Baldwin Investment Management, LLC

BREATHE DEEPLY……..NOW EXHALE

As the third quarter of 2008 closes, many investors are "licking their financial wounds" and searching for clarity amidst all the market tumult. We shall not recount what you already know about bank "failures", GSE takeovers (Fannie and Freddie), the failed "rescue" bill before the House of Representatives and the U.S. financial "ailment" spreading to Europe. Rather, we will turn our attention to where we are now and where we might be going.

CHEAP would be an accurate adjective for equities compared to bonds – here in the United States and in many other markets elsewhere in the world. But let us compare the U.S. stock market as represented by the S&P 500 to other market bottoms in 1962, 1966, 1970, 1974, 1982, 1987, 1990, 1998 and 2002, to today's. For example:

- Nominal interest rates are lower today than at any other market bottom;
- Real interest rates (i.e. Treasury yields less expected inflation rates) are similarly low;

The two factors above should translate into higher than normal P/E ratios. However twelve month trailing and forward looking P/E ratios are lower today than many former market bottom P/E ratios; and

- The peak to trough stock price decline registered through 9/29/08 has been 29.3% vs. average peak to trough declines of 28.2%.

In short, given the inflation and interest rate environment extant today in America, stocks look cheap.

We have written in the past about the strong fiscal condition of most of corporate America. There are obvious exceptions like the automobile industry, banking and residential real estate industries which are not "flush" with corporate vigor. Unfortunately, these forlorn businesses seem to be the only ones getting any press (all quite negative, mind you) except for the oil business, which in spite of being healthy and a nice counterbalance to the forlorn gets "pasted in the press" for making too much money. Nevertheless, not all of corporate America is in bad shape.

Despite the fact that all is not bleak, the stock market in 2008 has had quite a tumble. The culprit is the debt market. The debt market in the U.S. is "frozen". Bankers are scared to lend and this is reflected in extraordinary rates being charged by banks to other banks and companies. Earlier we said that nominal interest rates are low. The nominal rates about which we speak in this instance are Treasury bond rates – the safest paper in the world. Any other notes or bonds (i.e. corporate) are not accorded such a warm investor welcome because they are not considered by investors to be as safe as Treasury debt and to attract investor interest issuers must offer much higher coupons. More reflective of today's environment, banks are hoarding cash for fear of not getting paid back. In some instances, no matter what the interest rate offered, no money will be lent. As an example, AT&T can sell their commercial paper for one night only instead of their usual 7 to 30 days. The market is frozen because of fear.

This is very important, because our economic system operates using credit. No credit and our economy will shut down. Stores which finance inventory (i.e. dresses, shirts, shoes, etc.) for the holiday season will not be able to do so – thus no holiday season. Payrolls will not be met because of mismatching receivables and payables. People will not be able to buy cars unless they pay cash. Home sales which are very slow today will simply stop. The smooth flow of commerce will come to a "grinding halt".

Legislation has been introduced by Treasury Secretary Paulson to help "unfreeze" the credit markets. Is it a panacea? No. It is an important first step. More will need to be done and there will be plenty of time once our economy is more stabilized to attach blame to various "bad actors". But we need to get on with the task of dealing with the systemic risk present in our economy today.

> *We need to correct, by drastic means if necessary, the faults in our economic system from which we now suffer. We have not been brought to our present state by any natural calamity – by drought or floods or earthquakes or by the destruction of our productive machine or our manpower. This is the awful paradox with which we are confronted, a stinging rebuke that challenges our power to operate the economic machine which we have created. The country needs and – unless I mistake its temper – the country demands bold, persistent experimentation. It is common sense to take a method and try it: If it fails, admit it frankly and try another. But above all, try something.* [1]

Besides Secretary Paulson's effort to unclog the system, we support two other ideas that have been discussed for quite some time. First, the SEC needs to reinstate the "uptick rule". This was in place since the Great Depression and then eliminated in 2007. The uptick rule did not allow short sellers (people who sell borrowed stock planning to buy it back at a lower price for a profit) to sell stock on a downtick – i.e. a lower price. In other words, short sellers could only sell a stock if the price moved up the trade before the short sale; this prevented "piling on". Recently, investors have witnessed stocks getting decimated in the marketplace. In a day, an equity can lose 95% of its value as a result of "piling on" – selling on downticks. This must be stopped.

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[1] Franklin Delano Roosevelt, Oglethorpe University, 1932

