

## 2008: A Year For The History Books

It's a sure bet that your children, grandchildren, and great grandchildren will get a hefty dose of 2008 in their history books. Although more than a handful of mavens liken the current economic meltdown to that of the Great Depression, the truth is that this economic debacle is history in the making.

Yes, the stock market tanked in 2008 as it did in 1931. It is also true that commodity prices have deflated as they did in the 1930's. It is also "odds on" that the unemployment rate will be etched in double digit percentages as it was during the Great Depression. However, the government's response to today's economic cataclysm is nothing like that of the 1930's. Furthermore, the \$6-plus trillion lost in the U.S. stock market and the number of participants that saw a lifetime of savings melt away dwarfs similar statistics of the 1930's.

Here is a chronological list of what we believe were the biggest stories of 2008.

### January

- Bank of America agrees to buy Countrywide Financial for \$4 billion.
- Rogue Trader at Societe General cost the bank more than \$7 billion.
- Standard & Poor's downgrades more than 8,000 collateralized debt obligations and forecasts that financial firms will lose more than \$265 billion.

### February

- Congress approves a \$168 billion stimulus plan.

### March

- Eliot Spitzer resigns in disgrace as New York's attorney general.
- Bear Stearns is acquired by JP Morgan at a fire sale price.

- The price of an ounce of gold closes above \$1,000 an ounce for the first time ever.
- Visa's \$19.65 billion initial public offering is the largest in history.



Dr. Gerald  
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### April

- Mars and Berkshire Hathaway acquire William Wrigley for \$23 billion.
- Delta and Northwest Airlines agree to merge.

### May

- Linens N Things files for Chapter 11 bankruptcy protection. Later it would begin to close all of its retail outlets.
- Tropicana files for Chapter 11 bankruptcy protection.

### June

- Barack Obama secures enough delegates to win the democratic party's Presidential nomination.
- Gasoline hits \$4 a gallon for the first time.
- In Bev launches a successful bid for Anheuser-Busch.

### July

- Indy Mac is seized by Federal Regulators.

### August

- Swimmer Michael Phelps becomes the most successful Olympian of all time.

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*DR. PERRITT continued on page 2*

DR. PERRITT continued from page 1

## September

- The government seizes Fannie Mae and Freddie Mac.
- The Federal Reserve agrees to convert Morgan Stanley and Goldman Sachs into traditional bank holding companies.
- Warren Buffett invests \$5 billion in Goldman Sachs.
- President Bush signs \$700 billion financial services rescue bill.

## November

- Barack Obama elected President of the United States.
- China announces a \$586 billion stimulus package.
- Circuit City Stores files for chapter 11 bankruptcy protection. After failing to find financing, the company then decides to liquidate.

## December

- The National Board of Economic Research announces that an economic recession in the U.S. began December 2007.
- Pilgrim's Pride files for bankruptcy protection.
- The U.S. loses 500,000 jobs, the largest monthly drop in 34 years.
- Bank of America and Merrill Lynch shareholders approve a merger agreement.
- The Tribune Company files for Chapter 11 bankruptcy protection.
- The U.S. Treasury sells four-week notes at zero percent interest.
- Bernard Madoff is arrested for carrying out a \$50 billion Ponzi scheme.
- The Bush administration agrees to lend General Motors and Chrysler \$17.4 billion.
- The government commits \$6 billion to GMAC.

## 2008 Financial Market Statistics

### Commodities

Gold	5.8%
Corn	-10.6
Cattle	-12.2
Soybeans	-18.9
Silver	-23.8
Wheat	-31.0
Platinum	-38.7
Oil	-53.5
CRB Index	-36.0

### Foreign Markets

U.K. FTSE 100	-31.3%
DAX	-40.4
CAC 40	-42.7
Japan	-42.1
Hong Kong	-48.3
India	-52.4
China	-63.6
Mexico	-24.2
Brazil	-41.2
Argentina	-49.8

### U.S. Industry Performance

Basic Materials	-51.7%
Consumer Goods	-28.4
Consumer Services	-32.6
Financials	-50.1
Health Care	-24.8
Industrials	-40.9
Oil & Gas	-37.4
Technology	-43.6
Telecomm	-36.2
Utilities	-32.1

