics might be, it is simply too close to call. First quarter real GDP is likely to range as low as -3.9% to as high as 4.3%. That's, of course, not very helpful. We'll see.

## Employment Numbers and Inflation

Employment numbers and other important releases provide forward-looking inflation data. These March numbers imply that the Leading Index of Inflation rose from 100.9 to 103.1. The index has generally been rising and implies the following outcome for consumer inflation and consumer inflation excluding food and energy prices for the next seven quarters. We include the April consensus forecast for consumer prices as assembled by *Blue Chip Economic Indicators*.

Year/Qtr	Consensus	CPI	CPI (ex Food&Energy)
Q1 2008	4.1%	4.1%	2.4%
Q2(e)	3.6%	3.6%	2.4%
Q3(e)	3.5%	4.1%	2.4%
Q4(e)	2.8%	3.6%	2.3%
Q1 2009(e)	2.5%	3.0%	2.3%
Q2(e)	2.4%	3.3%	2.3%
Q3(e)	2.3%	3.2%	2.3%
Q4(e)	2.4%	2.6%	2.3%
2006	3.2%	3.2%	2.5%
2007	3.5%	3.9%	2.4%
2008	2.4%	3.0%	2.3%

Source: Blue Chip Economic Indicators, Johnson Illington

Importantly, we expect that the consumer price index (y/y) will remain above the consensus forecast and will remain above 3% through the fourth quarter of 2009.

### Federal Reserve Policy

The consensus forecast is that the Federal Reserve will reduce short-term interest rates from 2.25% to 1.75% in the second quarter.

Fed Policy Section		For FOMC Meeting on		
		30-Apr	25-Jun	05-Aug
Fed Funds Rate	<b>Med:</b>	1.88%	1.75%	1.75%
	<b>Mean:</b>	1.88%	1.74%	1.74%
	<b>St. Dev:</b>	0.13%	0.22%	0.22%
	<b>Low:</b>	1.75%	1.25%	1.25%
	<b>High:</b>	2.00%	2.00%	2.00%
	<b>Count:</b>	22	22	22
Balance of Risk	<b>Med:</b>	-1	-1	-1
	<b>Mean:</b>	-0.81	-0.75	-0.56
	<b>St. Dev:</b>	0.40	0.45	0.51
	<b>Low:</b>	-1	-1	-1
	<b>High:</b>	0	0	0
	<b>Count:</b>	16	16	16
<i>(+1 = Inflation, 0 = Balanced, -1 = Weak Growth)</i>				

Source: Action Economics

We include a longer-term forecast for Federal Reserve policy from Blue Chip Economic Indicators. Implicit in the forecast is that the federal funds rate will average 1.8% in the fourth quarter of this year and begin to rise in 2009. That is, the consensus forecast is that the Federal Reserve will begin to raise short-term interest rates in the first quarter of 2009 in response to some upward pressure on prices. This is, of course, consistent with our comments on the economy and inflation above.

Quarter	Federal Funds Rate
2008-Q1	3.27%
2008-Q2	2.00%
2008-Q3	1.80%
2008-Q4	1.80%
2009-Q1	2.00%
2009-Q2	2.20%
2009-Q3	2.50%
2009-Q4	2.80%
2007 Average	5.0%
2008 Average	2.2%
2009 Average	2.4%

Source: Blue Chip Economic Indicators

### Implications of the Consensus Forecast for Economy and Inflation for Interest rates and Stock Prices

The consensus forecast is that the economy will slow, but only slow in the first half and begin to recover in the second half. More specifically:

