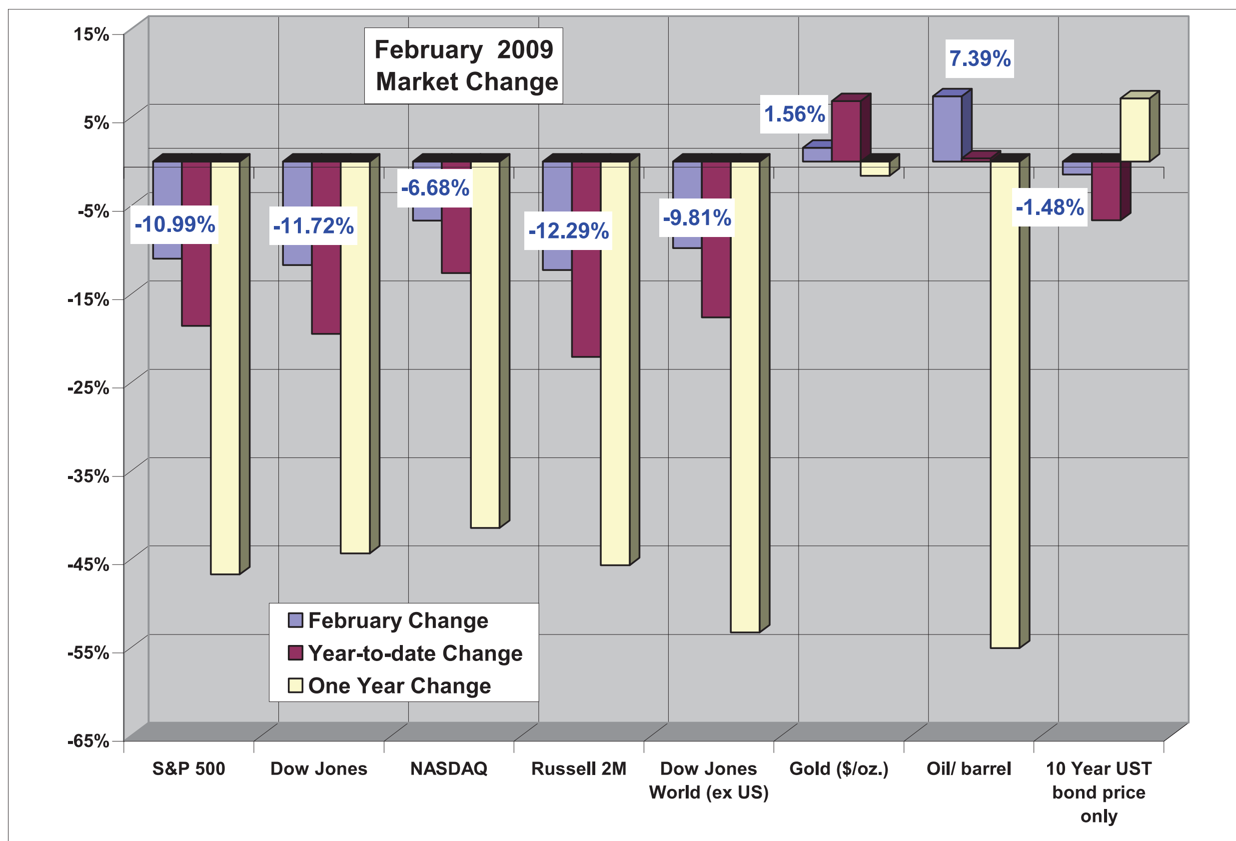
Investment Outlook

March 2009

Paths to prosperity

February Markets
Buy the rumor...

sell the news... certainly describes February's equity markets as investors eagerly bought stocks in anticipation of each proposed policy of the new Obama Administration only to sell them in disappointment when the details (or lack of them) became known. The oft delayed and revised Treasury plan to again rescue banks, the stimulus plan to boost our economy and the proposed deficit-funded budget all failed to engender market confidence.



Stocks retreated during February to levels last seen in 1997, about the time that then Federal Reserve Chairman Alan Greenspan warned against *"irrational*

exuberance" in various markets. The equity retreat continued to the end of the month driving prices down to levels equal to one half of their value at the record highs in 2007.

To be sure, economic and corporate earnings data provided no lift either as last quarter's annual GDP rate was revised downward to -6.2%, continuing unemployment claims reached a record level and corporate earnings within the S&P 500 turned negative. Although all of the major equity measures were negative for the month not all were equal. The continued crisis of uncertainty that swirls around the large banks took its toll on the S&P 500 and the Dow 30, which both declined -11%, while the 'financial light-technology heavy" NASDAQ surrendered only -6.7%. The disparity for the two months of 2009 (year to date period) is also to the benefit of the growth oriented NASDAQ.