### U.S. Stocks

Dow Industrials	-33.8%
Nasdaq Composite	-40.9
Nasdaq 100	-41.9
S & P 500	-38.5
Russell 2000	-34.8
Wilshire 5000	-38.7

### U.S. Dollar

up	4.5 %	Euro
up	36.2	British Pound
up	22.5	Canadian Dollar
down	18.6	Japanese Yen

### Bond Yields (year end)

30-yr T-bond	2.69%
1-yr T-note	2.22
3-mo T-bill	0.04

Source: Yahoo Finance



## Be Weary Of The So-Called “January Effect” Barometer

According to stock market lore, the stock market’s direction in January is a barometer of the stock market’s direction during the entire year. In other words, a stock market gain in January signals a gain for the entire year while a market decline in January signals a decline in stock prices for the year.

Recently, we checked the record for this bit of stock market wisdom. Beginning with the year 1926, we calculated the change in the Standard & Poor’s 500 Index during the month of January and the change in the Index during the entire year. Here is what we found.

During the last 83 years, the stock market’s direction during January was accompanied by a similar change in the stock market for the year 60 times. In other words, the January barometer correctly forecast the direction of change in the stock market 72.3 percent of the time. However, remember that January’s return is included in the market’s annual return. Thus, the January effect is biased toward correct forecasts. To truly measure the accuracy of the January Barometer, one should compare the direction of the stock market’s change in January with the market’s return *during the remaining 11 months of the year*. When we removed the bias in the January effect, we

found that the direction of the move in stock prices during the month of January correctly predicted the direction of the market during the next 11 months during 55 of 83 years. That is, the forecasting accuracy of the January effect declines from 72.3 percent to 63.9 percent.

There are those who would argue that, even after adjusting for the bias, the January barometer is still a good indicator of the market’s direction during the remaining months of the year. (After all it still rings true about two-thirds of the time.) However, if you ignore the stock market’s direction during the month of January and simply guess that the stock market will rise during the remaining 11 months of the year, you would have been correct in your prediction 67.5 percent of the time.

Given that it sure looks like the stock market is going to finish January 2009 with a loss, look for pundits to paint a dim picture for stock returns during the entire year. Given the state of the global economy, chances are that the stock market could have another difficult year. However, an examination of stock market returns during the last 83 years tell us to pay no attention to January 2009 returns when making our prediction for the remainder of the year.

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## We Are Going To Miss George Bush 43

I, for one, am going to miss President George W. Bush, if for no other reasons than his ability to butcher the English language and to say what he doesn’t mean. Here is a small sample of some of my favorite “Bush-isms.”

“Families is where our nation finds hope, where wings take dream”

“I know how hard it is to put food on your family.”

“I know the human being and fish can coexist peacefully.”

To a divorced mother of three in Omaha, Nebraska. “You

work three jobs? Uniquely American, isn’t it? I mean, that is fantastic that you’re doing that.”

“Too many good docs are getting out of the business. Too many OB-GYNs aren’t able to practice their love with women all across this country.”

“They underestimated me.”

“Rarely is the question asked: Is our children learning?”

“Our enemies are innovative and resourceful, and so are we. They never stop thinking about new ways to harm our country and our people, and neither do we.”

## It's A Wacky World Out There

The "Big Three" auto executives jumped in their company jet planes and headed to Washington to cry poverty and to ask the government for a \$30 billion handout to save their troubled companies. (Just what were these guys thinking?)

Bernie Madoff (as in made off), the former Chairman of Nasdaq, admitted to stealing a mere \$50 billion of client's money in a record-breaking Ponzi scheme. Despite efforts to have him jailed, the court ruled that he should be confined to his luxurious New York apartment, where he immediately began sending millions of dollars of trinkets to friends and relatives. (If convicted, perhaps the government will let him continue to reside there and save the money that would be spent during a prison term.)

Barack Obama upset an overconfident Hillary Clinton to win the democratic nomination and then trounced an economically confused John McCain in the Presidential election.

