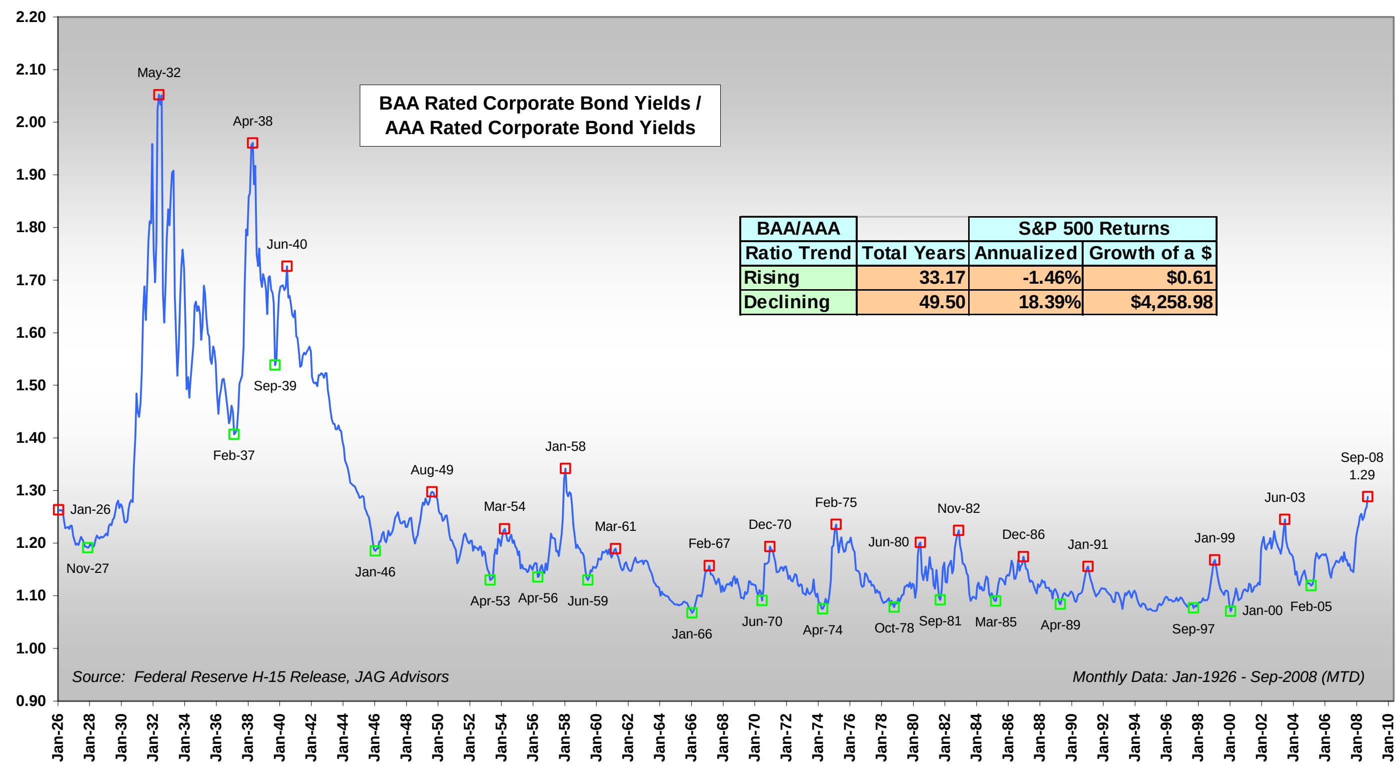
<u>Where Are The Capital Markets Headed? Watch Bond Yield Ratios for Clues</u>

Forecasting stock market returns without access to a genie or a crystal ball is a notoriously frustrating and humbling endeavor. Money manager Ken Fisher calls the market "The Great Humiliator" - acknowledging its power to confound and confuse even the most astute analysts. Now and then, however, we uncover some persistent tendencies that help shed light on the market's mysterious ways.