Investors didn't shun all risk in February as indicated by the second monthly decline in Treasury notes. While Treasurys are still holding their gains from a year ago, prices remain under pressure from investor demand for higher yields, at least for longer-dated bonds. As noted last month, investor confidence has returned to the corporate bond markets where new issuance has continued to expand and prices have rallied. When this confidence may return to equity markets remains to be seen.

Commentary

The end of the beginning...

In his recent address to the nation President Obama suggested our economic challenges were approaching the *"...beginning of the end"*. With all due respect to our President the words of another great orator, Sir Winston Churchill, may be more apt when he described his country's situation as being at the *"...end of the beginning"*.

It seems that little economic recovery can be made until banking confidence is restored. As we approach the first anniversary of our government's initial market intervention, in the form of the Bear-Stearns "sale" to J.P. Morgan/Chase, we are still struggling to return confidence to major sectors of the global banking system.

Indeed, actions by global regulators to increase deposit insurance coverage last year served to avert a "run on the bank" type of crisis. Concurrently, actions by central bankers have also restored liquidity to the system as evidenced by increased inter-bank lending and commercial paper issuance. However the basic question that continues to reign in many executive suites and government offices is ...*can the assets on left side of the balance sheet pay off the liabilities on the right side?*

Last Friday's action by our Treasury to convert its preferred stock holding in Citigroup to common stock would indicate that the answer remains unclear at best. At the time of this writing news is also emerging of a plan to rewrite the AIG deal again, this time with the Treasury directly owning some of insurance company units.

How markets respond when this rumor becomes news on Monday is less relevant than the recognition that converting assets to cash at an acceptable price remains difficult. We'll avoid a discussion of "mark to market" accounting here, other than to note that it remains a secondary cause of much of the current problem with the global banks (the first being loss of underwriting and investment discipline).

Rebuilding financial markets remains "job-one" for any budding recovery. This includes evolving a replacement for the "shadow banking" system that was the final investor in so many of the securitized assets that were generated by the now defunct investment banks. While members of the Senate Banking Committee might like it to be otherwise, the fact remains that even if all of the TARP-recipient banks were lending at full capacity they could still not meet the capital that flowed from various pension plans, endowments, hedge funds, foreign banks, etc.

We do note that the Federal Reserve intends to launch some initiatives to bolster banking capacity by taking bank-generated assets on to its own balance sheet. These programs have yet to start leaving their effectiveness unknown but promising. In the meantime the evolution of new private asset sources will require both time and improved confidence.

In addition to stability in the financial sector improvements in labor conditions, consumer sentiment and housing markets will be needed for an economic recovery to take hold. As noted earlier, many of the metrics related to these components continue to be negative, although we have recently seen some pockets of encouragement. The problem is that they remain too infrequent for us to change our view that our present position remains closer to the beginning than it is to the end.

Outlook and Strategy
Is flat the new up…?

For all of the reasons noted earlier, and many more not enumerated, equity markets have been brutal for the first two months of this year, with the first day of March adding an exclamation point. Investors, including ourselves, rightly ponder how far markets will decline and when one might expect a recovery.

This week's trading has answered the question of whether the low levels reached last November marked the bottom of this bear market when those levels were breached to close even lower. It seems that most of the short term trading is

emotionally charged and tied to the "rumor/news" scenario noted earlier. At best it produces price volatility which may provide opportunities to establish new positions or exit old ones. Longer term decisions need to move past the "emotion de jour" and demand a more clinical approach.

Stock values are derived from three numbers; earnings per share, the rate of change in the earnings and the multiple (P-E ratio) that investors are willing to pay for the future "stream of earnings". Currently investors need to see an environment where the change in earnings is positive as no one will pay up for a declining investment return. Consequently, just as we look for slowing in the pace of decline among economic fundamentals, we anxiously look for hints of a slowing in the decay rate of corporate earnings. Said differently, we need to pull out of the dive before we can start to anticipate the heights of the next climb.

The good thing about markets is their ability to discount the future. Understanding that the long term trend of the U.S. economy is to expand at least 66% of the time we should reasonably expect a positive future experience. When this will become visible in markets seems more closely tied to improving corporate business conditions which need to stop getting worse before they can get better. We would also expect these changes to be uneven at best among various industries and regions.

Given our focus on establishing appropriate investment objectives and constructing portfolios to fulfill them, our present strategy remains to hold onto our cash pending improved investment conditions. While the declining price of stocks magnifies the future potential return we would like to validate the numbers described above before increasing our equity holdings.

Investors with questions or comments are always welcome to call.

Dow Jones Industrial Average: *6,726.02* *Mark Fingerlin*
Yield on 10 Year U.S. Treasury Note: *2.938%* *March 3, 2009*

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