The entire country of Iceland sank into bankruptcy because of an overleveraged banking system. (Hummm)

The Treasury let Lehman Brothers go bankrupt but later changed its policy and handed its competitors, Goldman Sachs and Morgan Stanley, billions of dollars to insure their survival.

The Bush administration enacted a mid-year economic stimulus plan that called for the distribution of \$130 billion to low- and middle-income families. The result was

a spike in consumer spending (including a huge jump in

## Looking Ahead

In the September issue of Perritt Capital Management's Client Letter, I outlined my reasons for believing that the stock market would find a bottom in November 2008.

That belief was based on the notion that the U.S. economy would begin to improve by mid-summer 2009. So far the prediction of a market bottom last November has held true. However, when I made that prediction, I had no idea that the credit markets were in the dire straits they proved to be in during last year's final three months. In addition, I underestimated the size of both monetary and fiscal stimulus that would be needed to thaw the freeze in the financial markets and reverse the trend in economic growth.

I am going to hold to my earlier predictions of a late 2008 stock market bottom and a 2009 second half economic

Internet pornography site revenues) that lasted all of one month.

Former Federal Reserve Chairman Alan Greenspan, a champion of deregulation in the financial service markets, when asked by Congress why he was so certain that a lack of government regulations would be beneficial to the American economy, he replied "oops."

Eliot Spitzer, a steadfast champion of ma and pa investors and the surge of Wall Street's institutional investment community, admitted to buying sexual favors from ladies of the night, abruptly resigned as New York's attorney general. (We're willing to bet that champagne sales soared in the neighborhood of Wall and Broad.)

Michael Phelps won a record eight Olympic gold medals in the only eight events he entered in Beijing. (Could another comic book superhero, Gillman, be in the offing for 2009?)

In December, the U.S. Treasury (proving it knows a good deal when it sees one) sells billion of dollars of four-week notes and agrees to pay zero percent interest on them.

The Tampa Bay Rays (after dropping the "Devil" in their name) soared from worst to first in the American league before losing the World Series to the Philadelphia Phillies.

Not so wacky was the 53 percent, 13-month plunge in the Standard Poor's 500 Index. When the market closed December 31, 2008, it marked the worst year for stocks since 1931.

recovery. However, the probabilities associated with these calls, in my eyes, has been markedly reduced.

Why am I having a change of heart? First, the Bush administration's handling of a rescue package (the so-called Troubled Asset Relief Program), was sloppy at best and totally mismanaged at worst. The Treasury changed direction in mid-stream. It backed away from toxic asset purchases and pursued injections of capital into the financial system. I am not sure which course of action would have been the best. But it appears that the Treasury was also not sure of the correct course of action, and that is quite disturbing. In short, it now appears that it is going to take some experimenting by both the Treasury and the

LOOKING AHEAD continued on page 5



LOOKING AHEAD continued from page 4

Federal Reserve before a "correct" course of action is identified. That prospect will most likely lead to a longer economic recession than I anticipated back in September 2008.

Despite all of the negative news recently, (a plunge in fourth quarter GDP, tumbling corporate profits, expanding unemployment, large corporate bankruptcies, and continued credit issues) the financial markets are a bit improved over what they were in October and November. Believe it or not, banks are lending again. It's not a flood; it's more of a trickle. In addition, the yields on short term Treasury securities are beginning to rise. This indicates a modest up-tick in the willingness of investors to assume a bit of risk. The last time I looked, the rate of three-month T-bills had risen from 0.03% to 0.22%. In other words, investors who were willing to earn a zero percent return on short-term Treasury securities because of the protection they provided have begun to divert some of their investments to marginally more risky assets. For example, after months of outflows, equity mutual funds actually posted net purchases of \$25 billion in December. This is a far cry from the monthly injections in 2007 and early 2008, but it indicates that investors are willing to dip their toes into risky asset waters.