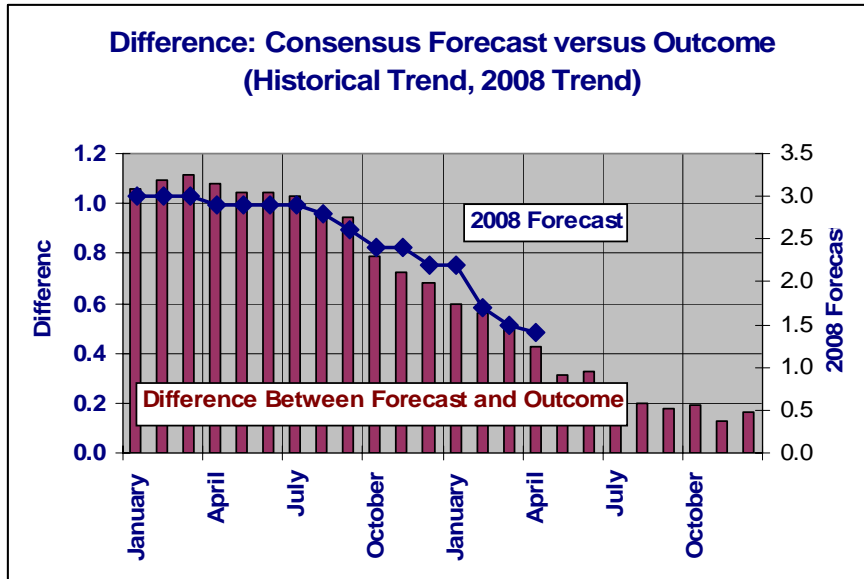
April 2008 Forecast				
Quarter	Real GDP	Q/Q Annual Rate%	CPI Y/Y	Federal Funds Rate
2008 IQ	\$11,679.5	0.1%	4.1%	3.27%
IIQ	\$11,682.6	0.1%	3.6%	2.00%
IIIQ	\$11,744.7	2.1%	3.5%	1.80%
IVQ	\$11,799.9	1.9%	2.8%	1.80%
2009 IQ	\$11,859.6	2.0%	2.5%	2.00%
IIQ	\$11,935.4	2.6%	2.4%	2.20%
IIIQ	\$12,018.3	2.8%	2.3%	2.50%
IVQ	\$12,103.5	2.9%	2.4%	2.80%
2007 (average)	\$11,566.8	2.2%	2.9%	5.0%
2008 (average)	\$11,726.7	1.4%	3.4%	2.2%
2009 (average)	\$11,979.2	2.2%	2.4%	2.4%

Source: Blue Chip Economic Indicators

We would only add that (a) the consensus forecast has tended to be .4 percentage points too high or too low at this stage of the forecast period, (b) the consensus tend to pull in only one direction during the forecast period (either up or down), (c) the consensus forecast, after “pulling” in one direction during the forecast period, nears the outcome (i.e. “gets it right”) only at the last stages of the forecast period, and (d) the consensus forecast for 2008 has been “pulling lower” throughout this forecast period.

The implication is that the current consensus for 2008 (see below) is most likely too high. More specifically, the implication is that real GDP growth in 2008 will be 1.0% (“fun with numbers”). Every reader should take this into account when reviewing the “statistical implications of the current consensus.”

The following chart summarizes changes in consensus during the forecast period and changes in the current consensus for 2008.



Source: Johnson Illington Advisors, LLC

If the consensus forecast for Federal Reserve policy is correct, then short-term interest rates should play out as follows. **Short-term interest rates are currently at levels that are consistent with the level forecast for the federal funds rate for the 1<sup>st</sup>-2<sup>nd</sup> quarters 2009 (2.0%-2.2%).**

Quarter	Federal Funds Rate	91-Day U.S. Treasury	2-Year U.S. Treasury	5-Year U.S. Treasury
2008-Q1	3.27%	2.04%	1.98%	2.70%
2008-Q2	2.00%	1.00%	1.10%	2.10%
2008-Q3	1.80%	0.90%	1.30%	2.30%
2008-Q4	1.80%	0.90%	1.30%	2.30%
2009-Q1	2.00%	1.10%	1.60%	2.50%
2009-Q2	2.20%	1.40%	1.90%	2.70%
2009-Q3	2.50%	1.70%	2.20%	2.90%
2009-Q4	2.80%	2.20%	2.70%	3.20%

Source: Johnson Illington Advisors, LLC

If short-term interest rates play out as forecast, then longer-term interest rates should play out as follows.