JAG Advisors recently discovered that a couple of bond yield ratios illustrate a pattern of behavior that investors may be able to use to their advantage. Using data from the Federal Reserve, we created a chart that shows how the ratio of BAA-rated corporate bond yields/AAA-rated corporate bond yields has behaved since January 1926. The ratio rises when the yield on lower rated BAA bonds rises faster than AAA yields. The ratio declines when BAA yields fall relatively faster than the yield on their AAA cousins. Typically the ratio rises during periods of economic stress or uncertainty. During these periods, bond buyers demand higher yields from the lower rated BAA issues to compensate for increased credit risks. On the other hand, a falling ratio generally foreshadows improving business conditions and a lower risk of defaults. In the chart below, we've labeled significant peaks and troughs in the ratio all the way back to January 1926.

In perusing the chart's squiggles, we see that the ratio has generally moved up and down in a fairly well defined range, peaking at around 1.30 and bottoming around 1.10. A significant exception to this pattern occurred during the Great Depression, when the ratio reached a high of 2.05 in May 1932 and remained extremely volatile throughout the 1930's.

As one can see below, the ratio is currently at 1.29, its highest level since January 1958:

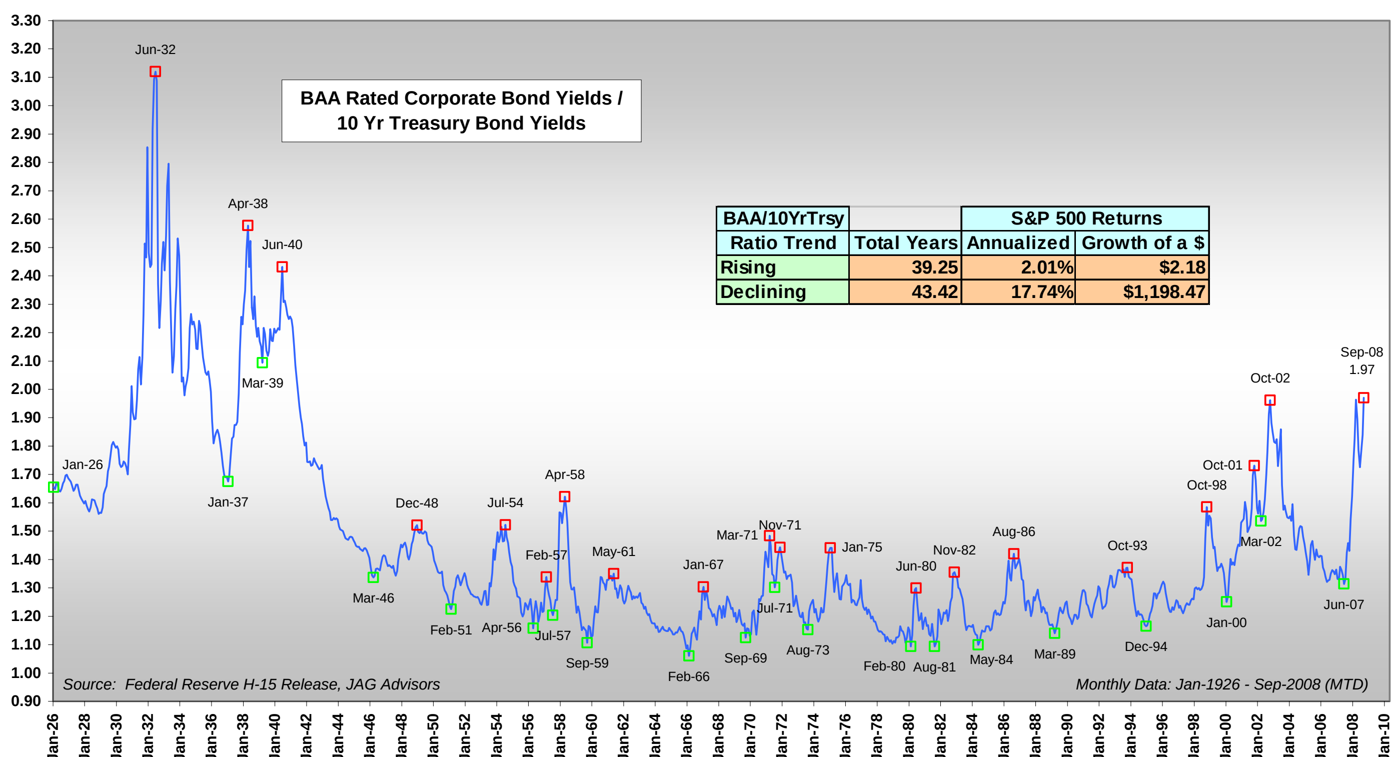


BAA/AAA		S&P 500 Returns	
Ratio Trend	Total Years	Annualized	Growth of a $
Rising	33.17	-1.46%	$0.61
Declining	49.50	18.39%	$4,258.98

With this historical data in hand, we continued our analysis and looked at how equities behave during periods when the ratio is rising and falling. The results are extraordinary and are summarized in the table embedded in the chart. We found that the ratio was rising during just over 33 of the last 82+ years. The ratio was in decline during roughly 49 of those years. If you had owned the S&P 500 only during periods when the ratio was headed up, your equity portfolio would have *declined* in value at a -1.46% annualized rate. In total, your portfolio would have lost 39% of its value – each dollar invested in January 1926 would be worth only $.61 at the end of September 2008. However, if you took the opposite approach and invested in stocks only when the ratio was falling, your portfolio would have compounded at an annualized rate of 18.4%. Each dollar invested in this portfolio in January 1926 would have grown to $4,259 by the end of September 2008.

