



October 2008

Dear Gamble Jones Client:

Some things to keep in mind during this financial crisis:

1-The Economy

The economy is certainly in a recession, and in recent days, seems sinking. Remember, recessions are part of the economic cycle. Fed Chair Bernanke is a student of the Great Depression, and will likely advocate that the Fed continue to take an activist role as the lender of last resort.

However, it is important to note that this is not the Great Depression. Unemployment is relatively low and well over 90% of families are employed and paying their bills, including their mortgage obligations.

What is missing now is confidence, and we are in an environment where fear is outweighing greed. This environment will not last forever.

2-Origins of Crisis

Nearly 80 years later, economic historians still debate the causes of the Great Depression. This will also be the case with the current crisis. However, you can pinpoint the following:

1. Deregulation of the financial services industry. An outgrowth of the Great Depression was the Glass Steagall Act, which separated investment banks (underwriting) from commercial banks (deposit gathering). In the last decade this distinction has eroded.
2. Beginning with the Y2K scare, and then, as a result of the attacks of September 11, the Fed flooded the monetary system with excess liquidity. This led to low interest rates and speculative lending policies.
3. Leverage. Commercial banks leverage their capital about 10 times. Investment banks, private equity, and Fannie and Freddie leverage much more. If you earn a 2% spread on an asset levered 10 times you earn 20%. If you lose 2% on an asset levered 10 times you lose 20%. This is a recipe for a train wreck.
4. Expansion of Fannie Mae and Freddie Mac were mandated beyond their original intent.

5. There is plenty of blame for politicians of all stripes. Adding \$110 billion of “goodies” to the final bailout legislation will not boost Congress’s polling numbers.

3-Terms of Government Action

Will the bailout work? It will likely have the effect of stabilizing financial institutions and, over time, restoring confidence. But it will not happen overnight. Talk is likely to begin for a massive stimulus package for the economy.

4-The Markets

Are we near the bottom? The current P/E ratio of the market is about 13-14. This is slightly below historical norms. Contrast this with the height of the “tech bubble” of 2000-2002, when the P/E average of the overall market was about 30, or, in 1973-74, when in the midst of inflation and high interest rates, quality common stocks had P/Es less than 5.

Can the markets go lower? Yes. Will they ultimately recover? Yes. You cannot overlook the resources and magnitude of the U.S. economy and the productivity of our people, which, given time, will likely overcome ill-conceived government policies and speculative greed.

Sincerely,

Gamble Jones Investment Counsel