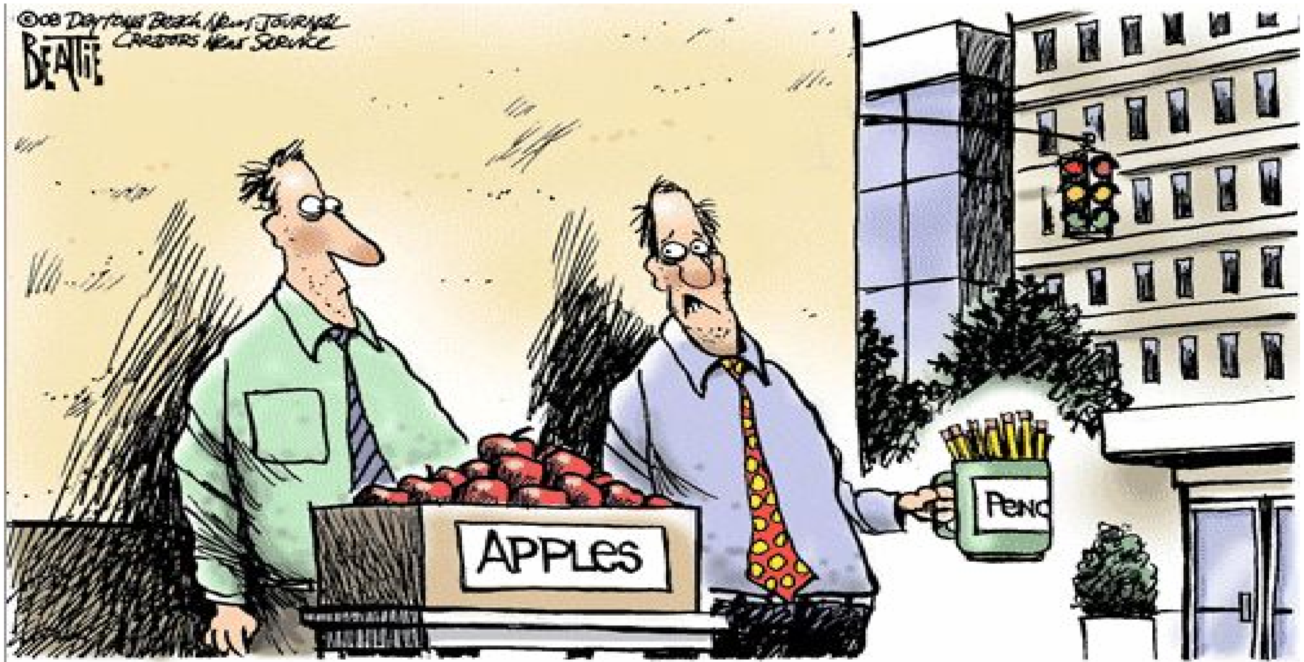
Also, while we believe that "Fair Value Accounting" is very sensible in theory – in practice, it leaves much to be desired, especially when the assets to be "fairly valued" are illiquid. The thought behind this fair value theory is to make company balance sheets as accurate and current as possible. Proponents do not want managements hiding behind fictitious valuations if assets put on the balance sheet deteriorate in value over time. The assets should be "marked to market". This is all well and good ***if*** there is an accurate market against which to value an asset. However, if an asset is unusual and illiquid with no good comparable market against which to measure its value, then the result could be a very flawed "mark to market" valuation. This is exactly the situation we have today. Many of the mortgage backed assets held by financial institutions are being measured against a derivative index which is not directly comparable and can be "gamed" by market participants hoping for a particular outcome. Consequently, billions and billions of dollars of assets are being and have been inaccurately marked. This has led to huge and possibly unnecessary write downs, which have crippled numerous financial institutions. We are in favor of fair value accounting. We do *NOT* think that it is being correctly implemented. Accurate comparable markets need to be found for measurement purposes or fair value accounting can not be used in an instance where there is no market.

In summary, value is at present being overwhelmed by emotion – primarily fear. The credit market is "frozen" with bankers unwilling or unable to lend even at times to their best customers. This is not a good situation and one that must be corrected quickly if we are not to further hurt our immediate economic prospects. The chances of the U.S. economy falling into a recession have risen quite sharply. Earnings outlooks will probably be coming down as we enter the third quarter reporting season. If credit begins to flow and interest rates stay low, economic repair will begin in our system. Stock prices should begin to anticipate an earnings recovery in the second half of 2009 resulting in market improvement towards the end of 2008 and the beginning of 2009.

NB. As this is going to "press" the second vote of Secretary Paulson's revised version of TARP (Troubled Asset Relief Program) goes to a vote before the House. Passage would be a significant first step in resolving America's crisis.

PREDICTIONS FOR 2008	COMMENTS
1. Late in 2008, the Fed will begin to raise interest rates	No – if anything there will be a cut in rates
2. The dollar will appreciate in value vs. the Euro and Yen	Yes – the dollar is one of the best performing assets in the financial maelstrom
3. Housing will stabilize in the second half of 2008	Still hoping –builder stocks imply that the stock market is sensing a change for the better
4. Financial stocks will outperform in 2008	No – bad call
5. There will be Middle East progress in Palestine and in Iraq	Progress continues, but at the moment this is back page news
6. Oil prices will come down	Yes – and this will be helpful with inflation & consumer sentiment
7. Inflation will be a little worrisome in the first half of 2008; but not in the second	Yes
8. Hillary Clinton will not be elected President; and Michael Bloomberg will run if the Republican field is "muddled" coming out of South Carolina	Got that right
9. International equity markets will continue to distance themselves from U.S. markets	No – the only thing that rises in a down market is correlation
10. The U.S. stock market will do better in 2008 than it did in 2007	No – investor mood is too ugly

A FINAL THOUGHT



"Things must REALLY be bad . . . Warren Buffett is on a buying spree."

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