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In this Issue:

- Market Outlook
- Inside MCM

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Time To Take A Deep Breath

By Ted Cronin, CIO

The palpable anxiety that we have felt in the markets has turned to panic as investors watch the credit markets come to a virtual halt. Banks and financial institutions of all sizes are hoarding cash; afraid to lend to anyone because of the uncertainty of whether the borrower will be able to repay.

GE Capital, for example, recently stopped loaning money to Sonic Corporation, a mid-western restaurant chain (good burgers) that regularly borrows money to purchase supplies, pay for equipment, and expand new restaurants. When Sonic Corp restricts operations because it can't borrow money, its franchisees don't open new restaurants, contractors don't get hired, and equipment makers don't get orders. The negative effects are multiplied throughout the economy.

Lenders are in a coma because they see their peers being crushed by excess bad debt leveraged in a way that destroys balance sheets and their capital base. Selling begets short selling, short selling begets panic selling, and panic selling begets bank runs.

In the last few months, Lehman Brothers has failed, Merrill Lynch has disappeared into Bank of America, Freddie Mac and Fannie Mae have been taken over by the government, and perhaps the most shocking of all, AIG has collapsed into receivership. Even now it seems inconceivable that a firm with the size and business merits of AIG could crash. No one predicted such an outcome even a few months ago. Such uncertainty ignites understandable fear as it proves we don't know what could happen next.

This is not the time to be optimistic, nor a time to be pessimistic. It is a time to be realistic. It is the time to set aside the normal human emotion to run and hide. When I step back to gain some perspective I notice that the camp at each end of the spectrum is ruled by their

(Continued from page 1)

respective passions of fear or greed.

Alarmists who wring their hands in fear and declare that this is the worst crisis since the Great Depression seldom offer any plan of action, although their implication is that we should sell everything and hide in the basement with gold coins. However, their analogy doesn't match the facts. During the Great Depression of the 1930s, unemployment soared to 25% (it's at 6.1% today), the Gross Domestic Product plunged by more than 30% (it was up 2.8% last quarter), and land values plummeted by more than 50% (home prices are now back to the levels of 2001). Clearly, the current economic state of affairs bears little resemblance to the conditions of the 1930s. There is a crisis of confidence not a crisis of most business fundamentals. Campbell is still selling soup.

Optimists identify indicators of a bear market bottom, and suggest now might be the time to take on new risk. Market prices are generally down around 20 to 25%, which is the norm for most bear markets. Fear levels, as measured by the volatility index, such as the VIX, or the put-to-call ratio, are approximate to bear market bottoms, and close to record levels. The markets have shown incredible durability in the face of an onslaught of negative news from every media outlet.

And smart investors, such as Warren Buffett, are buyers of selected assets. He recently purchased a large stake in Goldman Sachs and a nuclear energy utility, and anyone who doubts that Mr. Buffett makes investments for any reason other than opportunity for gains isn't familiar with his history. That said, there are few with Warren Buffett skills, and trying to trade a market as volatile as this one is more dangerous than ever. The current market decline is littered with smart investors, such as the private equity team at TPG or money managers such as Bill Miller, that are paying the price for being too optimistic about the extent of the credit troubles.

Realists recognize that the US economy is exhibiting its most inspiring characteristic – creative destruction, whereby the bad ideas and the bad players are being flushed from the system. Capital is being reallocated to new enterprises that offer promise while those

(Continued from page 2)

enterprises that are faulty are exposed and terminated. America has a remarkable capacity to admit errors, accept the consequences, and move forward toward a solution.

The US Congress is passing new legislation that will allow the government to purchase some of the bad debt and hopefully allow the credit markets to begin functioning again. Lending will probably not start until there is clarity about what some of the bad mortgage pools are actually worth, and only the government has the capital strength to begin buying them and establishing prices. GE Capital might resume loaning money to Sonic. The current panic might be replaced by a new hope that our troubles will be solved.

However, I suspect that the economy will suffer the ill-effects of the credit problems for several years. We don't know yet how much the credit disruption has slowed the economy. While most economic measures suggest the economy continues to grow rather than contract, these are trailing indicators that are in flux. Consumer confidence is weak, and global economic growth has slowed appreciably. Europe is particularly weak and is almost certain to enter a serious recession. Banks might begin to loan again, but at a modest, restrained pace until its management has greater confidence that economic conditions are healthy.

Most importantly, the housing market needs to stabilize. The housing market and the falling prices caused by subprime mortgage defaults have been at the root of the problem. Between 2002 and 2006, subprime mortgages went from 2% to 30% of the total loans. These poorly made loans were packaged into fancy structures, sold by players such as Merrill, insured by firms such as AIG, and rated as if they were prudent investments. They turned out to be toxic, and like the loose yarn that unravels the entire sweater, their failure is what has undermined the banks capital base.

Current reports on the housing market continue to be largely negative, with declining prices, excess inventory, and reluctant buyers. Occasionally, there is a positive sign in one measure or another that offers reasonable hope that the housing market will bottom in 2009. As realists, we know that there is a price where buyers will begin to buy, and despite the initial excess mortgages, the

(Continued from page 3)
homes represent solid assets of value. People need homes to live in. The government will probably make money buying pools of mortgages at depressed prices and reselling them.

When investors focus on these facts, rather than the fear of an economic maelstrom or the greed of stocks at depressed prices, the markets will recover. Patient investors, who are sticking to well-thought out, diversified investment plans, will enjoy the rewards that come from taking a deep breath and maintaining the course.

Inside MCM

We are Pleased to Welcome Gary, Lauren, and Griffin to MCM!

Gary Dorfman joined the firm in March 2008 as the Managing Director of our Montecito office. He is responsible for leading the overall efforts of the West Coast business, including managing office operations and serving the needs of clients. He was formerly a Vice President at Sanford C. Bernstein, and a Managing Director at Robertson Stephens & Co. Gary received his BA from the University of California at Santa Barbara and completed coursework at the Wharton School of the University of Pennsylvania. Gary is a Montecito resident and is the proud father of his daughter and two sons, Tyler, Ava, and Colby. A lifelong sports lover, Gary is an avid swimmer and takes great pleasure in coaching his kids' baseball and soccer teams.

Lauren Crisenberry joined MCM's Montecito office in October 2007 as an Investment Associate and has recently taken on a new role as Executive Assistant to the President. She works directly with the President to coordinate administrative and operational functions and client relations. She provides support with the investment team, special projects, and back office operations for the West Coast. A Santa Barbara local, Lauren is a graduate of the University of California at Santa Barbara having obtained her BA in Business Economics. In her free time Lauren enjoys hiking, bicycling, snowboarding, wake boarding, singing, dancing, and spending time with her friends and family.

Griffin Sivret joined the firm in February 2008 as an Investment Associate and has recently taken on a new role as Operations Manager. He is responsible for supporting all aspects of the investment team and acting as a resource with operational functions. Griffin previously worked as an operations analyst at JPMorgan Chase and Grantham, Mayo, Van Otterloo in Boston. Griffin received his BS in Marketing from the University of New Hampshire. He resides in Walpole, New Hampshire where he enjoys hiking, tennis, soccer, and an occasional round of golf.