We must point out that peaks and troughs in the yield ratio do not coincide exactly with tops and bottoms in the equity markets. But the general trend in the ratio does an excellent job of gauging how stocks will likely perform.

Our second chart is similar to the first, but in this case we calculate the ratio using 10-year Treasury bond yields in the denominator instead of AAA bond yields. The history of this comparison is similar to the first, but there are some differences. Note that the yield ratio at the end of September 2008 was as high as it has been since the early 1940's (!). This is a clear picture of the level of fear currently gripping the capital markets, and we would venture to say that there are very few, if any, investment professionals today who have lived through this kind of extreme credit environment.



BAA/10YrTrsy Ratio Trend	Total Years	S&P 500 Returns Annualized	Growth of a $
Rising	39.25	2.01%	$2.18
Declining	43.42	17.74%	$1,198.47

The charts both demonstrate that bond yield ratios are now at multi-decade highs, reflecting an (almost) unprecedented level of fear and loathing in the capital markets. So, what next? Given the historical data, the trillion dollar question is whether or not we are near a peak level of fear in capital markets? In other words, could we be near an inflection point in these ratios? If so, then equities and corporate credits could experience meaningful outperformance in the coming months.

We think the answer to the first question is a cautious and qualified "yes." Unless we are facing a true global financial meltdown on the order of the Great Depression (in which case the only true areas of "safety" would be U.S. Treasuries and, perhaps, physical gold), capital market fear should begin to subside from these peak levels in the coming weeks and months. We believe that a broad-based financial "calm-down" may occur if there is a successful passage of some version of the Troubled Asset Relief Program (TARP) here in the U.S. Another possible positive catalyst, even in the absence of a successful vote on the TARP, could be continuation of the ongoing recapitalization programs of large U.S. financial institutions. However, even if fear ebbs in the short term, history shows us that we should *not* expect an immediate collapse in risk spreads. Both equity and credit markets will likely be on tenterhooks for a period of months, as market participants will demand more evidence of stability before plunging back in with both feet. And whether we like it or not, this data indicates that the prospective returns of the equity markets are likely to hinge upon a recovery of the credit markets.

Michael Buck, CFA
JAG Advisors
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