

Market Insights

October 16, 2008

More straight talk.



The market has exhausted all clichés in the last few weeks. Crash, toxic assets, liquidity strains, credit crunch have all become part of the banter which passes as commentary. So what happened and what's next?

As mentioned before, the problem lies with an over leveraged financial sector. The system built up debt following the stock market fall of 2000 to 2002. A period of easy money, coupled with financial innovation and obsolete regulation, allowed banks and lenders to extend credit gratuitously. Household debt, mainly in the form of mortgages, rose 77% in the seven years ending in 2007, while the economy grew 30%¹. Debt fed a housing and commodity price bubble with prices increasing by 85% and 108%², respectively, from 2002 to 2007. Financial service companies benefited. At the height, financial services accounted for 4% of the country's employment, 20% of salaries and 30% of profits³. This kind of leverage is simply not sustainable and when the market called the sub-prime bluff, chaos ensued.

In the last few weeks, governments from around the world have tried to shore up confidence. The measures have taken five forms: 1) buying assets for which there is no discernible value or market from banks and insurance companies, 2) extending guarantees and lines of credit to companies, 3) guaranteeing bank deposits, funds and interbank lending, 4) coordinating rate cuts and, 5) recapitalizing banks through equity purchases. The market greeted each with initial interest but quickly grasped that none would suffice to unlock capital and restore confidence. Only the last, recapitalization in the form of equity purchase, has a proven record of success, in Sweden and Japan. Gordon Brown, the UK Prime Minister promoted the idea and several countries followed. The US market pulled back from taking the same road because of an outmoded attachment to government control of private enterprise. While laudable in other times, the time for ideological rigidity has passed.

Stocks have been culled. No sector untouched. As of the time of writing, the S&P 500 Index⁴ is down 34% for the year. Only 32 companies showed a positive return while 119 companies fell over 50%. The MSCI World Index⁵ has fared little better with a 32% decline over the same period. At these levels, valuations are attractive by recent measures. The US market sells on a forward price-earnings ratio of about 13.0 and the world markets of 9.0. Many blue chip names trade at even keener prices. Dividend yields are often in excess of government bond yields, a common measure of relative attraction of stocks, and corporate returns on equity are strong.

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1 Source: Federal Reserve Website

2 Source: Bloomberg

3 Source: Robert Merton, Harvard Financial Markets Panel, 9/25/08

4 The S&P 500 Index is an unmanaged index considered representative of the U.S. stock market. An investment cannot be made directly into an index.

5 The MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. A direct investment cannot be made directly into an index.

<p>But while these are compelling numbers, they are subject to revision. So there are probably three requirements before we see the bottom:</p> <p>Clarity on corporate earnings. Companies are revising earnings down and until the news settles investors remain nervous.</p> <p>Direction on the real economy. Recent news on retail sales, jobless claims and manufacturing all indicate that we are in recession. We do not yet know its depth or dispersion.</p> <p>Legislative and government action. The Treasury and Fed have made copious announcements with very little effect. The faster the government can take steps to reassure its citizens, the better.</p> <p>At times like this, it is difficult to see the light. Yet there are many examples of optimism. First, the U.S. remains a bastion of entrepreneurialism. Many U.S. companies remain role models that others seek to emulate. Second, the global economy offers many opportunities and there are countries and companies with sufficient wealth and strength to prosper in more difficult times. Third, there is an opportunity to revitalize the government and private sector links. These have been separate and equal for much of the last 20 years. Recent events suggest a more productive relationship.</p> <p>Markets are very good predictors and tend to lead events in the economy by between six to nine months. If any or all of the above start to clear, we will see confidence return. Meanwhile, we at Sentinel will stick to what has worked for us in the past. We invest in what we understand. That means companies with strong balance sheets, management and products. We will look to be owners of those companies for many years and we expect that the current market offers opportunities to those prepared to wait.</p> <p>Many of us here at Sentinel have significant holdings in the Sentinel Funds. Investors should continue to monitor their needs but follow the great rules of investment: diversify, manage risk and buy quality companies. Prosaic perhaps, but rules that we know and follow here at Sentinel.</p>								
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