Quarter	10-Year U.S. Treasury	Moody's Baa Corporate	Bond Buyer 20 Bond Index
2008-Q1	3.61%	6.8%	4.6%
2008-Q2	3.20%	6.6%	4.4%
2008-Q3	3.50%	6.8%	4.6%
2008-Q4	3.50%	6.8%	4.5%
2009-Q1	3.70%	6.9%	4.6%
2009-Q2	3.90%	7.0%	4.7%
2009-Q3	4.10%	7.2%	4.8%
2009-Q4	4.40%	7.4%	5.0%

Source: Johnson Illington Advisors, LLC

If the consensus forecast for the economy is correct, then S&P 500 operating earnings and the S&P 500 should play out as follows. That is, the S&P 500 is now 3.4% above the

level it should average for Q2, 3.9% above the level it should average for Q4 and 3.8% below the level it should average for Q4 2009.

Quarter	S&P 500 EPS (LTM)	P/E	S&P 500
2008-Q1	\$80.99	16.6	1342.7
2008-Q2	\$77.04	16.7	1288.7
2008-Q3	\$74.22	17.2	1275.9
2008-Q4	\$73.34	17.5	1280.9
2009-Q1	\$74.01	17.5	1294.7
2009-Q2	\$76.03	17.3	1314.5
2009-Q3	\$79.07	16.9	1339.6
2009-Q4	\$82.67	16.6	1369.6

Source: Johnson Illington Advisors, LLC

It is, of course, encouraging to quantify the forecast. The economy should be expanding and interest rates and stock prices “should” be rising through 2009. This performance would be, of course, quite consistent with the pattern of post-war cycles with stock prices, the economy, and interest rates expanding/rising.

### Portfolio Strategy

Although the message of the financial markets has improved...marginally... and although the forecast as we quantify it is positive (for 2009), we continue to recommend a defensive structure for balanced portfolios until (a) the financial trends become “meaningful” and (b) we begin to see some improvement in important economic variables such as the composite Index of Leading Economic Indicators.

### Asset Allocation

We recommend a low allocation to equities in balanced portfolios. More specifically, we recommend that investors maintain an allocation to equities in balanced portfolios between levels summarized in the following two tables.

Asset Allocation	Percent	Asset Allocation	Percent
Range Allowed	Recommended	Range Allowed	Recommended
Under Guidelines		Under Guidelines	
20-50	20.0%	20-50	35.0%
30-60	30.0%	30-60	45.0%
35-65	35.0%	35-65	50.0%
40-70	40.0%	40-70	55.0%
50-80	50.0%	50-80	65.0%
60-90	60.0%	60-90	75.0%
70-100	70.0%	70-100	85.0%
Source: Johnson Illington Advisors, LLC		Source: Johnson Illington Advisors, LLC	

### Sector Allocation

Although we continue to recommend that investors overweight traditionally defensive stock market sectors (consumer non-cyclicals, utilities), we also recommend overweighting basic materials, industrials, and technology.

Sector	Recommended Weight	Market Weight	Ratio
Basic Materials	4.4%	3.6%	1.24
Consumer Non-Cyclical	13.7%	11.1%	1.24
Energy	16.4%	13.3%	1.24
Industrial	15.0%	12.2%	1.24
Technology	19.4%	15.7%	1.24
Telecommunications	4.2%	3.4%	1.24
Utilities	4.4%	3.6%	1.24
Consumer Cyclical	5.1%	8.6%	0.60
Finance	10.1%	16.8%	0.60
Healthcare	7.1%	11.9%	0.60

Source: Johnson Illington Advisors, LLC

### Capitalization Allocation

We recommend that investors have a meaningful exposure to both large capitalization and mid-sized issues.

Capitalization	Recommended Weight	Market Weight	
Large	87.6%	87.2%	1.00
Mid	9.6%	8.6%	1.11
Small	2.8%	4.2%	0.67

Source: Johnson Illington Advisors, LLC

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