When will the stock market head for higher ground? Based on History, the answer is somewhere between three and six months before the economy begins an upward journey. I know that this answer is far short of definitive, but it's the best I can muster at this time. Where is the buying going to come from that will cause stock prices to rise? My best guess is from private equity funds and other corporate investors who recognize the extremely low valuations that currently exist in the equities market. This is especially true in the micro cap sector of the market, where selling in late 2008 caused stock prices to plunge

well below tangible book values. (See Michael Corbett's comments in this newsletter for some details.)

Even though I believe that the stock market is in the bottoming process and that the lows may have already been seen, I am not calling for the onset of a bull market. The damage to the economy and to investor's confidence has

been so severe that it is going to take time for both to heal. The accompanying table lists the lengthiest economic recessions on record. This one is 14 months long and we are still counting. Economists don't expect an economic upturn until at least July 2009. If these expectations are correct, the current economic recession will last a total of 19 months at a mini-

mum. That would make the current economic slump the seventh longest on record.

Barring some jolting and completely unexpected event, we look for the stock market to gyrate in a range of 7500 to 9200 on the Dow Jones Industrial Average during the next three to six months. Should signs of economic healing begin to appear in the second half of the year, I believe the market will be set to make a run to much higher ground.

## Longest Economic Recessions on Record

Peak	Trough	Months
April 1865	December 1867	32
June 1869	December 1870	18
October 1873	March 1879	65
March 1882	May 1885	38
December 1895	June 1897	18
June 1899	December 1900	18
September 1902	August 1904	23
January 1913	December 1914	23
January 1920	July 1921	18
August 1929	March 1933	43
December 2007	Present	14 & counting

Source: National Board of Economic Research

## Farewell

During 2008, we said goodbye to some new and some long-time friends. I, for one, will surely miss them all.

- William Buckley, Jr. (age 82)
- Heath Ledger (age 28)
- Paul Newman (age 83)
- Suzanne Pleshette (age 70)
- Tim Russert (age 58)
- Margaret Truman (age 83)
- Gene Upshaw (age 58)



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Top Ten Holdings as of 12/31/08: PRCGX - Baker Michael Corp. (2.48%), Comfort Systems USA (2.00%), Vaalco Energy (1.93%), Star Gas Partners (1.80%), Actel Corp. (1.78%), Flanders Corp. (1.77%), Kimball Intl. (1.66%), Universal Electronics (1.64%), Barrett Business Services (1.60%), Aceto Corp. (1.56%); PREOX - North American Galvanizing & Coatings (2.12%), NovaMed (2.10%), Espey Mfg. & Electronics (1.98%), Rentak Corp. (1.76%), Universal Power Group (1.64%), Versant Corp. (1.63%), Birner Dental Mgmt. Services (1.55%), KSW (1.53%), Perma-Fix Environmental Services (1.52%), Astro-Med (1.51%). Fund holdings and sector allocations are subject to change at any time and are not recommendations to buy or sell any security.

Price to Sales ratio is a tool for calculating a stock's valuation relative to other companies, calculated by dividing a stock's current price by its revenue per share. Price to Earnings ratio is calculated by dividing current price of the stock by the company's trailing 12 months' earnings per share. Price to Book Value Ratio is calculated by dividing the current price of the stock by the company's book value per share. Price to Cash Flow is calculated by dividing the current price of the stock by the company's cash flow per share. Book Value is the net asset value of a company, calculated by subtracting total liabilities from total assets. Cash Flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income. The S&P 500 Index is a broad based unmanaged index of 500 stocks, which is widely recognized as representative of the equity market in general. The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividend. The NASDAQ Composite Index is a market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded only over-the-counter and not on an exchange. Nasdaq 100 Index an index composed of the 100 largest, most actively traded US companies listed on the Nasdaq stock exchange The Russell 2000 Index consists of the smallest 2,000 companies in a group of 3,000 U.S. companies in the Russell 3000 Index, as ranked by market capitalization. The Wilshire 5000 Stock index consists of more than 5000 companies, representing virtually all of the capitalization of the entire U.S. stock market. FTSE 100 is an index of the share prices of the 100 largest companies in the UK. The CAC-40 Index is a narrow-based, modified capitalization-weighted index of 40 companies listed on the Paris Bourse. You cannot invest directly in an index.

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